Guam Society of CPAs
August 20, 2024
Law of Bankruptcy (including tax ramifications)

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I. History and Development of Tax Treatment in Bankruptcy

¶ TX1.01. Introduction.

Advising financially troubled taxpayers that are either insolvent or are considering filing a title 11 case, or are debtors in a pending case, links the complicated, and normally distinct, legal practices of taxation and bankruptcy. Further, the subject of federal taxation in relation to a title 11 case reflects a delicate commingling and balancing of conflicting public policy objectives.

Collecting taxes is the keystone for the operation of governmental entities. The system of taxation and the imposition and collection of taxes were designed by Congress and the U.S. Treasury to maximize the dollar return to the government, by such means as: priority in payment of taxes over the debts of other creditors; easily created lien rights in favor of the collector to secure past due taxes; simplified attachment of wages and receivables; simplified securing of delinquent taxes through the IRS administrative process; interest assessed and collectible on past due taxes; penalties assessable and collectible for unpaid taxes; and imposition of third party liability for failure to collect and pay over taxes.

The Internal Revenue Code seeks the full, complete and prompt payment of taxes.[1] All taxes due to the government must be collected, and it is the IRS's duty and responsibility to do so promptly and efficiently.[2]

Title 11 was designed by Congress in 1978 to provide debtors with a "fresh start" by granting them a discharge from certain obligations, to distribute assets and pay claims in a predetermined scheme with a statutory system of priorities, and to provide debtors with an opportunity to reorganize, rehabilitate, or liquidate.[3]

¶ TX1.01.

[1] *See* Bull v. United States, 295 U.S. 247, 259, 55 S. Ct. 695, 79 L. Ed. 2d 1421 (1935) ("taxes are the lifeblood of government and their prompt and certain availability an imperious need.").

[2] *See* Bob Jones University v. Simon, 416 U.S. 725, 94 S. Ct. 2038, 40 L. Ed. 2d 496 (1975), *modified on other grounds by* South Carolina v. Regan, 465 U.S. 367, 104 S. Ct. 1107, 79 L. Ed. 2d 372 (1984); *In re* A & B Heating and Air Conditioning, Inc., 823 F.2d 462, 17 C.B.C.2d 1409 (11th Cir. 1987); *see generally* Bancroft, *Postpetition Interest on Tax Liens in Bankruptcy Proceedings*, 62 Am. Bankr. L.J. 327 (1988).

[3] For a philosophical discussion of the elements of the Bankruptcy Act and its goals, *see* The Report of the Commission on the Bankruptcy Laws of the United States, Chapter 3, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed. Revised); *see also* Trost and King, *Congress and Bankruptcy Reform*

It may be argued that if all tax liabilities were excused and discharged, and all debtors reorganized and rehabilitated, the new debt free entities created could theoretically generate greater business revenue and larger tax collections. However, in practice, the legislative policies of the Bankruptcy Code and the Internal Revenue Code tend to conflict with each other. How is the conflict between the policy of promptly and efficiently collecting all taxes due balanced against the orderly administration of the objectives of the Bankruptcy Code, the concept of "fresh start" and rehabilitation? Is the conflict irreconcilable? Congress addressed this issue when the Bankruptcy Code was initially enacted in 1978 and acknowledged that a tension exists among the interests of creditors, debtors, and the government; interests which are susceptible to a balance in treatment in the bankruptcy process.[4]

The Bankruptcy Code seeks equality of distribution, financial rehabilitation and a fresh start. Although there are many points of divergence in the operation of the two legislative schemes, it is possible that the overall objectives of the Bankruptcy Code and the Internal Revenue Code do not

(Text continued on page TX1–5)

Circa 1977, 33 Bus. Lawyer 2 (1978); Hanover National Bank v. Moyses, 186 U.S. 181, 22 S. Ct. 857, 46 L. Ed. 1113 (1902); Kuehner v. Irving Trust Co., 299 U.S. 445, 57 S. Ct. 298, 81 L. Ed. 340 (1937); United States v. Whiting Pools, Inc., 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983).

[4] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S. Code Cong. & Admin. News 5787, 5799-5800 (*reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 4 (Matthew Bender 15th Ed. Revised):

In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.

A three way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law restrained him from collecting. *See also* Local Loan Co. v. Hunt, 292 U.S. 234, 54 S. Ct. 695, 78 L. Ed. 2d 1230 (1934) for the Supreme Court's concepts of the purposes of the Bankruptcy Act of 1898, the predecessor to the Bankruptcy Code.

conflict because "successful reorganization satisfies the goals of bankruptcy and tax."[5]

On the other hand, there will always be tension between the debtor, creditors, and the Internal Revenue Service in every bankruptcy case where the debtor has not paid prepetition taxes and this tax liability is carried forward to the bankruptcy estate.[6]

¶ TX1.02. History of Tax Treatment in Bankruptcy.

An important element of income tax planning for a debtor corporation about to file for bankruptcy relief is adjustment of debt without further federal income tax liability, loss of favorable tax attributes or net operating loss carryovers.[1]

The Bankruptcy Act of 1898 ("Bankruptcy Act") contained some provisions which affected the bankruptcy court's right to determine taxes owed by the trustee of the bankrupt's estate to the Internal Revenue Service.[2] The bankrupt had the ability to ask the bankruptcy court to take

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[5] Rothman, *Responsible Persons and Irresponsible Doctrine: The Allocation of the Bankrupt's Postpetition Payments on Unpaid Prepetition Federal Taxes,* 95 Comm. L.J. 24, 36 (1990). The author makes the point that viable reorganization provides more money to creditors than liquidation and preserves the economic life of the business entity, thus allowing the government to receive partial payments with interest for many years for tax obligations as a part of the reorganization plan; so that over a six-year period the government theoretically receives interest and all revenue owed or, at least, maximizes the funds it collects.

[6] *See* Jenks, "The Tax Collector in Bankruptcy Court: The Government's Uneasy Role as Creditor in Bankruptcy," 71 Taxes 847 (1993).

¶ TX1.02.

[1] Asofsky, *Reorganizing Insolvent Corporations Today,* 47 Inst. on Fed. Tax'n 40-3 (1989). The author discusses debt adjustment objectives from a tax standpoint. He concludes that the tax consequences can play a significant role in determining whether a plan of reorganization is feasible and whether the debtor corporation can survive, successfully reorganize and have its plan confirmed. Asofsky points out that attaining the goals of both the policies of the Internal Revenue Code and the Bankruptcy Code should not be regarded as "tax avoidance" because the bankruptcy tax rules reflect congressional tax policies which were designed to integrate rehabilitative policies and tax collection objectives. He complains that the 1980s ushered in a new tax policy attitude: "In the guise of reform and equity many of them [tax breaks] have been swept aside without regard to the economic consequences." Asofsky, *Reorganizing Insolvent Corporations Today,* 47 Inst. on Fed. Tax'n 40-4 (1989). He concludes that "tax relief once afforded to struggling companies is being slowly withdrawn. Practitioners in the bankruptcy field must learn the new rules to take advantage of the tax benefits that still exist." Asofsky, *Reorganizing Insolvent Corporations Today,* 47 Inst. on Fed. Tax'n 40-4 (1989).

[2] Bankruptcy Act § 2(a)(2)(A), *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 3(a) (Matthew Bender 15th Ed. Revised); City of Amarillo v. Eakens, 399 F.2d 541 (5th Cir. 1968), *cert. denied,* 393 U.S. 1051, 89 S. Ct. 688, 21 L. Ed. 2d 692 (1969).

jurisdiction over tax issues. If the bankruptcy court made a ruling on prepetition income taxes, this ruling may not have been binding on the IRS. Frequently, even though a bankruptcy court had ruled on the amount of nondischargeable tax claims exclusive of those paid out of the administration of the bankrupt's estate, the IRS could relitigate the tax questions and liability in a nonbankruptcy court.

The bankruptcy court and the Tax Court had concurrent jurisdiction to determine tax liability. A decision of the Tax Court was not binding on the bankrupt's estate unless the bankruptcy trustee intervened and participated in the litigation before the Tax Court. On the other hand, the bankruptcy court's decision would not have had binding effect on the individual bankrupt unless the bankrupt had invoked the bankruptcy court's jurisdiction. The bankruptcy court had no jurisdiction over refund suits. If a bankruptcy trustee sought a refund from the IRS, suit was required to be filed in the Tax Court, the United States District Court, or the Court of Claims.[3]

There was no jurisdiction in the bankruptcy court to force the IRS to audit and approve tax returns filed, to determine and calculate net operating losses, or to enter judgments or orders which determined the tax consequences of plans of arrangement or reorganization.[4]

Once a bankruptcy case was filed, there was no automatic stay, and the IRS had the power to assess income tax liabilities against the bankrupt. This concept of immediate assessment was detrimental to the bankrupt taxpayer because it took away the power of the Tax Court to pass on tax issues. After immediate assessment the Tax Court had no jurisdiction over the bankrupt's tax liabilities. The bankrupt's right to invoke the jurisdiction of the bankruptcy court was available after immediate assessment of tax by the IRS, but the ruling of the bankruptcy court had a limited effect on the IRS. The IRS could proceed after the immediate assessment of the tax to collect the tax by levy on the bankrupt's property and could seize and sell assets in which the bankrupt had an interest. The bankrupt had limited effective remedies. One remedy was to pay the tax assessed and

[3] Danning v. United States, 259 F.2d 305 (9th Cir. 1958), *cert. denied*, 359 U.S. 911, 79 S. Ct. 587, 3 L. Ed. 2d 574 (1959); Bankruptcy Act, § 23(b).

[4] *In re* Wingreen Company, 412 F.2d 1045 (5th Cir. 1969); *In re* Inland Gas Corp., 241 F.2d 374 (6th Cir. 1957), *cert. denied sub nom.* Allen v. Williamson, 355 U.S. 838, 78 S. Ct. 35, 2 L. Ed. 2d 50 (1957). Plans of arrangement were proposed and approved by the bankruptcy court in Chapter XI, and affected and modified unsecured debt only if approved by 51 percent of the creditors affected in number and amount.

sue for a refund of the tax paid in the United States District Court. This court could order the IRS to refund the erroneous tax collected with interest. The bankrupt could also elect to sue the IRS in the Court of Claims after the tax had been paid. The bankruptcy court had no jurisdiction to order the IRS to refund the taxes collected even though the IRS had filed a proof of claim with that court.

Because the bankruptcy court had limited jurisdiction in tax matters, very little interest had been generated with respect to the tax aspects of bankruptcy and reorganization prior to the Report of the Commission on the Bankruptcy Laws of the United States (the "Commission").[5] The Commission was created by Congress to study the Bankruptcy Act existing at that time.[6] The Commission Report and its recommended legislation were introduced in the House as H.R. 10792 and in the Senate as S. 2565. At that time, many practitioners recognized that tax reform was sorely needed in the bankruptcy area with regard to tax benefits derived from debt cancellation and net operating loss ("NOL") carryovers.[7] A

[5] The Report of the Commission on Bankruptcy Laws of the United States was issued in two parts, Part I and Part II, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed. Revised). Part I of the Commission Report was a survey in narrative form and contained recommendations, authorities and reasoning. Part II was the proposed Bankruptcy Act of 1973 introduced in the House as H.R. 10792 and in the Senate as S. 2565.

[6] The Commission was established by Pub. L. No. 91-354, 84 Stat. 468, effective July 24, 1970. The Commission Chairmen, Harold Marsh, Esq., Professor Charles Seligson, and J. Wilson Newman, were appointed by the President. Two United States District Judges were appointed by the Chief Justice of the Supreme Court, two Senators were appointed by the President of the Senate, and two Representatives were appointed by the Speaker of the House. The Commission became operational on June 1, 1971, and utilized a full-time staff, research associates and assistants, and a number of consultants.

[7] *See* Blum, *Ramifications of Bankruptcy in Federal Tax Matters,* 29 Inst. on Fed. Tax'n 937 (1971); Glancy, *Carrying Losses Through Chapters X and XI Reorganizations,* 28 Tax L. Rev. 27 (1974); Horwich, *The Taxation of Appreciation Income in the Course of Bankruptcy,* 73 Com. L.J. 448 (1968); Kay, *Federal Taxes, Bankruptcy and Assignments for the Benefit of Creditors—A Comparison,* 73 Com. L.J. 78 (1968); Kingsmill, *Bankruptcy and the Tax Law,* 18 Tul. Tax Inst. 633 (1969); Mansfield, Coogan, Scheffer, and Stuetzer, *Practical Techniques for Handling Tax Problems in Bankruptcy: A Panel Discussion,* 27 Inst. on Fed. Tax'n 1115 (1969); Newton, *Tax Planning Factors to be Considered by Debtors and Creditors in and Out of Court,* 83 Com. L.J. 513 (1978); Paul, *Debt and Basis Reduction Under the Chandler Act,* 15 Tul. L. Rev. 1 (1940); Plumb, *Tax Recommendations of the Commission on the Bankruptcy Laws—Income Tax Liabilities of the Estate and the Debtor,* 72 Mich. L. Rev. 937 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims,* 59 Cornell L. Rev. 991 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers, and the Effects of Debt Reduction,* 29 Tax L. Rev. 229 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws—Tax Procedures,* 88 Harv. L. Rev.

distinguished tax expert had previously recognized that the cancellation of indebtedness in the tax area was a problem of "creeping confusion." He urged comprehensive statutory treatment.[8] It might be noted that both of these areas continue to be of major concern today and were and have been addressed in tax legislation subsequent to the Bankruptcy Tax Act of 1980.[9]

Similarly, the Commission Report recommended and suggested numerous amendments to the Bankruptcy Act and to the Internal Revenue Code.[10] The Commission proposed the reduction of NOL carryovers to the extent that indebtedness that was cancelled or reduced had contributed to those losses. The Commission adhered to the view that the mere filing of a reorganization petition should not bar the carryforward of tax attributes or generate tax consequences apart from the specific tax rules applicable to the transaction itself.[11]

For example, a series of amendments to I.R.C. §§ 371, 381 and 382 were recommended.[12] As the law stood, an I.R.C. § 371 bankruptcy

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1360 (1975); Sheinfeld and Parkins, *Tax Problems of a Business in Reorganization and Arrangement,* 13 Hous. L. Rev. 480 (1976); and Tillinghast and Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act,* 26 Tax L. Rev. 663 (1971).

[8] *See* Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion,* 14 Tax L. Rev. 225, 288 (1959), in which Professor Eustice stated:

[I]t would seem sufficient experience has been accumulated in the cancellation of indebtedness field, both among members of the tax bar and the Legislature, to sustain the intelligent drafting of a uniform and comprehensive statutory treatment of this problem. There is a crying need for some adequate guideposts to taxpayers and the Government in this exceedingly complex field. Reason and necessity can demand no less.

[9] The Tax Reform Act of 1984, Pub. L. No. 98-369 (1984) and the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986). *See also* The Tax Simplification Act of 1991 (proposed and introduced as S. 1394 in the 102d Congress, 1991). *See* discussion at ¶ TX8.04[2] *infra.*

[10] The Commission Report (Part I, Chapter 11, pp. 227-297) sets forth the recommendation of amendments to bankruptcy and tax statutes to eliminate inequities that the Commission felt existed from the interaction of bankruptcy and tax. Part I and Part II, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed., Revised).

[11] This position was articulated in the Commission Report with the recommendation that I.R.C. § 381, which provides that the acquiring corporation in a tax-free reorganization under I.R.C. § 368 succeeds to loss carryovers and specified tax attributes of the acquired corporation, should be applicable to a nonjudicial insolvency reorganization under I.R.C. § 371. In other words, the Commission recommendations provided for carryforward of losses and tax attributes after a reorganization regardless of whether the general requirements of a tax-free reorganization pursuant to provisions of I.R.C. § 368 were met.

[12] I.R.C. § 371 provided for tax-free treatment of reorganization of a corporation in Chapter X of the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding. The provisions of I.R.C.

reorganization was not apparently within the scope of I.R.C. § 381; therefore, the NOL carryover of the reorganized corporation was lost. The Commission recommended that I.R.C. § 381 be made applicable to a bankruptcy reorganization so that the reorganized entity or its successor could succeed to and use the NOL carryforward as provided in I.R.C. § 381(a). All NOL carryforwards would have been made available to a successor corporation following reorganization in bankruptcy or outside of bankruptcy pursuant to the Internal Revenue Code provisions. This objective would have been reached by an amendment to I.R.C. § 382, which would have provided that an increase in the amount of stock owned by creditors in cancellation of their indebtedness would not be treated as a "purchase" of the debtor corporation's stock.[13]

The Commission proposed an adjustment of the basis of property in a reorganization case by the amount of the debt reduction if the reduction would otherwise have been taxable as income from the discharge of indebtedness. The extent of the proposed basis reduction would not have exceeded the amount by which the reorganized debtor was solvent after the cancellation or reduction of debt. The Commission's recommendation with regard to stock given to creditors in exchange for debt, whether partially or fully in satisfaction of creditors' claims, was based on the premise that such a transaction was not an act requiring a reduction of corporate indebtedness, a basis reduction, or a reduction in NOL carryforwards. The Commission reasoned that creditors exchanging debt for stock had a financial interest in the reorganized debtor and, therefore, should

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§ 371 did not apply to Chapter XI of the Bankruptcy Act when transfers of assets occurred from a debtor corporation to a new corporation pursuant to an arrangement. I.R.C. § 381 permitted loss carryovers and other tax attributes of the transferor corporation to be acquired by the transferee corporation if the reorganization qualified under I.R.C. § 368(a) as a tax-free corporate reorganization. This was not applicable to insolvency reorganizations. I.R.C. § 382(b) limited the use of net operating loss carryovers by an acquiring corporation under I.R.C. § 381 where shareholders immediately after the reorganization owned less than 20 percent of the fair market value of the stock of the acquiring corporations.

[13] Specifically, it was proposed that I.R.C. § 382(a)(1) be amended to assure that an increase in stock ownership resulting from a creditor's exchange of stock for debt in a bankruptcy reorganization or a nonjudicial insolvency reorganization under I.R.C. § 371 would not be considered an increase resulting from a "purchase" of stock. It proposed a restriction if the creditor's claim had been obtained for the purpose of acquiring the stock in either a bankruptcy reorganization or insolvency reorganization. In such event, the transaction would be tainted and result in a stock purchase.

not be responsible for making the debtor successful or bear the burden of future financial success.[14]

Prior to the Commission's consideration, the tax consequences of a Bankruptcy Act Chapter X reorganization, Chapter XI arrangement, or Chapter XII real property arrangement were determined by specific mandatory provisions dealing with taxes, contained within the Bankruptcy Act itself. No taxable income resulted from the reduction of indebtedness when debts were discharged by agreement among the creditors if the debtor was insolvent immediately after the agreement took effect.[15] Income was realized only if the discharge of debt rendered the debtor solvent, and only to the extent of the solvency. If the reorganization or arrangement did not involve the transfer of assets, the basis of assets remaining in the debtor's hands was reduced by the amount of debt forgiven by the creditors.[16] Forgiveness of debt usually resulted from a plan of reorganization or plan of arrangement, depending on the applicable chapter within which the proceeding fell.

There was a limitation to the amount of basis reduction, however. Generally, a bankrupt's basis in its assets could not be reduced below the fair market value of the assets at the date of confirmation of the corporate reorganization or arrangement plan.[17] Any excess debt discharged which did not reduce basis because of the limitation was excluded from income.

A significant dispute existed concerning the interrelationship of losses, carrybacks, and carryforwards in reorganizations or arrangements under the Bankruptcy Act. In brief, there was no unanimity on the extent to which an NOL carryover of a reorganized debtor remained available after reorganization had taken place. This depended on whether the reorganization was internal, or was accomplished by a transfer of assets or by a successor corporation acquiring the debtor corporation's stock.[18]

Subsequent to the Commission's Report and recommendations, the Commission introduced a number of bills containing substantive tax

[14] The Commission's recommendations, according to one interpretation, appear consistent with a policy favorable to rehabilitation. One could conclude that the Commission felt that an exchange of stock for debt would be a favorable reorganization device.

[15] Bankruptcy Act §§ 268 (Chapter X), 395 (Chapter XI), and 520 (Chapter XII).

[16] Bankruptcy Act §§ 270 (Chapter X), 396 (Chapter XI), and 522 (Chapter XII).

[17] Bankruptcy Act §§ 270 (Chapter X), 396 (Chapter XI), and 522 (Chapter XII).

[18] *See* Plumb, Report on Loss Carryovers and Debt Reduction in Proceedings Under Chapters X, XI, and XII, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. 1-178 (1973).

provisions.[19] The National Conference of Bankruptcy Judges proposed a revised Bankruptcy Act as a counterproposal to the Commission's bill.[20] This bankruptcy bill did not change the Commission's bill with regard to the special tax provisions and the tax consequences of liquidation and reorganization. From 1974 to 1977, a number of proposed bankruptcy bills were introduced in the House and Senate.[21]

As a result of the Commission's tax recommendations, the modernization of tax treatment in bankruptcy generated continuing interest by governmental entities in an effort to strengthen their position in bankruptcy. The tax provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[22] brought together ideas and concepts from the Department of Justice, the Internal Revenue Service and the National Association of Attorneys General.[23] The tax provisions of BAPCPA were designed to simplify tax collection and give more strength and power to federal, state and local tax collectors in a bankruptcy case.

The historical evolution of the Bankruptcy Code, the Bankruptcy Tax Act of 1980 and BAPCPA is discussed later in this introductory material.[24] The foregoing discussion brings the chronological development of tax treatment and problems to 1978, before the enactment of the Bankruptcy Code.

¶ TX1.03. Legislative History of Tax Treatment in Modern Bankruptcy Practice.

In 1977, the Bankruptcy Reform Act of 1978, with tax provisions, was introduced in the House.[1] Because H.R. 8200 contained tax provisions

[19] The Commission's proposed bill, H.R. 10792, was introduced by Congressmen Edwards and Wiggins in 1973.

[20] H.R. 16643 was introduced by Congressmen Edwards and Wiggins in 1973.

[21] For a thorough and comprehensive legislative history of the making of the Bankruptcy Code, *see* Vol. B Collier on Bankruptcy, App. Pt. 4 (Matthew Bender 15th Ed. Revised).

[22] Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

[23] Report of the ABA Tax Section Task Force on the Tax recommendations of the National Bankruptcy Review Commission, Asofsky and McKenzie, 97 TNT 90-22 (May 9, 1997), hereafter the ABA Tax Section Task Force Report.

[24] *See* ¶ TX1.03 and ¶ TX1.05 *infra*.

¶ TX1.03.

[1] H.R. 8200, 95th Cong., 1st Sess., was reported by the House Committee on the Judiciary on

that were within the jurisdiction of the Committee on Ways and Means, a dispute between the Judiciary and Ways and Means Committees ensued. An accord was reached. The Judiciary Committee removed the federal tax provisions in the Bankruptcy Code and reported the bill. Certain substantive tax provisions remained in H.R. 8200 but those provisions operated only with respect to state and local taxes.[2] As a consequence, when H.R. 8200 was signed into law on November 6, 1978 (effective on and after October 1, 1979), it was, from a tax practitioner's point of view, incomplete.

On November 3, 1977, H.R. 9973, a bankruptcy tax bill, was introduced specifically to cover federal taxes that had been omitted from H.R. 8200. The Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee proposed H.R. 9973 as a special bankruptcy tax bill designed to modify and modernize the tax treatment of insolvency proceedings and title 11 cases. H.R. 9973 was referred to the Committee on Ways and Means, which commenced hearings on February 22, 1978. The bill was designed to deal with certain tax aspects of title 11 and, in particular, the tax treatment of discharge of indebtedness income, the reorganization of debtor corporations, the jurisdiction of various courts over tax deficiency and refund litigation, priority rights of the taxing entity, and questions of tax liability and collection of taxes arising during a title 11 case. Hearings of the Committee on Ways and Means on H.R. 9973 were concluded in 1978 but no action was taken on the bill.

H.R. 5043, the Bankruptcy Tax Act of 1979, was introduced on August 1, 1979. This bill was heralded by the announcement that it had been

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September 8, 1977. The bill was then debated on the floor of the House of Representatives on October 27–28, 1977 and on February 1, 1978. This bill was passed by the House and sent to the Senate along with House Judiciary Report 95-895. The Senate Bill S. 2266, substantially identical to H.R. 8200, was considered by the Senate Judiciary Committee and reported favorably on July 14, 1978. The Senate considered and acted on S. 2266 on September 7, 1978. H.R. 8200 was amended by the Senate by striking out all the text after the enacting clause and substituting the text of S. 2266. This is the manner in which the Senate approved S. 2266 and blended H.R. 8200 into the compromise bill that became Pub. L. No. 95-598, the Bankruptcy Reform Act of 1978.

[2] The special tax provisions of H.R. 8200 (§§ 346, 728, 1146, and 1331), as originally written, were applicable to state, local, and federal taxes. The Ways and Means Committee and Judiciary Committee agreement allowed H.R. 8200 to be immediately considered by the Judiciary Committee. The special tax provisions remained in H.R. 8200, but an amendment was adopted limiting the scope of such special tax provisions to state and local tax rules. *See* 3 Collier on Bankruptcy, ¶ 346.01 (Matthew Bender 15th Ed. Revised); it was hoped that the void would be filled by H.R. 9973.

developed by the congressional staffs based on extensive studies, commentaries, and recommendations for changes in bankruptcy tax rules made over the previous six years. On September 27, 1979, the Ways and Means Subcommittee on Select Revenue Measures held hearings on H.R. 5043. H.R. 5043 was approved by the Subcommittee on November 1, 1979, subject to further commentary on certain aspects.

On December 13, 1980, the House was asked to concur in certain Senate amendments to H.R. 5043, which was called the Bankruptcy Tax Act of 1980.[3] The Senate amendments were read into the Congressional Record.[4] The bill was described as an amendment to the Internal Revenue Code of 1954 to provide for the tax treatment of title 11, insolvency, and similar proceedings. The Bankruptcy Tax Act of 1980 was characterized by the Chairman of the Committee on Ways and Means, Representative Ullman, as an important bill which had been carefully developed over the past two years.[5] Representative Ullman advised his colleagues that unless the Bankruptcy Tax Act of 1980 was enacted, there would be confusion and controversy regarding the statutory rules governing the tax treatment of debt discharged and other tax aspects of title 11 cases.[6] On December 24, 1980, the Bankruptcy Tax Act of 1980, as passed by the Senate and House, was signed by President Carter. The Bankruptcy Tax Act was very controversial insofar as it permitted special tax treatment for bankruptcy transactions. Many opposed relaxation of traditional tax rules in bankruptcy reorganization situations and preferred to keep out-of-court reorganizations and bankruptcy reorganizations on equal footing. These critics

[3] The House passed H.R. 5043 on March 24, 1980 by a vote of 324-0 after it was considered by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. H.R. 5043 was considered by the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance on May 30, 1980. Throughout this chapter, the compromise legislation, Pub. L. No. 96-589, passed by Congress and signed by President Carter, will be referred to as the Bankruptcy Tax Act of 1980.

[4] A full statement of the Senate proposed amendments may be found in 126 Cong. Rec. S. 16489-16492 (daily ed. Dec. 13, 1980). The proposed Senate amendments were read into 126 Cong. Rec. H. 12419-12422 (daily ed. Dec. 13, 1980).

[5] Representative Ullman's full statement is found at 126 Cong. Rec. H. 12461-12464 (daily ed. Dec. 13, 1980).

[6] Representative Ullman characterized the "stock-for-debt" rule proposed by the Senate amendment as a favorable tax treatment that encouraged reorganization rather than liquidation of financially distressed companies. He also expressed the view that the proposed Senate amendments represented a fairly balanced approach between the policy of the tax collector and the Bankruptcy Code concept of a "fresh start." Final Senate and House Debate, 126 Cong. Rec. S16489-16493 and H. 12439-12464 at H. 12461-12462.

argued that the debtors in a title 11 case received an advantage, or "head start" over other taxpayers.[7]

The Bankruptcy Tax Act has been affected by subsequent amendments to the Internal Revenue Code. Of particular importance are revisions made as part of the sweeping tax simplification and reform program passed by the 99th Congress. The Tax Reform Act of 1986,[8] embodying these reforms, was signed into law on October 22, 1986. This was the culmination of much debate.[9] The 1986 Act included amendments in areas that have historically been of concern to bankruptcy practitioners. It addressed and substantially restricted the ability of a debtor corporation to continue to use net operating loss and other carryovers following a change of stock ownership. It also limited the application of the stock for debt exchange rules.[10]

The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986[11] became effective on November 26, 1986. Chapter 12—"Adjustment of Debts of a Family Farmer With Regular Annual Income"—was added to the Bankruptcy Code.[12] No specific tax provisions were added to address the ramifications and federal tax consequences of Chapter 12. Special tax provisions applicable only to state and local taxes[13] are provided which require the trustee to file state and

[7] Hearings on H.R. 9973 before the House Committee on Ways and Means, 95th Cong., 2d Sess. (1978) (statements of Daniel I. Halperin, Tax Legislation Counsel, Office of Assistant Secretary for Tax Policy, Department of Treasury, and M. Carr Ferguson, Assistant Attorney General, Tax Division, Department of Justice); Hearings on H.R. 5043 before Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 95th Cong., 1st Sess. (1979) (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

[8] Pub. L. No. 99-514.

[9] The House bill, H.R. 3838, was passed in December 1985, the Senate bill in May 1986, and the Conference bill in September 1986.

[10] The stock for debt exception has been repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception took place in two stages, becoming fully effective for stock transfers after January 1, 1995. *See* chapter TX8 *infra*. For a full discussion of discharge of indebtedness and I.R.C. § 108 relief, the stock for debt exception, the special title 11 tax-free reorganization provisions and the net operating loss rules, *see* chapters TX8, TX10 and TX11, *infra*, respectively.

[11] Pub. L. No. 99-554 (1986), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

[12] Chapter 12 was later permanently reenacted, effective July 1, 2005, and amended to include family fishermen by the Bankrutpcy Abuse Prevention and Consumer Prevention Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App Pt. 10(a) (Matthew Bender 15th Ed. Revised).

[13] 11 U.S.C. § 1231. *See* 8 Collier on Bankruptcy, ¶ 1231.01 (Matthew Bender 15th Ed. Revised).

local tax returns. The taxable period for those taxes terminates on the date the order for relief is entered.[14] Chapter 12 has been permanent reenacted by BAPCPA.

The Bankruptcy Code grants the bankruptcy court jurisdiction to determine tax questions unless the tax issue has previously been adjudicated by a court of competent jurisdiction before the bankruptcy case began. This jurisdiction is constantly expanding by court decision.[15]

Some doubt existed as to the authority of the bankruptcy court to declare the federal tax consequences of a plan.[16] There existed controversy over the scope of section 1146(d)(2) on the grounds that it limits the bankruptcy court's authority to declare tax consequences only with regard to state and local taxes and not to federal.[17]

The Bankruptcy Reform Act of 1994[18] amended section 106 of the Bankruptcy Code to "effectively overrule" the Supreme Court's decisions in *Hoffman v. Connecticut Department of Income Maintenance*[19] and *United States v. Nordic Village.*[20] Section 106 now expressly provides for a waiver of sovereign immunity by governmental units with respect to monetary relief as well as declaratory and injunctive relief.[21] The purpose of the sovereign immunity waiver of both Federal and State governments is to permit the recovery of money judgments. Additionally,

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[14] 11 U.S.C. § 1231(a) and (b).

[15] 11 U.S.C. § 505(a). *See* chapter TX5 *infra*, for a full analysis of the bankruptcy court's jurisdiction to determine tax questions.

[16] 11 U.S.C. § 1146(d)(2).

[17] *In re* Goldblatt Brothers, Inc., 106 B.R. 522 (Bankr. N.D. Ill. 1989); *see also* U.S. v. Nordic Village, Inc., 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992); Holywell Corp. v. Smith, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) (regarding the availability of declaratory relief as a vehicle for determining the obligation to file tax returns, pay taxes, and the amount and dischargeability of any tax); *see also In re* Thomas Vinson Blanton, Jr., 105 B.R. 321 (Bankr. E.D. Va. 1989) (in which a creditor was allowed to seek declaratory relief from the bankruptcy court with regard to the determination of the debtor's taxes).

[18] Pub. L. No. 103-394, signed into law and effective (as to most amendments) on October 22, 1994, is *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

[19] 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 (1989).

[20] 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1993).

[21] *See* § 106, as amended. *See also* House Report Part II, "Bankruptcy Reform Act of 1994, A Section-by-Section Description," *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

a compulsory counterclaim may be asserted against the governmental unit where that unit has filed a proof of claim in the bankruptcy case.[22]

Recent activity by the IRS and Treasury continues to demonstrate their "concern" with the use of title 11 as a tax advantage vehicle. The IRS is taking an activist position in the areas of tax-free exchanges,[23] tax avoidance by ownership change through the filing of a title 11 case,[24] and restricting stock for debt exchanges qualifying for the exception from

[22] Sullivan v. Towne & Country Nursing Home Services, Inc., 963 F.2d 1146 (9th Cir. 1992); *In re* Gribben, 158 B.R. 920 (S.D.N.Y. 1993); and *In re* The Craftsman, Inc., 163 B.R. 88 (Bankr. W.D. Tex. 1994) are effectively overruled by the amendment to section 106(b).

The 1996 decision of the Supreme Court in Seminole Tribe of Florida v. Florida, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) raised serious questions concerning the constitutionality of section 106. In that case the Court held, in a 5-4 decision, that Congress lacks the power under the Indian Commerce Clause in Article I of the U.S. Constitution to override the Eleventh Amendment and subject unconsenting states to suits in federal court for violations of federally created rights. In so holding, the Court overruled Pennsylvania v. Union Gas Co., 491 U.S. 1, 109 S. Ct. 2273, 105 L. Ed.2d 1 (1989), a plurality decision finding that the Interstate Commerce Clause granted Congress the power to abrogate state sovereign immunity. The Court did recognize, however, that Congress does have the power to abrogate state sovereign immunity under Section 5 of the 14th Amendment. Seminole Tribe of Florida v. Florida, 517 U.S. 44, 59, 116 S. Ct. 1114, 1125, 134 L. Ed. 2d 252, 268, 34 C.B.C.2d 1199, —. Although the ruling in *Seminole* did not directly address Congress' power under the Bankruptcy Clause in Article I, Section 8, Clause 4 of the Constitution, the decision held that state sovereignty under the Eleventh Amendment overrides Congressional power under Article I of the Constitution, signaling that section 106 may be unconstitutional as it relates to suits to recover money judgments against states. Unfortunately, the majority opinion in *Seminole* did not give clear guidance as to the applicability of the decision to the Bankruptcy Code.

In another case sustaining the state's claim to sovereign immunity and the invalidity of section 106, the Massachusetts Department of Revenue prevailed. InIRS v. Gosselin, 252 B.R. 854 (D. Mass. 2000) the district court reversed the bankruptcy court decision discharging the debtor's tax liability in chapter 7. In this case, the IRS did not file a proof of claim or participate in the case and the debtor filed a complaint seeking to discharge the income tax due. The bankruptcy court granted a discharge and the motion to dismiss the complaint was denied. The district court held that the bankruptcy court did not have subject matter jurisdiction to hear the complaint seeking discharge of tax due because of the Eleventh Amendment.

[23] In the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Congress enacted I.R.C. § 108(e)(11), redesignated § 108(e)(10) by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. This new section was designed to ensure recognition of discharge of indebtedness income with respect to the issuance of a debt instrument in satisfaction of indebtedness and to incorporate fully the original issue discount rules.

[24] *See* Treas. Reg. § 1.269-3(d). For a discussion, *see* chapter TX11 *infra.* For an analysis of whether a transactional acquisition in a title 11 case was for the purpose of avoidance of federal income tax, *see* In the Matter of Federated Department Stores, Inc., 1992 LEXIS 392 (Bankr. S.D. Ohio 1992) and cases cited therein.

the realization of discharge of indebtedness income.[25] These areas have and will continue to receive attention.

¶ TX1.04. Tax Issues Considered by the National Bankruptcy Review Commission.

The nine-member National Bankruptcy Review Commission (the "NBRC") was created by Congress pursuant to the Bankruptcy Reform Act of 1994. The purpose of the NBRC, which held its first meeting in October 1995, was to study the bankruptcy laws and make recommendations for reform. To accomplish this task, the broad topic of "bankruptcy" was divided into eight subcategories, including a "government issues" category which included bankruptcy tax matters. Three Commissioners were assigned to each of the eight subgroups, which were termed "Working Groups" by the NBRC. In addition to these eight subgroups, the NBRC created a discussion dialogue with the interested public.[1]

The Government Working Group compiled a list of proposed tax reform measures, some of which were developed into formal proposals. Some of these proposals included review of the burden of proof on tax claims and matters pursuant to 11 U.S.C. section 505; repeal of 18 U.S.C. section 1231(b); requiring mandatory filing of tax returns by trustees; barring tax-related setoffs under 11 U.S.C. section 362(a); requiring notice of federal tax audit to state tax authority; tightening requirements for seeking contempt sanctions against the Internal Revenue Service; and specific notice requirements for taxpayers seeking expedited audits.

In addition to the dialogue within the Government Working Group and at numerous publicly held meetings, the NBRC created an advisory committee of expert private and government tax individuals to assist it on tax-related issues. The Tax Advisory Committee, formed in late February 1997, was charged with proposing and discussing all issues related to federal, state, and local tax collection compliance and reporting

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[25] The stock for debt exception has been repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception took place in two stages. The repeal is effective in chapter 11 cases commenced after 1993 and exchanges effected after 1994. *See* chapter TX8 *infra.*

¶ TX1.04.

[1] In accordance with statute, the National Bankruptcy Review Commission submitted a final report with recommendations to Congress, the President, and the Chief Justice on October 20, 1997. This final report contained detailed statements of findings and conclusions with recommendations for legislative action. Some of these suggestions are discussed *infra.*

related to the bankruptcy process and the administration of the bankruptcy estate. The Tax Advisory Committee identified a number of controversial issues for discussion and consideration. These issues include: strengthening notice requirements with respect to expedited audits under 18 U.S.C. section 505(b); selection of one applicable interest rate for deferred tax claims under 11 U.S.C. section 1129(a)(9); selection of one applicable interest rate for secured priority claims under 11 U.S.C. section 1322(a)(5); conforming 11 U.S.C. section 346 to Internal Revenue Code section 1398(d)(2); excepting from discharge those taxes that were fraudulently unpaid by business entities in compliance with applicable tax laws; amending 11 U.S.C.section 1141(d)(3) to clarify federal tax liability of bankruptcy estates for both alternative minimum tax and capital gains tax; clarification of when an individual voluntary bankruptcy case commences for tax purposes; when tax creditors must file proof of priority claims in chapter 7; whether individual chapter 11 debtors may be treated as employees of the bankruptcy estate; whether the time period specified in 11 U.S.C. section 507 should be tolled in successive bankruptcy filings; consider amending 11 U.S.C. section 507(a)(8) to provide that any pending offer in compromise will toll the 240-day pre-and postpetition assessment period; amendment of 11 U.S.C. section 362(a)(8) so that no automatic stay is in effect to bar commencement or continuation of proceedings before the U.S. Tax Court if the taxpayer files bankruptcy; amendment of 11 U.S.C. section 545(2) to overrule reported cases that penalize the government due to certain *bona fide* purchases provided for and lien provisions of the Internal Revenue Code; and amendment of 11 U.S.C. section 503 and 28 U.S.C. section 960 to eliminate the need for requests by governmental tax entities to debtors to pay taxes which have administrative priority.

Additionally, the Tax Advisory Committee suggested that the Bankruptcy Code be amended to provide more realistic and effective notice to governmental units in connection with income taxes, trust fund taxes, and postpetition ad valorem taxes.

Further issues suggested by the Tax Advisory Committee for consideration by the NBRC include amendments of I.R.C. section 108 to identify when a discharge is entered; defining the term "assessed"; and setting specific standards for tax disclosure in chapter 11. An additional proposal was added to clarify possible inconsistencies in 11 U.S.C. section 346 and I.R.C. section 1398 with regard to carryover of tax attributes.

The Tax Advisory Committee furnished a final report in August 1997. The final report contains three sections. One section lists and discusses 27 consensus items, of which 23 were adopted unanimously by the NBRC. Another section contains a listing and discussion of six consensus items which were forwarded to the NBRC without prior vote of the federal participants on the Committee. The third portion of the report lists and discusses 32 proposals that are classified by the Committee as very important, highly controversial, or controversial. There is no consensus on these items.

The Tax Section of the American Bar Association ("ABA") created a task force to monitor the work of the government working group, the tax advisory committee of the NBRC and the NBRC. In April 1997, the task force submitted an extensive memorandum to the NBRC on its recommendations relating to tax issues that the working groups had been discussing.

The ABA opposed the amendment of section 505 to limit bankruptcy court jurisdiction in connection with issuance of declaratory judgments on tax consequences of plans of reorganization.

The ABA opposed the repeal of *U.S. v. Energy Resources*[2] and sought to confirm the fact that the bankruptcy court has jurisdiction under section 105 and section 1123(b)(5) to order the Internal Revenue Service to apply plan-allocated tax payments to trust fund debts first and then to nontrust fund tax debts where this is necessary to the success of the reorganization plan.

The ABA further recommended that the Bankruptcy Code and the I.R.C. be amended to provide an automatic stay applicable upon filing a chapter 11 petition, and a permanent injunction on plan confirmation against collection of trust fund taxes from the debtor's employees.

The ABA opposed any modification of the chapter 13 discharge to restrict dischargeability of a tax if all criteria for discharge are met.

The ABA opposed any repeal of section 724(b), which would require subordination of valid tax liens to the cost of administration and other unsecured priority claims occurring when a case is converted from chapter 11 to chapter 7.

The ABA recommended amending I.R.C. section 1398(f)(2) to provide that on abandonment of an asset administered by a bankruptcy trustee when

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[2] United State v. Energy Resources, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 550, 22 C.B.C.2d 1093 (1990).

the asset is subject to a debt in excess of the basis, the asset is deemed to have been disposed of immediately before the filing of the bankruptcy, and the liability for tax on disposition is a nondischargeable debt of the estate. This position is supportive of *In re A. J. Lane & Company.*[3]

The ABA attempts to deal with tax liability of a corporation for the year of filing of a bankruptcy petition. Presently, the tax liability of a corporation for the year of filing is divided into a prepetition claim prior to the filing and an administrative claim subsequent. The competing position issues are: whether corporate income tax liability for the tax year that straddles the petition date should be an administrative expense for the entire year; or whether it is appropriate to bifurcate the tax liability for the year of filing, with the portion of liability attributable to the prepetition period having a priority status and the portion attributable to the postpetition period having an administrative priority status.[4]

The ABA is concerned with the definition of "willfulness" as used in section 523(a)(1)(C). It believes that willfulness should be defined in the manner consistent with the criminal case interpretation of willfulness under I.R.C. section 721. There should be a sufficient conduct standard to support a finding of willfulness in connection with section 523.

The ABA believed that section 505 should be amended to broaden the jurisdiction of the bankruptcy court to determine tax liability for all members of a consolidated group in a proceeding to determine the tax liability of the parent, and to determine that payment provisions applicable to the parent should be applied equally to the members of the consolidated group.

The ABA recommended that subordination of tax penalties be restored in chapter 11 cases and that section 507(a)(8) be amended to exclude subsection (G), which affords priority status to a penalty related to a tax.

The ABA endorsed a reversal of the repeal of the stock-for-debt exception, so corporations undergoing reorganization may take advantage of the fresh start election.

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[3] 133 B.R. 264 (Bankr. Mass. 1991).

In August 1997, the NBRC voted to clarify the tax treatment of property of the estate that is abandoned to the debtor. Abandonment would be treated as a disposition by the debtor immediately prior to bankruptcy. To the extent the tax is not satisfied out of the bankruptcy estate, the debtor will be responsible.

[4] In August 1997, the NBRC adopted a proposal for the bifurcated treatment of a corporate tax year that straddles the petition date. This proposal would allow a bifurcation by election.

A number of other organizations became active, some supporting the Commission's Tax Advisory Committee and others supporting the ABA Task Force or advocating positions of their own. Some of these organizations are the National Association of Attorneys General, the Department of Justice, the National Association of County Treasurers & Finance Officers, the American College of Bankruptcy, the Commercial Law League of America and the National Bankruptcy Conference.

The Tax Advisory Committee held a further meeting in May 1997 and presented a reported 24 committee consensus tax matters to the NBRC at that time. The same month the NBRC acted on the consensus tax issues, characterized as recommendations. The NBRC approved 23 of the 24 recommendations which would do the following: strengthen the notice requirements on expedited audits under section 505(b); require one applicable statutory interest rate for those tax claims presently entitled to receive interest; recommend the amendment of section 1141(d)(3) to except from discharge those taxes that were unpaid by a business debtor as a result of fraud; subject income of a bankruptcy estate to alternate minimum tax and capital gain tax treatment; require a taxing authority to file a claim for priority tax before the final order approving a trustee's report is entered in chapter 7 cases; recommend the amendment of 11 U.S.C. sections 362(b)(9) and 507(a)(8) to clarify the definition of the terms "assessed" or "assessment" to mean "that time in which the taxing authority may commence an action to collect the tax"; amend section 545(2) to overrule those cases that penalize the government due to certain benefits for *bona fide* purchasers provided for in the lien provisions of the Internal Revenue Code; and amend section 1125(b) to establish standards for tax disclosures in a chapter 11 disclosure statement.

Additionally, the NBRC agreed that in the event of successive filings of bankruptcy, the time period specified in 11 U.S.C. sections 507(a)(8) and 523(a)(1) should be tolled during the pendency of the previous bankruptcy; section 507(a)(8)(A) should be amended to toll the 240-day assessment period for both pre-and postpetition assessment offers to compromise; and section 503 and 28 U.S.C. section 960 should also be amended to eliminate the need for a governmental unit to make a request to the debtor to pay tax liabilities that have administrative priority.

The NBRC favorably determined that section 362(a)(8) should be amended to overrule the decision in *Halpern v. Commissioner*,[5] which

[5] 90 C. T. C. 895 (1991).

held that section 362(a)(8) stays the commencement or continuation of a proceeding involving the individual debtor's postpetition tax liabilities. The NBRC also recommended that appeals from tax court decisions should be permitted without violating the automatic stay of 11 U.S.C. section 362.

A number of suggestions for amending the Bankruptcy Code to conform the treatment of state and local taxes to federal taxes were also adopted by the NBRC. These included: recommending an amendment of section 346 to conform state and local tax attributes to the federal attributes in I.R.C. section 1398; and repealing 11 U.S.C. sections 728, 1146, and 1231, which amended section 346 and I.R.C. section 1398 to provide that making an election to close a debtor's tax year commences on the date the order for relief is entered in the bankruptcy case.

A number of proposals by the Tax Advisory Committee were controversial and unanimous approval was not forthcoming. The Tax Advisory Committee reported a possible consensus on the following additional items: provide for a method where a trustee may obtain safe harbor and certainty regarding the nature, amount and consequences of a debt discharged;[6] amend I.R.C. section 1398(e)(3) to provide that payment of estate assets to the debtor for services performed is ordinary income such that the estate has a deduction;[7] allow a bankruptcy estate a one-time exclusion of $125,000 for capital gain on the sale of a residence;[8] if personal residence exemptions remain nonuniform, adopt a *pro rata* share standard for the tax treatment of gain on the sale of a debtor's homestead by the estate;[9] amend I.R.C. sections 108 and 382 to provide that a corporation in reorganization be permitted to make a fresh start election with respect to the issuance of stock in satisfaction of debt;[10] and amend I.R.C. section 1001 to provide for parallel tax treatment of recourse and nonrecourse debt.[11]

In June 1997, the NBRC met and approved three additional controversial tax proposals. The first proposal suggests an amendment or repeal of section 724(b) to exempt from subordination properly perfected non-avoidable ad valorem tax liens on real or personal property of the estate.

[6] This proposal was adopted by the NBRC in August 1997.

[7] This proposal was adopted by the NBRC in August 1997.

[8] This proposal was adopted by the NBRC in August 1997.

[9] This proposal was adopted by the NBRC in August 1997.

[10] This proposal was adopted by the NBRC in August 1997, with an ABA proposal to be annexed to the recommendations.

[11] This proposal was adopted by the NBRC in August 1997.

This proposal would require a marshaling of encumbered assets of a bankruptcy estate and a surcharge against secured claims under section 506(c) before any subordination of tax liens could take place. The proposal was supported by a majority of the Tax Advisory Committee of the NBRC and was suggested by the Government Working Group. This recommendation changes existing priorities which permit a trustee to subordinate valid tax liens to the cost of administration and other priority claims. The proposal is highly controversial and essentially exempts any lien on real or personal property created by an ad valorem tax from subordination.

In June 1997, the NBRC approved a second proposal which affects the application of the burden of proof rules in bankruptcy. This proposal enables nonbankruptcy law rules to be applicable to bankruptcy court rulings in sections 502 and 505. The purpose of this proposal is to treat tax claims uniformly by permitting nonbankruptcy law burdens of proof to be applicable to claims in bankruptcy disputes under the Bankruptcy Code. At the present time, taxing authorities in nonbankruptcy matters do not have the burden of proof; that burden falls on the taxpayer. If this provision is ultimately adopted by Congress, the burden of proof for tax claims in a bankruptcy court, in connection with tax disputes, would be on the debtor.

The third proposal recommended by the NBRC suggests that section 362(b) be amended to permit governmental units the right of set-off. An income tax refund that arose prior to the commencement of a bankruptcy case in chapter 7 or chapter 13 could be setoff against a prepetition undisputed income tax liability of an individual debtor. The automatic stay of section 362(a) would be inapplicable and an exception under section 362(b) would be provided to permit setoff of prepetition tax refunds against prepetition tax claims.

In the last NBRC meeting, in August 1997, the Commission adopted a proposal to subordinate prepetition tax penalties in chapter 11, 12, and 13 cases to the payment of unsecured claims without a requirement of a finding of governmental misconduct. Additionally, NBRC supported the authority of bankruptcy courts to grant declaratory judgments on prospective tax issues on chapter 11 plans of reorganization. This is novel because, traditionally, declaratory judgments have not been allowed in controversies regarding federal taxes (28 U.S.C. section 2201). This controversial proposal is advanced thinking and benefits creditors who must understand the tax consequences of a plan of reorganization when they vote in order to make an informed decision.

¶ TX1.05 The Tax Provisions of BAPCPA.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") was signed by the President on April 20, 2005.[1] Many Bankruptcy Code sections were affected by the BAPCPA which generally becomes effective and applicable for cases filed on or after October 17, 2005.

Many of the existing Bankruptcy Code sections have been re-written. For example, section 346, which originally was designed to determine the substantive and procedural uniformity of state and local taxes in bankruptcy tax matters, proved to be a source of confusion. BAPCPA rewrote the entire section to seek conformity of state and local tax practice to Internal Revenue Code provisions.

The following paragraphs will discuss the specific changes in the Bankruptcy Code provision effected by BAPCPA.

[1]—*Ad Valorem* Taxes and Liens.

[a]—Subordination of *Ad Valorem* Taxes.

The general rule in Chapter 7 liquidations is that, when property is sold, the claims of secured creditors must be satisfied before any payment is made to priority or general unsecured creditors. Under BAPCPA, subordination will not apply to liens securing claims for *ad valorem* real and personal property taxes, but these taxes would still be paid after certain wage and employee benefit plan claims. New rules governing payment priorities, expense recoveries, and the trustee's duty to exhaust the estate's unencumbered assets are mandated in cases where the downgrading rule continues to apply.[2] The policy behind subordination is the belief that the taxing authorities should not recover until administrative and other priority claims have been paid. The changes made by the 2005 Act to section 724 reverse that result, and will in some cases have a dramatic and negative impact on the recoveries obtained by holders of administrative and other priority claims (other than those wage and employee benefit plan claims that will retain their superiority to tax liens under the new law). State and local taxing jurisdictions, which have long argued (uniformly in vain) that

¶ TX1.05

[1] Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

[2] 11 U.S.C. § 724.

section 724(b) was an unconstitutional violation of their Tenth Amendment rights, have finally prevailed by statutory amendment.

[2]—Jurisdiction to Determine *Ad Valorem* Taxes.

Section 505(a) of the Bankruptcy Code confers extremely broad authority on the bankruptcy court to determine any unpaid tax liability of the debtor that has not been contested before or adjudicated by a judicial or administrative tribunal before the debtor filed for bankruptcy.[3] In particular, there is nothing in section 505(a) that expressly prohibits debtors from contesting in bankruptcy court tax liabilities (especially real property or *ad valorem* tax claims) that arose many years ago and with respect to which the debtor never filed timely objection.[4] The state and local taxing jurisdictions have occasionally argued that there is an unwritten, equitable time limitation on debtor actions to contest stale property tax claims under section 505(a), but the bankruptcy courts have generally been unreceptive to these arguments.[5] The effect of the BAPCPA is to reverse this result, but only with respect to *ad valorem* taxes. Under the 2005 Act, if the liability became fixed and the debtor's time to contest it outside of bankruptcy court had expired by the time of the filing, the debtor may not contest the liability in bankruptcy.[6]

[3]—Creation of Property Tax Liens.

Under present law, the automatic stay does not prevent the creation of property tax liens for taxes becoming due after the filing of the petition.[7] BAPCPA will extend this principle to a "special tax or special assessment."[8]

[4]—Avoidance of Statutory Liens Prohibited.

Under present law, the trustee is given lien avoidance rights of a hypothetical bona fide purchaser, whether or not such a purchaser exists.[9]

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[3] 11 U.S.C. § 505(a).

[4] *See generally* 15 Collier on Bankruptcy ¶ TX5.04[2][a] (15th Ed. Revised).

[5] *See, e.g.*, Custom Distrib. Servs., Inc. v. City of Perth Amboy (*In re* Custom Distrib. Servs., Inc.), 216 B.R. 136 (Bankr. D.N.J. 1997).

[6] 11 U.S.C. § 505(a)(2)(C).

[7] *See generally 3 Collier on Bankruptcy* ¶ 362.05[17] (15th Ed. Revised).

[8] 11 U.S.C. § 362(b)(18).

[9] 11U.S.C. § 545(2).

BAPCPA will make this provision inapplicable to federal tax liens arising under Section 6321 of the Internal Revenue Code ("I.R.C.").[10] This provision arguably does no more than codify existing law.[11]

[5]—Priority and Subordination of Taxes.

[a]—Priority Status of Straddle-Year Tax Claims.

Several U.S. Court of Appeals panels have held that the income tax liability of a corporate debtor for the year of bankruptcy filing (the "Straddle Year") must be bifurcated into a pre-petition component and an administrative expense component, notwithstanding that the filing of a petition does not terminate the corporate debtor's taxable year. BAPCPA amends section 507(a)(8) governing the priority of taxes to provide that income and gross receipts taxes for Straddle Years are post-petition administrative expense claims that must be paid in full in the ordinary course, rather than pre-petition priority claims that are not payable until emergence (and may at that point be subject to the deferred payment rules of section 1129(a)(9)(C)).

[b]—Priority Status of Stale Tax Claims.

Under present law, a claim for income taxes of a debtor receives priority status if the return in respect of such tax is due, including extensions, after three years before the date of the filing of the petition.[12] Under BAPCPA, the three-year period is tolled during the stay period of the prior case plus 90 days. In addition, under present law, a claim for income taxes of a debtor receives priority status if it was assessed within 240 days before

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[10] 11 U.S.C. § 545(2).

[11] I.R.C. § 6321 provides that, "[i]f any person liable to pay any tax neglects or refuses to pay the same after demand, the amount [of that tax plus various enumerated costs associated with it] . . . shall be a lien in favor of the United States upon all property and rights to property. . . belonging to such person." I.R.C. § 6323 limits the reach of this lien by making it invalid against any "purchaser". I.R.C. § 6323(h)(6) then defines "purchaser" to mean "a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice." The lien avoidance power given to the trustee by section 545(2) is that of "a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists." The courts have generally held that the lien avoidance right given to the trustee does *not* allow a trustee to avoid a tax lien by invoking I.R.C. § 6323. *See, e.g.*, United States v. Hunter (*In re* Walter), 45 F. 3d 1023 (6th Cir. 1995) (since "bona fide purchaser" standard lower than "adequate and full consideration in money or money's worth" standard, trustee cannot avoid liens under I.R.C. § 6323).

[12] 11 U.S.C. § 507(a)(8)(A)(i).

the filling of the petition.[13] That 240-day period is also tolled during the period an offer in compromise was pending plus 30 days, if made within 240 days after the assessment.[14] Under BAPCPA, the tolling will apply to the period when an offer in compromise is actually in effect plus 30 days, and during the time a prior bankruptcy case is in effect plus 90 days. Finally, under present law, the 240-day assessment safe harbor is not tolled during other periods during which a taxing authority is precluded from taking action. Under BAPCPA, tolling will apply during any period when a taxing authority is prohibited from collecting a tax as a result of a request by a debtor for a hearing and an appeal of any collection action taken or proposed against the debtor.

[c]—Priority Status of Property Taxes.

Under present law, priority status applies to property taxes "assessed" before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition.[15] Confusion arises because the term "assess" has a different meaning under state and local *ad valorem* real property tax laws than under other tax laws. BAPCPA substitutes the word "incurred" for the word "assessed" in the case of such taxes.[16]

[d]—Tardily Filed Priority Tax Claims.

Under present law, priority claims are entitled to distribution in chapter 7 even if tardily filed, provided they are filed before the trustee commences distribution.[17] Under BAPCPA, if the trustee mails to creditors a summary of his final report prior to commencing distribution, a late-filed priority claim must be filed within ten days after the mailing of the summary.[18]

[6]—Determination and Payment of Taxes.

[a]—Request for Determination of Taxes.

Under section 505(b) of the Bankruptcy Code, a trustee or debtor in possession may seek a prompt determination of the debtor's liability for

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[13] 11 U.S.C. § 507(a)(8)(A)(ii).

[14] *Id.*

[15] 11 U.S.C. § 507(a)(8)(B).

[16] 11 U.S.C. § 507(a)(8)(B).

[17] *See* 6 Collier on Bankruptcy ¶ 726.02[1] (15th Ed. Revised).

[18] 11 U.S.C. § 726(a)(1)(A).

administrative expense taxes. In order to invoke the procedure, the debtor submits a tax return and a request for determination of tax to the governmental unit charged with responsibility for collecting the tax in question. If the governmental unit does not notify the debtor within 60 days that the return has been selected for examination, or complete such an examination within 180 days of the request, the debtor is generally discharged from liability for that tax.[19] It has not always been clear to debtors seeking to invoke section 505(b) what procedures should be followed in notifying the taxing authority. Under BAPCPA, taxing authorities may register with the clerk of the bankruptcy court an address for service of requests and describe where further information concerning additional requirements may be found. If a taxing authority fails to do so, the trustee may serve the request at the address for filing a tax return or protest with the applicable taxing authority.[20]

[b]—Rate of Interest on Tax Claims.

Present law is silent on the applicable rate of interest on tax claims when such interest is allowed. Under section 1129(a)(9)(C), if a chapter 11 debtor avails itself of the privilege of deferring payment of tax claims, the payments must have a present value equal to the allowed amount of the claim. BAPCPA has established a new section 511 which provides that the interest rate paid on pre-petition and administrative period tax claims (as well as the interest rate applied to deferred payments made under section 1129(a)(9)(C)) shall be the applicable rate under non-bankruptcy law. In the case of a confirmed plan, the interest rate in effect as of confirmation may be used, rather than the variable rate called for by some state tax laws.[21] This provision will generally increase the rate of interest that debtors pay on oversecured pre-petition tax claims or deferred tax payments made after emergence. Note also that the enactment of new section 511 would appear to circumscribe the impact of the U.S. Supreme Court's decision in *Till v. SCS Credit Corp.*,[22] where at least the Court plurality suggested in *dictum* that the so-called prime-plus method (pursuant to which the national prime rate is treated as the starting spot and is augmented as necessary to account for the nonpayment risk posed by the

[19] 11 U.S.C. § 505(b). *See generally* 15 Collier on Bankruptcy ¶ TX5.04[3][b] (15th Ed. Revised).

[20] 11 U.S.C. § 505(b).

[21] 11 U.S.C. § 511.

[22] 541 U.S. 465, 124 S. Ct. 1951 (2004).

debtor's particular financial position) should be applied to deferred payments under section 1129(a)(9)(C).

[c]—No Discharge of Fraudulent Taxes in Chapter 13.

Under present law, individuals who file under chapter 7 face a different set of rules with respect to the discharge of taxes than individuals who file under chapter 13. First, in order for income taxes to be discharged in a chapter 7 case, the individual must have filed returns with respect to the taxes whose discharge is being sought and must have done so in timely fashion to the extent that the taxes in question arose in the last two years prior to bankruptcy.[23] By contrast, in a chapter 13 case taxes can be discharged without any return being filed after all.[24] Second, a taxpayer who files a fraudulent return or willfully attempts to evade or defeat a tax cannot discharge that tax in a chapter 7 case,[25] but the same is not the case in chapter 13.[26] Under BAPCPA, the chapter 13 rules will be largely conformed to those in chapter 7, with the consequence that this "superdischarge" result will no longer be applicable to taxes owed by chapter 13 debtors who fail to file, file late, or file fraudulently.[27]

[d]—No Discharge of Fraudulent Taxes in Chapter 11.

Under present law, confirmation of a plan of reorganization discharges a corporate debtor from all debts, except when the plan is a liquidating plan.[28] Under BAPCPA, a corporation will not be discharged from a tax or a customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax or duty.[29]

[e]—Stay of Tax Court Proceedings.

Under present law, the filing of a petition operates as a stay against the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.[30] Literally read, this stay would

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[23] *See* 11 U.S.C. § 523(a)(1)(B).

[24] *See* 11 U.S.C. §§ 1322(a)(2) and 1328(a).

[25] *See* 11 U.S.C. § 523(a)(1)(C).

[26] *See* 11 U.S.C. § 1322(a)(2).

[27] 11 U.S.C. § 1328(a).

[28] *See* 15 Collier on Bankruptcy, ¶ TX1.08[10] (15th Ed. Revised).

[29] 11 U.S.C. § 1141(d)(b).

[30] 11 U.S.C. § 362(a)(8).

apply even to a post-petition year over which the bankruptcy court has no jurisdiction.[31] Under BAPCPA, the stay will apply to a corporate debtor's tax liability for any period that is subject to the bankruptcy court's jurisdiction and to an individual debtor's pre-petition tax liability.[32]

[f]—Deferred Payment of Priority Taxes.

Under present law, a chapter 11 debtor's pre-petition liability for unsecured priority taxes may be spread over a period ending not later than six years from the date of assessment of the tax, provided that the taxing authority receives payments having a value not less than the allowed amount of the claim.[33] Under BAPCPA, the deferred amounts must consist of "regular" installment payments in cash, must not extend beyond five years from the date of the order for relief (i.e., normally the petition date), and the taxing authority must be treated not less favorably than the most favored non-priority unsecured claimant other than a convenience class. These provisions will also apply with respect to secured tax claims.[34] The change to the period over which deferred tax payments can be made will drastically shorten the actual deferral period in many major corporate bankruptcies. Under prior law (where the six-year time period began to run on the date of assessment), it was very common for reorganized debtors to have a full six years *from the date of emergence* to pay pre-petition taxes, because the date of assessment would typically have been delayed throughout the case. Once the provisions of section 1129(a)(9) become effective, however, the new five-year period will begin on the petition date. This will mean that, in major cases in which the debtor is in bankruptcy for several years, the deferral benefit conferred by section 1129(a)(9) will dwindle or even disappear entirely.

[g]—Payment of Taxes in the Conduct of Business.

Under present law, it is not clear that all post-petition taxes must be paid when due. BAPCPA makes a number of changes in existing law in an effort to make it clear that current payment is required. First, language in section 960 of Title 28 provides that any taxes that must be paid pursuant to section 960 are due "on or before the due date of the tax under applicable nonbankruptcy law," unless (a) the tax is a property tax secured by a lien

[31] *See generally* 15 Collier on Bankruptcy, ¶ TX1.04 (15th Ed. Revised).

[32] 11 U.S.C. § 362(a)(8).

[33] 11 U.S.C. § 1129(a)(9)(C).

[34] 11 U.S.C. § 1129(a)(9).

against property that is abandoned promptly after the lien attaches, (b) payment of the tax is excused by an express provision of title 11, or (c) in a chapter 7 case the tax was either not incurred by the trustee or the bankruptcy court issues an order prior to the due date of the tax finding that the estate is probably administratively insolvent. BAPCPA amends section 503(b)(1)(B)(i) of the Bankruptcy Code to clarify that post-petition *ad valorem* taxes qualify as administrative expenses. BAPCPA also makes it unnecessary for taxing authorities to file a request for payment before a post-petition tax qualifies as an allowed administrative expense. BAPCPA also clarifies that state taxes, including *ad valorem* property taxes, can qualify for treatment as secured claims under section 506, even though they do not arise from any agreement.[35]

[h]—Discharge of the Estate's Liability for Unpaid Taxes.

Under present law, following a request for a prompt assessment of taxes made by the trustee and upon payment of the tax shown on the return, if a taxing authority does not timely respond or audit the return, the trustee, the debtor, and any successor to the debtor are discharged from any tax liability in excess of the tax paid.[36] Some cases have held that this discharge does not apply to the "estate" so that a taxing authority may participate in the distribution in respect of late-claimed taxes. Under BAPCPA, the estate will also receive the benefit of the discharge when the taxing authority does not comply with Section 505(b) procedures.[37]

[7]—Filing of Tax Returns.

[a]—Income Tax Returns Prepared by Tax Authorities.

Under present law, an individual may not receive a discharge in chapter 7 in respect of a tax for which a return, if required, has not been filed.[38] Under BAPCPA, a return will include a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal and a return based upon information supplied by the taxpayer and signed by him, but prepared by a taxing authority pursuant to section 6020(a) of the Internal Revenue Code or similar state or local law. It will not include a substitute return

[35] 28 U.S.C. § 960; 11 U.S.C. § 503(b).

[36] 11 U.S.C. § 505(b).

[37] 11 U.S.C. § 505(b).

[38] *See* 15 Collier on Bankruptcy, ¶ TX4.02[2] (15th Ed. Revised).

under section 6020(b) of the Code, which is not a full return, but merely a predicate for assessment.[39]

[b]—Requirement to File Tax Returns to Confirm Chapter 13 Plans.

Under present law, a debtor is entitled to the benefits of chapter 13 notwithstanding that he has unfilled returns outstanding. Under BAPCPA, the debtor will be required to have filed tax returns for the four taxable years immediately preceding the filing of the petition. Limited extensions will be permitted, during which the trustee will hold open the first meeting of creditors. Conversion or dismissal will result from failure to file within the extended periods.[40]

[c]—Dismissal for Failure to Timely File Tax Returns.

Under present law, a debtor may continue to exercise the right to reorganize under bankruptcy protection notwithstanding the failure to file post-petition tax returns. Under BAPCPA, a debtor who fails to file post-petition returns may, on request of a taxing authority, have his case converted or dismissed.[41]

[d]—Providing Requested Tax Documents to the Court.

Under BAPCPA, the court may not grant an individual a chapter 7 discharge or confirm the chapter 11 or chapter 13 plan of an individual unless requested tax documents have been filed with the court. The court must retain such documents for three years, subject to extension in the event of an audit enforcement action.[42]

[e]—Providing Tax Returns to Trustee or Requesting Creditor.

Under BAPCPA, the debtor is required to provide federal income tax returns to the Chapter 7 or 13 trustee not later than 7 days before the date set for the first meeting of creditors.[43] The federal income tax return required is for the most recent tax year ending before the filing of the

[39] 11 U.S.C. § 523(a).

[40] 11 U.S.C. § 1308.

[41] 11 U.S.C. §§ 1112(b)(4)(i) and 521(j)(1) and (2).

[42] Pub. L. No. 109-8, § 1228 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

[43] 11 U.S.C. § 521(e)(2)(A)(i).

bankruptcy case. In the event the debtor has a transcript of the tax return that may be provided instead of the tax return itself.[44] Any creditor who timely requests a copy of the tax return or transcript must also be furnished copies.[45] If the debtor fails to comply with these requirements the bankruptcy court shall dismiss the case, unless the debtor can demonstrate that the failure to comply is due to circumstances beyond the debtor's control.[46]

[8]—Miscellaneous Tax Provisions

[a]—Standards for Tax Disclosure.

Under present law, prior to solicitation of acceptances for a chapter 11 plan, a proponent must submit and have approved by the court a disclosure statement containing adequate information.[47] The Bankruptcy Code does not specify what constitutes adequate information as to the tax consequences of the plan. Under BAPCPA, the disclosure statement will be required to contain a discussion of the potential material federal tax consequences to the debtor and a hypothetical investor typical of the holders of claims or interests in the case.[48] It has been the better practice to include an adequate statement of federal tax consequences in most disclosure statements, usually in a section of the disclosure statement entitled "tax consequences."

[b]—Setoff of Tax Refunds.

Outside of bankruptcy, the IRS is generally permitted to set off refunds owed to a taxpayer against unpaid taxes owed by that taxpayer.[49] Current bankruptcy law preserves the government's right of setoff with respect to pre-petition taxes but prevents the taxing authority from exercising that right while the automatic stay is in place.[50] Under BAPCPA, setoffs will

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[44] *Id.*

[45] 11 U.S.C. § 521(e)(2)(A)(ii).

[46] 11 U.S.C. § 521(e)(2)(B) and (C). *See In re* Ring, 2006 Bankr. LEXIS 787 (Bankr. D. Me. 2006) for a case where dismissal was denied when the debtor demonstrated that the failure to comply with the delivery of copies of the tax returns to the trustee was due to circumstances beyond the debtor's control.

[47] 11 U.S.C. § 1125(b).

[48] 11 U.S.C. § 1125(a).

[49] *See* I.R.C. §§ 6402(a) & 6411(b).

[50] *See* 11 U.S.C. §§ 553 and 362(a)(7).

generally be permitted if setoff would have been permitted outside bankruptcy and if the taxable periods giving rise to both the overpayment and the deficiency are pre-petition. If setoff is not permitted under non-bankruptcy law because of a contest over the amount or legality of the deficiency, the taxing authority will be permitted to hold the refund pending resolution of the contest, unless the court grants adequate protection.[51] This provision will eliminate the existing procedural requirement that taxing authorities seek bankruptcy court approval before pre-petition setoffs can take place, even though outside bankruptcy such setoffs are generally permitted.

[c]—Special Provisions Related to the Treatment of State and Local Taxes.

Present section 346 of the Bankruptcy Code contains a series of detailed provisions that mandate a uniform outcome at the state and local level with respect to a variety of bankruptcy tax matters, both substantive and procedural. Under BAPCPA, section 346 is completely rewritten, and the provisions previously housed in section 728 and sections 1146(a) and (b) are largely transferred to section 346. Among other things, the new rules require uniformity among federal, state, and local tax administrative rules by (a) preventing a bankruptcy filing from resulting in the creation of a new taxable estate (or the termination of the debtor's taxable year) for federal purposes but not for state and local purposes (or vice versa), (b) conforming the federal, state, and local tax consequences of property transfers from the debtor to the estate (or vice versa), (c) preventing state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code, and (d) generally requiring states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income following the same rules applicable for federal purposes.[52] New section 346 is both simpler and more effective than its predecessor. Instead of laying out detailed tax rules for the states and localities to follow, it relies on simpler cross-references to federal law that should help keep the two more closely in sync. Although the validity and enforceability of section 346 itself may be thought to be open to some question in light of the sovereign immunity

[51] 11 U.S.C. § 362(b)(26).

[52] 11 U.S.C. § 346.

issues raised by several recent Supreme Court decisions,[53] the new version of section 346 is a significant improvement over the old one.

[d]—Treatment of Fuel Tax Claims.

The Bankruptcy Code is amended to provide that a claim arising from the liability of a debtor for fuel use tax may be filed by the base jurisdiction designated pursuant to the International Fuel Tax Agreement and, if so filed, shall be allowed as a single claim.[54] Nevertheless, standing orders or local rules in some bankruptcy courts permit setoffs of tax deficiencies and overpayments without court order in certain circumstances.

¶ TX1.06. Selected Tax Issues Common to Title 11 Cases.

Many tax issues are created and arise prior to filing a title 11 case, during the administration of the title 11 estate, and subsequent to the entry of discharge or confirmation of a plan of reorganization. The following is intended as a summary of the significant tax issues that can be encountered.

[1]—Tax Issues Prior to Filing.

A number of issues deal with prebankruptcy income tax considerations. Some of these issues are: (1) Is there a difference in tax treatment if there is a taxable event generated by a transfer of collateral to the lender (whether in a foreclosure or by deed in lieu of foreclosure) before the title 11 filing?; (2) Is the debtor an individual, a corporation, or a pass-through tax entity such as a partnership or S corporation?; (3) What is the tax effect of a transfer of property from one entity to another entity or a change in the tax status of the debtor?; and (4) Is taxable income generated by the "restructuring" of a debt where the amount of outstanding debt is reduced, and, if so, how much taxable income is recognized, for whom is the income a liability, and how is the tax to be paid?[1] Generally, different types of prepetition taxes arise in bankruptcy cases: (1) the ad valorem property tax is common in bankruptcy cases; (2) employment taxes or trust fund

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[53] *See e.g.*, Seminole Tribe v. Florida, 517 U.S. 44 (1996); Fed. Mar. Comm'n v. South Carolina Ports Auth., 533 U.S. 743 (2002).

[54] 11 U.S.C. § 501.

¶ TX1.06.

[1] For discussion of federal tax reporting requirements, *see* chapter TX3 *infra*. *See also* ¶ TX12.03 *infra* for state and local reporting requirements; ¶ TX5.04 *infra* for the jurisdiction of the bankruptcy court to determine tax liability.

taxes becomes a usual issue in bankruptcy cases; and (3) numerous other state taxes, for example, sales or use taxes, unemployment taxes and franchise taxes are sometimes involved.

[2]—Tax Issues Common in Title 11 Cases.

Frequently, the filing of a title 11 case creates numerous tax issues and questions of tax claims treatment. The first issue is whether a transfer of assets from the debtor to the estate on the filing of a title 11 case is a separate taxable event. Once a title 11 case is commenced and an order for relief is entered, tax questions primarily revolve around issues of dischargeability, priority of tax payment, amount of the tax claim, responsibility for filing tax returns, termination of tax years, and whether the tax claim includes post or prepetition interest or post or prepetition penalties. During the course of the administration of a case, issues may be presented such as the determination of tax, payment responsibilities for taxes, jurisdiction to enjoin or recover assets seized by taxing authorities, and the operation of the automatic stay on tax authorities exercising collection procedures, assessment, and third party nondebtor collection. Additionally, sometime during the case, the estate often disposes of assets by sale, transfer, or abandonment under Bankruptcy Code §§ 363 and 554. These actions generate issues of who is liable for the taxable gain, does basis carry over and if so, how much, to whom is the gain allocated, and what tax attributes, if any, are available to offset the gain. Issues involving collection and payment of withholding tax, responsible officer liability, and allocation of tax payments to withholding, income, interest, or penalty are generated during the administration of a case.[2]

[3]—Post-Filing Issues Generated by Actions Taken or Orders Entered During the Administration of a Title 11 Case.

Postpetition tax issues are commonly generated because of an abandonment of an asset during the title 11 case, the setting aside of exempt property, the denial or nondischargeability of tax claims, the setoff rights of the Internal Revenue Service against a debtor's tax refund, the validity of a prior recorded tax assessment and lien on post-petition property, the

[2] For a detailed discussion of many tax issues frequently encountered in a title 11 case, *see* chapter TX4, *infra*, for an analysis of priority and dischargeability of tax claims and treatment of interest and penalties; chapter TX6, *infra*, for discharge of indebtedness; chapter TX7, *infra*, for a discussion of the tax treatment of creditors; chapter TX13, *infra*, for a discussion of the treatment of debtor partnerships; and chapter TX5, *infra*, for a discussion of the jurisdiction of the bankruptcy court in tax issues and disputes with tax collecting entities.

sales and disposition of property by the bankrutpcy estate, franchise, sales and use tax liability, the tax treatment of creditor trusts in plans of reorganization, and the right to collect nondischargeable taxes out of postpetition assets acquired by the former debtor-taxpayer. Some postpetition issues may arise because of the failure to make tax payments provided in the Bankruptcy Code, required payments in a confirmed plan, the attempt to enforce tax liens on postpetition property, and collection activity against transferees of assets or responsible nondebtor parties.[3]

Since the form of the debtor entity in a title 11 case determines the type of tax liability, caution must be exercised in dealing with partnerships, S corporations, and individuals throughout the commencement and administration of a case and until its termination. Issues of solvency are important and the key to recognition of income from discharge of indebtedness for these debts discharged prior to the commencement of a title 11 case.[4] Serious concern should also be given to the issue of which tax attributes may survive a reorganization. Is the net operating loss available to the reorganized entity and, if so, to what extent will tax attribute reduction for discharge of indebtedness income excluded under I.R.C. § 108 offset the amount of such attributes?[5]

II. Survey of Bankruptcy Code Provisions Affecting Tax Law Issues

¶ TX1.07. Introduction.

The tax policy of maximum collection and protection of the Treasury through an aggressive network of voluntary tax returns, assessment, collection, litigation and pursuit of all potential responsible taxpayers clashes irrevocably with the policy of a "fresh start" for the bankruptcy debtor through the use of the bankruptcy process. The conflict between

[3] For a comprehensive discussion of post-petition tax compliance under the Bankruptcy Code, *see* Gargotta, *Post-petition Tax Compliance Under the Bankruptcy Code: Can the IRS Enforce Collection After Bankruptcy Is Filed?*, 11 Am. Bankr. Inst. L. Rev. 1, page 113 (Spring 2003).

[4] A taxpayer who is not a debtor in a title 11 case can exclude cancellation of indebtedness from income under I.R.C. § 108(a)(1)(B) only if the income is realized at a time when the taxpayer is insolvent.

[5] The law is not clear on the timing of the realization of cancellation of indebtedness income in title 11 cases. Realization of income may occur when a debtor receives a discharge from debts. In chapter 7 this is easily determined because it is based on the date of the entry of the order of discharge. In chapter 11 the timing is not easily calculated. The provisions of the chapter 11 plan would govern when realization of cancellation of indebtedness income occurs.

bankruptcy policy and tax policy is sometimes overwhelming. Tax disputes generate litigation and affect tax practitioners and litigators. When the taxpayer, the subject of the tax dispute and a party to the litigation becomes a debtor in a title 11 case, the elements of bankruptcy law become inextricably involved in the tax dispute process. Tax disputes in title 11 cases involve the determination of the amount of tax liability, questions of priority in tax payments as they relate to other claims against the bankruptcy estate, dischargeability of tax liability, setoff of tax refund against tax claims, and turnover of assets seized by the Internal Revenue Service prior to commencement of the case.

The bankruptcy court is the contemporary litigation forum for sophisticated and complicated business disputes involving billions of dollars. Because title 11 filings have increased dramatically, the bankruptcy court will be called upon more frequently to hear, determine and dispose of tax disputes between the debtor and all taxing authorities. It has been characterized as the "tax forum of the 90s."[1]

The Bankruptcy Code provides for the orderly distribution of a debtor's assets in accordance with a scheme which determines priorities for payment and discharge of obligations. The bankruptcy process is designed to provide the debtor with a fresh start. The fresh start is achieved because the debtor is discharged from obligations. A tax debt is among the obligations included in the discharge, providing it meets certain tests.

The reorganization and debt adjustment provisions of chapter 11 of the Bankruptcy Code are designed to rehabilitate a debtor, whether partnership, corporation or individual, by providing for the reorganization of the debtor through a plan which is filed with a disclosure statement. The plan is brought on for voting and approval by various classes of creditors and heard by a court as part of the confirmation process. Once a plan is confirmed, in the case of individuals and business entities which continue as reorganized debtors, discharge of debts is ultimately accomplished by the performance of those payment undertakings proposed in the plan. Discharge is the ultimate objective of the debtor.

Once a title 11 case is commenced, a bankruptcy estate is created and the administration of the estate is accomplished through the bankruptcy

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¶ TX1.07.

[1] This description of the bankruptcy court as the "Tax Forum For The 90's" was first used by Allegra in an article which appeared in 31 Fed. Bar News & J 338 (1991); *see also* Sheinfeld, "Litigating With The Internal Revenue Service In Bankruptcy: Bankruptcy Courts—The Tax Forum For The 90's," Great Plains Federal Tax Institute, Lincoln, Nebraska (1991).

[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 5043
(BANKRUPTCY TAX ACT OF 1980)

As Passed the House

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON MAY 30, 1980

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

MAY 27, 1980

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1980

62-647 O

JCS-25-80

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INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation for the public hearing on H.R. 5043, the Bankruptcy Tax Act of 1980, scheduled for May 30, 1980, before the Senate Finance Subcommittee on Taxation and Debt Management Generally.

The pamphlet provides background information on the bill, a summary of the major provisions of the bill, a more detailed description of present law and the provisions of the bill, and the estimated revenue effect.

(A separate pamphlet describes five Senate bills—S. 2484, S. 2486, S. 2500, S. 2503, and S. 2548—which are also scheduled for the May 30 Subcommittee hearing.)

I. BACKGROUND

H.R. 5043, the Bankruptcy Tax Act of 1980, concerns the Federal income tax aspects of bankruptcy, insolvency, and discharge of indebtedness. The bill passed the House of Representatives on March 24, 1980, by a vote of 324–0, after having been ordered favorably reported by the Ways and Means Committee on March 12, 1980 (House Report No. 96–833).

The bill was developed over the past several years on the basis of extensive hearings, studies, and suggestions as to appropriate tax rules for bankruptcy and related tax issues. This effort to review and modernize bankruptcy tax law began with Congressional establishment of the Commission on the Bankruptcy Laws of the United States and the report issued by that Commission in 1973.[1] That report recommended changes and clarifications in both substantive rules and tax rules of bankruptcy.

In 1978, the 95th Congress enacted legislation (Public Law 95–598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95–598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions.[2] The new law generally became effective for bankruptcy cases commencing on or after October 1, 1979. H.R. 5043 is intended to complete the process of revising and updating Federal bankruptcy laws by providing rules governing the tax aspects of bankruptcy and related tax issues.

Because of the October 1, 1979 effective date enacted in Public Law 95–598 for repeal of the Bankruptcy Act (including repeal of provisions governing Federal income tax treatment of debt discharge in bankruptcy), and for implementation of new bankruptcy court procedures, provisions of H.R. 5043 applicable with respect to bankruptcy

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[1] The present-law Federal income tax rules relating to taxpayers in bankruptcy cases and the Commission's recommendations for legislative changes, together with alternative proposals, are discussed in detail in a series of articles by William T. Plumb, Jr., Esq., entitled "The Tax Recommendations of the Commission on the Bankruptcy Laws." These articles appear at 29 Tax Law Review 227 (1974) (tax effects of debt reduction; insolvency reorganizations); 72 Mich. L. Rev. 935 (1974) (income tax liabilities of the bankruptcy estate and the debtor); and 88 Harv. L. Rev. 1360 (1975) (tax procedures).

[2] The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform Act of 1978"). This pamphlet refers to the 1978 bankruptcy statute as "P.L. 95–598." The substantive bankruptcy law which is superseded by P.L. 95–598 is referred to as the "Bankruptcy Act."

In this pamphlet, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95–598 are cited as "new 11 U.S. Code sec.—" References to the "Code" are to the Internal Revenue Code of 1954, as amended.

In the bill (H.R. 5043), bankruptcy cases to which the substantive provisions of P.L. 95–598 apply—generally, cases commenced on or after October 1, 1979—are referred to as "title 11 cases."

cases would generally be effective for bankruptcy cases commencing on or after October 1, 1979. Present law would continue to apply for bankruptcy cases commenced under the Bankruptcy Act, i.e., prior to October 1, 1979, including Bankruptcy Act cases which are commenced before and continue after that date. Provisions of H.R. 5043 applicable to transactions outside bankruptcy cases (such as discharge of indebtedness of a solvent taxpayer outside bankruptcy) generally would be effective for such transactions occurring after December 31, 1980.

Hearings were held on H.R. 5043 before the Ways and Means Subcommittee on Select Revenue Measures on September 27, 1979.[3] Throughout the development of the bill over the past several years, comments as to the appropriate tax rules in bankruptcy cases and related tax issues have been received from various groups and individuals, including the American Bar Association, Tax Section, Ad Hoc Committee for Bankruptcy Revision; the American Institute of Certified Public Accountants, Bankruptcy Task Force; the Association of the Bar of the City of New York, Committee on Taxation; the New York State Bar, Tax Section, Committee on Bankruptcy and Insolvency; the National Bankruptcy Conference, Committee on Tax Matters; the State Bar of California, Tax Section, Bankruptcy Tax Revision Committee; the Departments of Treasury and Justice; and the Internal Revenue Service.

[3] In 1978, the Ways and Means Committee held hearings on H.R. 9973 (95th Congress), concerning Federal income tax aspects of bankruptcy and related issues.

II. SUMMARY OF H.R. 5043

A. Tax Treatment of Discharge of Indebtedness

In Public Law 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill would provide tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and would make related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

Bankruptcy or insolvency

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets, the debt discharge amount would be applied to reduce the taxpayer's net operating losses and then certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes would be applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities). Any further remaining debt discharge amount would be disregarded, i.e., would not result in income or have other tax consequences.

The bill would provide that the taxpayer may elect to apply the debt discharge amount first to reduce basis in depreciable property, before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election could elect to reduce basis in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers). To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act.

To insure that ordinary income treatment eventually would be given to the full amount of basis reduction in depreciable or nondepreciable assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

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Outside bankruptcy—solvent taxpayers

The bill would modify the existing Federal income tax election (secs. 108 and 1017 of the Code) under which a solvent taxpayer outside bankruptcy may elect to reduce basis of assets instead of recognizing current income from debt cancellation. Similar to the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to the solvent debtor outside bankruptcy would require reduction in basis of depreciable assets.

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets would generally accord with present Treasury regulations under section 1017 of the Code. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Code.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, would be treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

Equity-for-debt rules

The bill also provides rules relating to discharge of indebtedness of corporate debtors (whether or not in a bankruptcy case) in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level.

If a corporate debtor issues stock to its creditor for an outstanding security (such as a bond), there would be no debt discharge amount and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transaction which is treated generally as a nonrecognition of gain or loss transaction for the creditors.

If a corporate debtor issues stock for other debts (such as debt held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's value. To the extent the stock's value is less than the debt discharged, the discharge of indebtedness rules summarized above would apply. This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and would reflect the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of the debt discharge rules of the bill and the creditor's bad debt deduction.

In light of these stock-for-debt rules, the bill provides that the special limitations on net operating loss carryovers (sec. 382 of the Inter-

nal Revenue Code) generally would not apply to the extent creditors receive stock in exchange for their claims.

The bill also provides that the debt discharge rules would apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.

Other rules concerning debt discharge

In addition, other rules in the bill concerning debt discharge would relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule of section 111 of the Code, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount, no investment credit recapture would occur by reason of the reduction.

Effective date

The provisions of the bill relating to tax treatment of debt discharge would apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. Present tax law would continue to apply for bankruptcy cases (or receivership, etc. proceedings) commenced prior to October 1, 1979.

In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill would apply to any discharge of indebtedness occurring after December 31, 1980.

B. Bankruptcy Estate of an Individual

In general

The bill would treat the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the bill provides that no separate taxable entity would be created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which would be treated as a separate taxable entity would include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

Debtor's election to close taxable year

Also, the bill generally would give an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election were made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case would become an allowable claim against the bankruptcy estate. If the election were not made, the commencement of the bankruptcy case would not terminate the taxable year of an individual debtor.

Effective date

These provisions of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganizations in Bankruptcy

Expansion of reorganization provisions

The bill would expand the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill would terminate the applicability of special rules of current law relating to insolvency reorganizations (secs. 371–374 of the Code).

The bill would permit a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill would allow the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. In light of the debt discharge rules of the bill, which would adjust tax attributes of a reorganized corporation to reflect changes in its debt structure, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would apply in the case of a "G" reorganization.

Since "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered would be taxed on the excess. Also, money or other "boot" property received in a "G" reorganization would be subject to the dividend-equivalence tests which apply to the reorganizations generally.

Property attributable to accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) would be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

Effective date

These provisions of the bill would apply to bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commencing on or after October 1, 1979. In addition, the amendments relating to property attributable to accrued interest also would apply to transactions occurring after December 31, 1980 (other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979).

D. Miscellaneous Corporate Amendments

The bill would make a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

1. PHC status.—Under the bill, a corporate debtor generally would not be considered a personal holding company, subject to additional taxes on certain passive income, while in a bankruptcy case (or receivership, foreclosure, or similar proceeding) commencing on or after October 1, 1979.

2. Liquidation rule.—The corporate nonrecognition tax rules applicable to 12-month liquidations would be extended to cover sales by insolvent corporations of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period from adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision would apply to bankruptcy cases (or receivership, etc. proceedings) commencing on or after October 1, 1979.

3. Subchapter S shareholder.—The bill provides that for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor could be an eligible shareholder in a subchapter S corporation.

4. Section 351 applicability.—Under the bill, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code. Also, the nonrecognition rule would not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case to the extent the stock or securities received in exchange for the assets were used by the debtor to pay off his debts. The effective date for these provisions would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

5. Earnings and profits.—The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount would not affect the debtor corporation's earnings and profits. The effective date for this provision would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

E. Changes in Tax Procedures

The bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

III. EXPLANATION OF H.R. 5043

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382, and 1017 of the Code)

Present law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction; [1] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[2] Treasury regulations provide that the gratuitous cancellation of a corporation's indebtedness by a shareholder-creditor does not give rise to debt discharge income to the extent of the principal of the debt, since the cancellation amounts to a contribution to capital of the corporation.[3] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4] Under a related exception, no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of the obligation satisfied.[5] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (sec. 111). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

A debtor which would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets in accordance with Treasury regulations (secs. 108 and 1017 of the Code). This income exclusion is available if the discharged indebtedness was incurred by a corporation or by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the

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[1] Treas. Regs. § 1.61-12(b)(1); *Dallas Transfer & Terminal Warehouse Co.* v. *Comm'r*, 70 F. 2d 95 (5th Cir. 1934).

[2] *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

[3] Treas. Regs. § 1.61-12(a).

[4] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, 604 F. 2d 734 (5th Cir. 1979).

[5] *Comm'r* v. *Motor Mart Trust*, 156 F. 2d 122 (1st Cir. 1946).

debt discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an income-exclusion election under sections 108 and 1017 of the Code is *pro tanto* a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74-184, 1974-1 C. B. 8).

Bankruptcy proceedings

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95-598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under chapter X).[6] The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[7] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the corporation's property is transferred to a successor corporation as part of the bankruptcy reorganization.[8]

Similar rules apply in the case of an "arrangement" (under chapter XI), a "real property arrangement" (under chapter XII), and a wage earner's plan (under chapter XIII), except that no basis reduction is required under a wage earner's plan.[9] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[10]

Explanation of provisions

Debt discharge in bankruptcy

In general

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[11] Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

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[6] Sec. 268 of the Bankruptcy Act.

[7] Sec. 270 of the Bankruptcy Act.

[8] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code).

[9] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[10] Treas. Regs. § 1.61-12(b). See text accompanying notes 1 and 2.

[11] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

Unless the taxpayer elects first to reduce basis of depreciable assets, the debt discharge amount would be applied to reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit, and the credit for alcohol used as a fuel; [12]

(3) capital losses and carryovers; and

(4) the basis of the taxpayer's assets.

The reduction in each category of carryovers would be made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[13] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer would be disregarded.

After reduction of the specified carryovers, any remaining debt discharge amount would be applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally would not result in income tax liability except to the extent the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which is left after attribute reduction under these rules would be disregarded, i.e., would not result in income or have other tax consequences.

Election to reduce basis in depreciable property

The bill provides that the taxpayer could elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property,[14] before applying any remaining amount to reduce net operating losses and other tax attributes in the order described above. A debtor making this election could elect to reduce basis (but not below zero) in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

An election first to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once

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[12] These credits would be reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction would avoid the complexity of determining a tax on the debt discharge amount and determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes would be reduced one dollar for each dollar of debt discharge amount.

[13] Thus in the case of net operating loss and capital loss, the debt discharge amount first would reduce the current year's loss and then would reduce the loss carryovers in the order in which they arose. The investment credit carryovers would be reduced on a FIFO basis, and the other credit carryovers also would be reduced in the order they would be used against taxable income. These reductions would be made after the computation of the current year's tax.

[14] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. See *Harry H. Kem, Jr.*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

Recapture rule

If the basis of property (whether depreciable or nondepreciable) were reduced pursuant to the rules in the bill, any gain on a subsequent disposition of the property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

Basis reduction—general rules

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction in other attributes, the particular properties the bases of which would be reduced would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction prescribed in such regulations would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016-7 and 1.1016-8).

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction were required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction would be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) would apply, any attribute reduction required under the bill would apply to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis would be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

Debt discharge outside bankruptcy—insolvent debtors

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge would be excluded from gross income up to the amount by which the taxpayer is insolvent,[15] and that the excluded amount would be applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debt discharged which would not be excluded from gross income

[15] The bill defines "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as would be added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

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(because it exceeds the insolvency amount) would be treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Debt discharge outside bankruptcy—solvent debtors

In the case of a solvent taxpayer outside bankruptcy, the bill would modify the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness. Under this modification, only the basis of depreciable property held by the taxpayer could be reduced.[16]

An election to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such other time as permitted by Treasury regulations. Once made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

If a taxpayer makes an election to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction among depreciable assets of the taxpayer would generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017–1 and 1.1017–2). The bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge takes place.

To the extent a solvent taxpayer outside bankruptcy does not make an election to reduce basis in depreciable property in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which, as under present law, constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code; Rev. Rul. 67–200, 1967–1 C.B. 15).

Recapture rule

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

Certain reductions as purchase price adjustments

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the

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[16] The exclusion from gross income under section 108(a) of the Code (as would be amended by the bill) would apply, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable assets.

For this purpose, the term "depreciable property" would be defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (see note 14, *supra*).

purchaser is insolvent, then the reduction to the purchaser of the purchase-money debt would be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule would apply only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision would be intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether in a particular case to which the provision applies the debt reduction should be treated as discharge income or a true price adjustment. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision would not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment; nor would it apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

Equity-for-debt rules

The bill would provide rules relating to corporate indebtedness in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level. These rules would apply whether the debtor is solvent or insolvent, and whether or not the debtor is in a bankruptcy case.

Securities

Under the bill, if a corporate debtor issues stock to its creditor for the principal amount of an outstanding security (such as a bond), there would be no debt discharge amount, and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transfer which is treated generally as a nonrecognition of gain or loss transaction for the creditor.

For purposes of this rule, the term "security" would mean an evidence of indebtedness which was issued by a corporate debtor with interest coupons or in registered form (within the meaning of sec. 165(g)(2)(C) of the Code) and which constitutes a security for purposes of section 354 of the Code.[17] Thus, the term "security" would be intended to mean those instruments with repect to which generally no reduction for partially worthless debts could have been allowed under section 166(a)(2) of the Code and with respect to which no loss could be recognized in an exchange under a plan of reorganization by reason of sections 354 or 356 of the Code.[18]

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[17] The bill provides that the stock-for-security exception would apply only if the debt for which the stock is issued constituted a "security" either on October 1, 1979, or if incurred after that date, then at all times after the debt was incurred. Accordingly, the exception in section 108(f)(1)(C) would not apply if non-security debt held by a creditor is transformed (after October 1, 1979) into security debt either directly (through an exchange of the non-security debt for debt in registered form, for example) or indirectly (through a "repayment" that is, as a practical matter, conditioned on reinstitution of the debt in the form of a security).

[18] However, if the creditor holding the security is a bank, the "securities rule" applies under the bill (i.e., there would be no tax consequences to the debtor) even though, unlike other taxpayers, banks are permitted under present law (sec. 582(a) of the Code) to claim a bad debt deduction for a partially worthless security.

The "securities rule" of the bill would not be intended to apply if only a *de minimis* amount of stock is issued for an outstanding security. Thus, the value of the stock received could not be very small when compared to the total amount of the creditor's claim, so that the debt forgiveness rules would not be circumvented by the issuance of token shares to a creditor with no real equity interest in the corporation.

If both stock and other property were issued for a debt evidenced by a security, the stock would be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. For example, if $30 cash and $20 worth of stock are issued to cancel a $100 bond, the cash would be treated as satisfying $60 of the debt (resulting in a debt discharge amount of $30 to which the rules of the bill apply), and the stock would be treated as issued for the other $40 of the debt (with no income resulting or attribute reduction required).

Debts other than securities

If a corporate debtor issues stock for other debts (such as debts held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's fair market value. To the extent the stock's value is less than the principal amount of the debt discharged, the discharge of indebtedness rules summarized above would apply.[19]

This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and reflects the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of tax calculations, including the debt discharge rules of the bill and the creditor's bad debt deduction.

Capital contributions

The bill also provides that the discharge of indebtedness rules would apply to the extent that the amount of debt transferred to a

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[19] For example, assume a corporate debtor borrows $1,000 on a short-term note and later issues $600 worth of stock in cancellation of the note. Under present law, the creditor recognizes a $400 loss, but the corporate debtor neither recognizes income nor must reduce tax attributes. Under the bill, the creditor would recognize a $400 loss (as under present law) and the corporation must account for a debt discharge amount of $400.

If the corporation is insolvent or in bankruptcy, it must apply the $400 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $400 in lieu of recognizing $400 of income in the year of discharge.

corporation as a contribution to capital exceeds the shareholder's basis in the debt.[20] Thus, the discharge of indebtedness rules would apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[21]

Application of rules

For purposes of the equity-for-debt rules, the bill provides that the term "debtor corporation" would include a successor corporation, and that the stock of a corporation in control of the debtor corporation would be treated as stock of the debtor.[22]

Partnership debt

Similar rules would apply in the case of discharge of partnership indebtedness if an equity interest in the partnership is exchanged for a partnership debt, or if partnership debt is contributed by a partner as a contribution to capital.

Other rules concerning debt discharge

No disposition on basis reduction.—If the basis of qualified investment credit property would be reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax would be incurred, because the reduction would not be considered a disposition. This rule would overturn the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as

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[20] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.

Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

[21] This contribution-to-capital rule would reverse the result reached in *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th cir. 1979). Moreover, it would be intended that the result reached in *Putoma* could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it would be intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.

[22] Thus the stock-for-debt rules of the bill would apply for an exchange by a successor corporation (i.e., a corporation whose attributes carried over under section 381 of the Code, as amended by this bill) of its stock for debt of its predecessor, or an exchange by the debtor of the successor corporation's stock for the debt. Also, these rules would apply where stock of a corporation in control of the debtor corporation or the successor corporation is transferred in the exchange.

would be amended by the bill), and would preclude extension of that position to bankrupt or insolvent debtors.[23]

Indebtedness of taxpayer.—The debt discharge rules of the bill would apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

Unamortized premium and discount.—The bill provides that the amount taken into account with respect to any discharge of indebtedness would be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[24]

Debt acquired by related party.—The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor would be treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department. For purposes of this rule, a person would be treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of sec. 414(b) of the Code) of which group the debtor is a member, (2) a trade or business treated as under common control with respect to the debtor (within the meaning of sec. 414(c) of the Code), (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of sec. 707 (b)(1) of the Code), or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in section 267(b) of the Code. The definition of "family" for this purpose would also include a spouse of the debtor's child or grandchild. This rule would be intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[25]

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[23] No inference would be intended, by virtue of adoption of the no-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as would be added by this bill) would continue to constitute an adjustment for purposes of the investment credit rules of the Code.

[24] This provision of the bill would not be intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

[25] It would be intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired by a related party subject to the rule of the bill treating the debtor as having acquired the debt.

If the debtor subsequently pays the debt to the related party and the related party recognizes gain on the payment transaction, a deduction equal to the amount of such gain will be allowed to the debtor for the year in which such payment occurs. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations would provide that the debtor will be allowed a $100 deduction in the year of such payment.

If a related party transfers to a corporation as a contribution to capital debt issued by the corporation and the debtor corporation thereby has a debt dis-

"Lost" deductions.—The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability would not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital, then the discharge would not give rise to income or require any reduction of tax attributes.

Section 382 exception.—Because the bill would contain rules providing for attribute reduction in certain circumstances where a corporation's indebtedness is discharged upon the issuance of stock, no further reduction of attributes would be required under sections 382 and 383 of the Code if stock is issued in exchange for a creditor's claim against the corporation (unless the claim were acquired for the purpose of acquiring the stock).[26] The bill specifically provides that acquisition of stock for debt in a bankruptcy or similar case would not be treated as an acquisition by purchase in applying section 382(a) of the Code and that the creditors of the debtor corporation would be treated as shareholders in applying the continuity rules of section 382(b) to a reorganization under section 368(a)(1)(G) of the Code (as added by this bill).

It is expected that the Treasury regulations defining a consolidated return change of ownership would be amended to conform with the amendment made by this bill to section 382 of the Code.

Tax benefit rule.—The bill would clarify present law by providing that in applying the tax benefit rule of section 111 of the Code in order to determine if the recovery of an item is taxable, a deduction would be treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction would be treated as having produced a reduction in tax even if it had entered into the calculation of a net operating loss that had not expired at the end of 1981 but had not been used as of that time.

Partnerships

The bill would provide that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at

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charge amount pursuant to the rules of the bill, a deduction equal to the debt discharge amount will be allowed to the debtor for the year in which the capital contribution is made. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year, assume the parent transfers the debt to its subsidiary as a contribution to capital (i.e., forgives the debt). The Treasury regulations would provide that the amount treated as a debt discharge amount under the capital contribution rules of the bill ($100 in the example given) will be reduced by the debt discharge amount previously taken into account by the subsidiary ($100).

[26] For example, any claim purchased after it had become evident that the claim would have to be satisfied primarily with stock could be considered to have been acquired for the purpose of acquiring the stock.

the partnership level.[27] Accordingly, income from discharge of a partnership debt would not be excludable at the partnership level under amended section 108. Instead, such income would be treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, would be separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner would depend on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner were bankrupt or insolvent, the debt discharge amount would be excluded from gross income pursuant to amended section 108 and would be applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable assets. If the particular partner were solvent (and not in a bankruptcy case), the amount allocated to that partner would be included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill would provide that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership. The bill also would provide that if a partner reduces his basis in the partnership under section 1017 of the Code by reason of the debt discharge rules of the bill, the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).[28]

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[27] The effect of these provisions of the bill would be to overturn the decision in *Stackhouse* v. *U.S.*, 441 F.2d 465 (5th Cir. 1971).

[28] For example, assume that a partnership is the debtor in a bankruptcy case which began March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership. (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 would not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount secs. 752 and 753 of the Code). Thus, there is no net change in each partner's

Technical amendments

The bill would amend section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as would be amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, would be amended to add a reference to the rules of the bill on capital contributions of indebtedness. Section 1032(b) of the Code, relating to basis, would be amended to add a cross reference to the stock-for-debt rules of the bill.

Effective date

The amendments to the Internal Revenue Code made by section 2 of the bill would apply to transactions in a bankruptcy case if the case commenced on or after October 1, 1979; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commenced on or after October 1, 1979; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 would not apply to any transactions in proceedings under the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding which proceeding began before October 1, 1979, even if such transaction occurs after December 31, 1980).

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basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as would be amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as would be specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment would apply in the case of insolvent partner B. In the case of solvent partner C, such partner could elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner could be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill would treat that interest as depreciable property. If a partner does so reduce basis in his interest in the partnership, the bill also would require that the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

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B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

Effect of bankruptcy law

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The bankruptcy estate generally is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

Explanation of provisions

1. Debtor and bankruptcy estate as separate entities

Present law

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated as a new taxable entity, separate from the individual (Rev. Rul. 72-387,1972-2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more.

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year (including income earned by the individual before commencement of the proceeding, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

General provisions of bill

The bill, like present law, would treat the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398) [1] would apply if a bankruptcy case involving an individual debtor is brought under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95-598. No separate taxable entity would be created on commencement of a case under

[1] In this pamphlet, provisions of the Internal Revenue Code which would be added by section 3 of the bill are cited as "new Code sec. —".

chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[2]

Exception

If a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate would not be treated as a separate entity (new Code sec. 1398(b)(1)). In this situation, where the bankruptcy case does not run to completion, it would be appropriate to treat the debtor's tax status as if no proceeding had been brought.[3]

Partnerships, corporations

The bill provides that no taxable entity would result from commencement of a bankruptcy case involving a partnership or corporation. This rule (new Code sec. 1399) would reverse current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68-48, 1968-1 C.B. 301), but would be the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case would be required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, would be required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012 (b)(3) of the Code; Rev. Rul. 79-120, 1979-1 C.B. 382).

2. *Debtor's election to close taxable year*

In general

The bill would give an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date would be divided into two "short" taxable years of less than 12 months. The first such year would end on the day

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[2] The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets. In a chapter 13 case, however, both future earnings of the debtor and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.

For purposes of the separate entity rules under new Code section 1398, a partnership would not be treated as an individual. The interest in a partnership of a debtor who is an individual would be taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2)).

[3] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor would include on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, would not constitute a taxable entity for Federal income tax purposes.

before the commencement date; the second such year would begin on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case would not affect the taxable year of an individual debtor (new Code sec. 1398 (d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year would become (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year would be collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year would not be dischargeable, the individual debtor would remain liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences would be collectible from the estate, but would be collectible directly from the individual debtor.

If the election were made, the debtor would be required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

Availability of election

The election provided under the bill would be available in cases to which new section 1398 of the Code applies. Accordingly, the election would be available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by Public Law 95-598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election would not be available to a debtor who has no assets other than property which he or she may treat as exempt property under new 11 U.S. Code section 522 (new Code sec. 1398 (d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected, there is no reason to authorize termination of the taxable year.

Due date, manner of election

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election would be made in such manner as prescribed by Treasury regulations, but the election would not be conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, would be irrevocable (new Code sec. 1398(d)(3)(D)).

Spousal election

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse could

join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year would not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse could elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor could join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor could not join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

Illustrative example

The rules relating to spousal elections under the bill would be illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

3. *Computation of bankruptcy estate's tax liability*

Gross income, deductions, credits

Under the bill, the gross income of the bankruptcy estate of an individual would consist of (1) any gross income of the individual debtor realized after the commencement of the case which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)). The deductions and credits of the bankruptcy estate would consist of (1) any item of deduction or credit of the debtor that is properly associated with gross income of the debtor which would be treated (under new Code sec. 1398(e)(1)) as gross income of the estate and (2) the deductions and credits of the estate (new Code sec. 1398(e)(3)).

Taxable year

The first taxable year of the estate would end on the same day as the taxable year of the debtor which includes the commencement date (new Code sec. 1398(d)(1)).

Attribute carryover

The estate would succeed to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;

(*g*) the debtor's method of accounting; and

(*h*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(g)). For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

Character of expenditures

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate.) To alleviate this problem, the bill would provide that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test would be applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec. 1398(e)(4)).

Administrative expenses

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are de-

ductible by the estate (see Rev. Rul. 68-48, 1968-1 C.B. 301). The bill would provide (new Code sec. 1398(h) (1)) that the estate could deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S. Code, ch. 123 (court fees and costs). Such deductions would be available whether or not considered trade or business expenses or investment expenses, but would be subject to disallowance under other provisions of the Internal Revenue Code, such as sections 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill would provide that any amount of the new deduction for administrative, etc. expenses not used in the current year could be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h) (2)). These carryovers would be "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc. expense which would be deductible solely under new Code sec. 1398(h) (1), or a carryover deduction for such expense, would be allowable only to the estate (new Code sec. 1398(h) (2) (D)).

Carryback of estate's net operating losses

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate could carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (new Code sec. 1398(j) (2)). Similarly, the bill would allow the bankruptcy estate to carry back excess credits, such as the investment tax credit, to pre-bankruptcy taxable years of the individual debtor.

Tax rate schedule, etc.

Except as otherwise provided in new Code section 1398, the taxable income of the bankruptcy estate would be computed in the same manner as in the case of an individual. The estate would be allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate and the tax rate schedule applicable to the estate would be the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate would not be eligible for income averaging.

Returns of estate

Under the bill, the trustee would be required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income is $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a) (9) of the Code), and to pay the estate's tax liability

due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

Change of accounting period

The estate would be permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (new Code sec. 1398(j)(1)). This rule would permit the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code sec. 505.

Disclosure of returns

The bill would provide that the estate's Federal income tax return would be open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure would be necessary so that the debtor could properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(2)).

4. Computation of individual's tax liability

Gross income, deductions, credits

If any item of gross income of the debtor realized after commencement of the bankruptcy case would be treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item would not be included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, would be intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment would be included in the estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor would be treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate (because such item is properly associated with gross income of the debtor which would be treated as gross income of the estate), that item would not be allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). This rule would insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(1)). For example, such a transfer of an installment obligation would not be treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

Carryback of net operating loss

The bill would provide that an individual debtor cannot carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (new Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the pre-bankruptcy income of the individual debtor.

Attribute carryover

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate:

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate[4]; and

(*g*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

Disclosure of returns

In a bankruptcy case to which new Code section 1398 would apply (determined without regard to whether the case is dismissed), the Federal income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years would be open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure would be necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such disclosure to the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for

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[4] In a bankruptcy case to which new Code sec. 1398 would apply, any attribute reduction under section 2 of the bill would apply to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill would provide that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, would carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

Also under the bill, prior year returns of the debtor in a bankruptcy case, or of a person whose property is in the hands of a receiver, would be open (upon written request) to inspection by or disclosure to the trustee or receiver, but only if the Internal Revenue Service finds that such trustee or receiver, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

5. *Technical amendment*

Section 443(c) of the Code, relating to cross references, would be amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

6. *Effective date*

The amendments made by section 3 of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

Present law

Definition of reorganization

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371–374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of section 368.

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[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas. Reg. § 1.371-1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (sec. 368(a)(2)(C) of the Code).

Carryover of tax attributes

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (sec. 381 of the Code).

"Principal amount" rule; "boot" test

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (secs. 354(a)(2)(B) and 356(d)(2) of the Code). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of section 356 of the Code. These rules do not apply under present law to insolvency reorganizations qualifying only under sections 371–374 of the Code.

Treatment of accrued interest

Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only as the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest although the unpaid interest would have been taxable as ordinary income if paid separately.[2]

Explanation of provisions

Section 4 of the bill generally would conform the tax rules governing insolvency reorganizations with the existing rules applicable to other corporate reorganizations.

Definition of reorganization

In general

The bill would add a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)).

[2] *Carman* v. *Comm'r*, 189 F. 2d 363 (2nd Cir. 1951); Rev. Rul. 59–98, 1959–1 C.B. 76.

The new category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding[3] in a Federal or State court.[4]

The special tax rules (secs. 371–374) now applicable to insolvency reorganizations would continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill would not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision would not require compliance with State merger laws (as in category "A" reorganizations), would not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and would not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill would require the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under section 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it would be intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction would not be precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, pay-

[3] For this purpose, the definition of a receivership, foreclosure, or similar proceeding would be the same as under present section 371 of the Code.

[4] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency would be treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a receivership proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association could qualify as a "G" reorganization.

ments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[5]

Relation to other provisions

A transaction which qualifies as a "G" reorganization would not be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" would not thereby be precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, could qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—could qualify for tax-free treatment.

It is expected that the courts and the Treasury would apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95–598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

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[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization would not be intended to apply to, or in any way to affect interpretations under present law of, the 'substantially all" test for other reorganization categories.

[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code. the "excess liability" rule of section 357(c) would apply if any former shareholder of the transferor corporation receives consideration for his stock. but would not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule would parallel present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

Triangular reorganizations

The bill would permit a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill would permit the acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.

Transfer to controlled subsidiary

The bill would permit a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidary without endangering the tax-free status of the reorganization. This provision would place "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would also apply in the case of a "G" reorganization. This would eliminate the so-called "clean slate" doctrine and would reflect the fact that adjustments may be made to a reorganized corporation's tax attributes under the rules in section 2 of the bill.[7]

"Principal amount" rule; "boot" test

Under the bill, "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations. Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered would be taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities would be taxed on the principal amount of any securities received. Also, any "boot" received would be subject to the general dividend-equivalence test of section 356 of the Code.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G"

[7] Special rules relating to limitations on net operating loss carryovers under section 382 of the Code are discussed in section III-A of this pamphlet. It is anticipated that the amount carried over under section 381 of the Code would be adjusted to take into account any amount of debt discharge income which the corporation realized after the close of the taxable year by delaying the discharge of its debts.

reorganization) would be treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which would reverse the so-called *Carman* rule,[8] would apply whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income could recognize a loss to the extent the interest is not paid in the exchange.

If the plan of reorganization allocates the value of the stock or other property received by the creditor between the principal amount of the creditor's security and the accrued interest, both the corporate debtor and the creditor would be required to utilize that allocation for Federal income tax purposes.[9] However, if the value of the stock or other property received by the creditor exceeds the principal amount of the security, the amount allocated to the security could not exceed such principal amount until an amount has been allocated to interest equal to the full amount of the accrued interest.

Example

The reorganization provisions of the bill may be illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100.000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will

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[8] See note 2, *supra*.

[9] For example, assume that a corporation, pursuant to a plan of reorganization, transfers stock with a value of $55 to its creditor in exchange for the creditor's $100 security with $10 accrued interest. Also assume that, under the terms of the plan, the $55 stock is exchanged for the principal of the debt and no portion of the stock is transferred for the interest claim. In this situation, (1) the security holder would not have any interest income on the exchange (or could deduct $10 if that amount previously had been accrued by the creditor as interest income), and (2) the corporation would have a debt discharge amount of $10, with the tax consequences as determined in section 2 of the bill (except that there would be no debt-discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under sec. 111 of the Code).

On the other hand, if the reorganization plan first allocates the stock to accrued interest and the remainder to principal, then (1) the security holder would have $10 of interest income (unless that amount had previously been accrued by the creditor as income) and (2) the corporation would not have any debt discharge amount (since the stock was exchanged for a security).

If the stock is allocated proportionately to principal and accrued interest, then (1) the security holder would have $5 of interest income (unless that amount had previously been accrued by the creditor as income), and (2) the corporation's debt discharge amount would be $5, with the tax consequences as determined in section 2 of the bill (except that there would be no debt discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under section 111 of the Code).

distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B's basis in the assets would be $75,000 (sec. 362), and B would succeed to A's net operating loss carryover (sec. 381).

Under the bill, the distribution of B stock to A's security holders would not result in income from discharge of indebtedness or require attribute reduction. On the distribution of B stock to A's trade creditors, A would exclude from gross income the debt discharge amount of $50,000—i.e., the difference between the $100,000 debt held by nonsecurity creditors and the $50,000 worth of stock given for such debt. A could elect to reduce the basis of its depreciable assets transferred to B by all or part of the $50,000 debt discharge amount; to the extent the election were not made, the debt discharge amount would reduce A's net operating loss carryover by the remainder of the debt discharge amount. Assuming that A's creditors did not acquire their claims for purposes of acquiring stock, there would be no reduction of A's net operating loss carryover under section 382.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes would prevent A from recognizing any gain (sec. 361(b)(1)(A)).[10]

Technical and conforming amendments

Section 4(h) of the bill would make technical and conforming amendments to the Internal Revenue Code.

1. Amendment of section 354(b).—Paragraphs (1) and (2) of section 354(b) of the Code, relating to exception to general rule on exchanges of stock and securities in certain reorganizations, would be amended by adding references to new subparagraph "G" of section 368(a)(1).

2. Amendment of section 357(c)(2).—Section 357(c)(2) of the Code, providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, would be amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[11]

3. Amendment of section 368(a)(1).—A conforming amendment would be made to section 368(a)(1) of the Code to take into account the addition of new category "G" reorganizations.

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[10] See sec. 371(a)(2)(A) of the Code and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

[11] See note 6, *supra*.

4. Amendment of section 368(b).—Section 368(b) of the Code, defining "party to a reorganization", would be amended to include references to new category "G" reorganizations.

5. Technical change.—A change would be made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

Effective date

The amendments made by section 4 of the bill would apply to bankruptcy cases commencing on or after October 1, 1979, and to receivership, foreclosure, or similar judicial proceedings begun on or after that date.

In addition, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, also would apply to transactions occurring after December 31, 1980, other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979.

D. Miscellaneous Corporate Amendments (sec. 5 of the bill)

1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

Present law

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

Explanation of provision

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case [1] would not be considered a personal holding company. This exception would not be available, however, if a major purpose in commencing or continuing the proceeding is avoidance of the personal holding company tax.

Effective date

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979 and to similar cases commenced on or after that date.

2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

Present law

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Code).

Explanation of provision

This provision would repeal the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy.

Effective date

The amendment made by this provision would apply to a redemption of stock issued after September 30, 1979 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

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[1] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code (i.e., bankruptcy cases commenced on or after October 1, 1979) and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial institution, a Federal or State agency).

3. Application of section 337 liquidation rule to insolvent corporations (sec. 5(c) of the bill and sec. 337 of the Code)

Present law

Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred on liquidation to creditors rather than to shareholders (Rev. Rul. 56-387, 1956-2 C.B. 189).

Explanation of provision

This provision would allow an insolvent corporation (i.e., where no shareholder of the corporation receives any consideration for his stock) in a bankruptcy or similar case[2] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and, upon the liquidation, all of the corporation's assets are transferred to its creditors within the nonrecognition period.[3] The period for nonrecognition would begin on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. This provision would not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.

Effective date

This provision would apply to bankruptcy cases commencing on or after October 1, 1979 and to similar cases commencing on or after that date.

4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

Present law

Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

The Internal Revenue Service has ruled that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66-266, 1966-2 C.B. 356). Accordingly, the Revenue Service also has ruled that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul. 74-9, 1974-1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter Selection.[4]

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[2] See note 1. *supra*.

[3] A liquidating solvent corporation in a bankruptcy or similar case could make tax-free sales during the 12-month nonrecognition period of present law (sec. 337).

[4] *CHM Company*, 68 T.C. 31 (1977).

Explanation of provision

Under the bill, the bankruptcy estate of an individual would be allowed as an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election would not be terminated because of commencement of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation could consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case.

Effective date

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979.

5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)

Present law

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security[5] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[6]

Explanation of provision

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code.

Also, the nonrecognition rule would not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or simliar case[7] to the extent the stock or securities received in exchange for the assets are used by the debtor to pay off his debts. Accordingly, gain or loss would be recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss would be recognized.) Since the basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors would reflect any amount recognized on the incorporation transfer.

Thus, the sum total of income or loss to the debtor in the two transfers would be the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also would be adjusted by any gain or loss recognized on the

[5] *Alexander F. Duncan*, 9 T.C. 468 (1947), acq. 1948-2 C.B., 2; Rev. Rul. 77-81, 1977-1 C.B. 97.

[6] See *Carman* v. *Comm'r*, 189 F.2d 363 (2d Cir. 1951).

[7] See note 1, *supra*.

transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[8]

Effective date

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

Present law

Under present law, the effect of discharge of indebtedness upon the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[9]

Explanation of provision

The bill would provide that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as would be amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

Effective date

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

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[8] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[9] In the case of *Meyer* v. *Comm'r*, 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.B. 117).

E. Changes in Tax Procedures (sec. 6 of the bill)

1. Coordination with bankruptcy court procedures (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

Procedures under Bankruptcy Act

Bankruptcy court jurisdiction

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate, which is under control of the bankruptcy court. This estate consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a(2A) of the Bankruptcy Act). In proceedings under the Bankruptcy Act[1] a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate, but might not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, if the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be fully paid out of estate assets.

Effect on Tax Court jurisdiction

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax.

Even if a statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contesting the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise

[1] The Bankruptcy Act was repealed by P.L. 95-598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning the debtor's tax liability. In other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

New bankruptcy statute (P.L. 95-598)

New 11 U.S. Code section 505(a) continues the jurisdiction of the bankruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.[2] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

Under new 11 U.S. Code section 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax de-

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[2] Under the law applicable to Bankruptcy Act proceedings, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, the bankruptcy court has jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service (if the debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

ficiency of the debtor. Also under the new law, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6)).[3] Unless the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate.

However, if the bankruptcy court does not lift the automatic stay, but instead itself decides the tax issue and (at the request of the Revenue Service or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.

Explanation of provisions

Sections 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598, as described above. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

Immediate assessment

General rule

Section 6(g) of the bill generally would repeal the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately

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[3] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)).

government.[4]

[4] 124 Cong. Rec. H-11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec.. S-17,427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95-598, the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor would not be precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

Exceptions

The bill would authorize the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill would permit immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

Conforming rules

The bill also would amend section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise would conform to the provisions of P.L. 95-598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired). Also, the bill would restate the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

Receiverships

The bill would not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill would expand the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), and 44 (real estate investment trusts).

Collection

Section 6(g) of the bill also would amend section 6873(a) of the Code to delete the rule that any portion of a claim for nondischarge-

able taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change would be made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service could make an immediate assessment of such liability without issuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes would apply.

Tax Court petition

Section 6(b) of the bill would provide that if the stay under new 11 U.S. Code section 362(a)(8) precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition is suspended during the stay and for 60 days thereafter. Also, the bill would clarify that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

Tax Court intervention

Section 6(c) of the bill would provide that the trustee of the bankruptcy estate of a debtor may intervene, as a matter of right, on behalf of the estate in any proceeding before the U.S. Tax Court to which the debtor is a party. This provision would apply where the bankruptcy judge lifts the automatic stay under new 11 U.S. Code section 362 so that the debtor's prepetition tax liability can be determined in the Tax Court.

Assessment and collection limitations

Section 6(a) of the bill would provide that if the automatic stay under new 11 U.S. Code section 362(a)(6) precludes the Internal Revenue Service from assessment or collection of tax, the running of the period of limitations is suspended, for assessment, for the duration of the stay and for 60 days thereafter; and for collection, during the period of the stay and for six months thereafter.

Cross references

Section 6(d) of the bill would add cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

2. Relief from certain failures to pay tax when due (sec. 6(e) of the bill and new sec. 6658 of the Code.)

Present law

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due

to willful neglect. Under bankruptcy rules, a debtor or the trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

Explanation of provision

Section 6(e) of the bill would relieve the debtor or the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[5]

In the case of a tax incurred by the estate, the relief would be granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill would apply if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules would not, however, apply with respect to liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

3. Preservation of FUTA credit (sec. 6(f) of the bill and sec. 3302 of the Code)

Present law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is required in the case of late contributions to a State fund (sec. 3302(a)(3) of the Code).

Explanation of provision

Section 6(f) of the bill would amend section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case.

4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)

Present law

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a bankruptcy proceeding under section 77B of the Bankruptcy Act which concluded before September 22, 1938, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation.

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[5] No inference would be intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankruptcy estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

Explanation of provision

Section 6(h) of the bill would repeal section 1018 of the Internal Revenue Code.

5. Technical and conforming amendments (sec. 6(i) of the bill)

Section 6(i) of the bill would make technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

1. Amendment of section 128(a).—In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act would be deleted.

2. Amendment of section 354(c).—Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, would be amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

3. Amendment of section 422(c).—Section 422(c)(5) of the Code relating to certain transfers by insolvent individuals of stock acquired pursuant to exercise of a qualified stock option, would be amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

4. Amendment of section 1023.—Section 1023 of the Code, relating to cross references, would be amended by deleting a cross reference to the Bankruptcy Act.

5. Amendment of section 6012(b).—Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

6. Amendment of section 6036.—Section 6036 of the Code, relating to notice of qualification as executor or receiver, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

7. Amendment of section 6155(b).—Section 6155(b)(2) of the Code, relating to cross references, would be amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

8. Amendment of section 6161(c).—Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, would be amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act).

9. Amendment of section 6216(1).—Section 6216(1), relating to cross references, would be amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy procedures.

10. Amendment of section 6326.—Section 6326 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

11. Amendment of section 6503(i).—Section 6503(i)(2), relating to cross references, would be amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running of period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

12. Amendment of section 6872.—Section 6872 of the Code, relating to suspension of period on assessment, would be amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

13. Amendment of section 7430.—Section 7430 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

14. Amendment of section 7508(d).—Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, would be amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

6. Effective date for provisions of section 6 of the bill

The provisions of section 6 of the bill (relating to changes in tax procedures) would be effective October 1, 1979, except that such provisions would not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

F. Revenue Effect

The revenue effect of the provisions of the bill, other than of those provisions of section 2 (tax treatment of discharge of indebtedness) which apply to solvent taxpayers outside bankruptcy, cannot be estimated with precision. However, it is estimated that the provisions of section 2 other than those applicable to solvent taxpayers outside bankruptcy would result in some revenue gain; that the provisions of section 3 (rules relating to title 11 cases for individuals) and of section 6 (changes in tax procedures) would have a negligible revenue effect; and that the provisions of section 4 and 5 (corporate reorganization provisions and miscellaneous corporate amendments) would result in some revenue loss.

It is not expected that these revenue effects would be significant during the next few fiscal years. This is because the provisions of the bill generally would apply only to bankruptcy cases or similar court proceedings beginning on or after October 1, 1979, to transactions occurring more than 90 days after the date of enactment, or to transactions occurring after December 31, 1980; because it can take considerable time for completion of bankruptcy cases or similar proceedings and of corporate insolvency reorganizations; and because the debt discharge rules of the bill generally would affect revenues in years subsequent to the year in which the debt discharge occurs.

It is estimated that those provisions of section 2 of the bill which apply to solvent taxpayers outside bankruptcy, and which would modify the election under sections 108 and 1017 of the Code to reduce basis of assets in lieu of recognizing income from discharge of indebtedness, would increase tax revenues by less than $5 million annually.

O

Internal Revenue Code

§ 108 Income from discharge of indebtedness.

(a) Exclusion from gross income.

(1) In general.

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged—

(i) before January 1, 2026, or

(ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.

(2) Coordination of exclusions.

(A) Title 11 exclusion takes precedence. Subparagraphs (B) , (C) , (D) , and (E) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion. Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(C) Principal residence exclusion takes precedence over insolvency exclusion unless elected otherwise. Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).

(3) Insolvency exclusion limited to amount of insolvency.

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes.

(1) In general.

The amount excluded from gross income under subparagraph (A) , (B) , or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2) .

(2) Tax attributes affected; order of reduction.

Except as provided in paragraph (5) , the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit. The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212 .

(E) Basis reduction.

(i) In general. The basis of the property of the taxpayer.

(ii) Cross reference. For provisions for making the reduction described in clause (i) , see section 1017 .

(F) Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27 .

(3) Amount of reduction.

(A) In general. Except as provided in subparagraph (B) , the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a) .

(B) Credit carryover reduction. The reductions described in subparagraphs (B) , (C) , and (G) shall be 33 ⅓ cents for each dollar excluded by subsection (a) . The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 ⅓ cents for each dollar excluded by subsection (a) .

(4) Ordering rules.

(A) Reductions made after determination of tax for year. The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (D) of paragraph (2) . The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the

carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

(C) Reductions under subparagraphs (B) and (G) of paragraph (2) . The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

(5) Election to apply reduction first against depreciable property.

(A) In general. The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

(B) Limitation. The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced. Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) Treatment of discharge of qualified real property business indebtedness.

(1) Basis reduction.

(A) In general. The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference. For provisions making the reduction described in subparagraph (A) , see section 1017 .

(2) Limitations.

(A) Indebtedness in excess of value. The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of—

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation. The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness.

The term "qualified real property business indebtedness" means indebtedness which—

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(C) with respect to which such taxpayer makes an election to have this paragraph apply.

Such term shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced.

(4) Qualified acquisition indebtedness.

For purposes of paragraph (3)(B) , the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A) , indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

(5) Regulations.

The Secretary shall issue such regulations as are necessary to carry out this subsection , including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) Meaning of terms; special rules relating to certain provisions.

(1) Indebtedness of taxpayer.

For purposes of this section , the term “indebtedness of the taxpayer” means any indebtedness—

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case.

For purposes of this section , the term “title 11 case” means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent.

For purposes of this section , the term “insolvent” means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

(4) Repealed.

(5) Depreciable property.

The term “depreciable property” has the same meaning as when used in section 1017 .

(6) Certain provisions to be applied at partner level.

In the case of a partnership, subsections (a) , (b) , (c) and (g) shall be applied at the partner level.

(7) Special rules for S corporation.

(A) Certain provisions to be applied at corporate level. In the case of an S corporation, subsections (a) , (b) , (c) , and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section .

(B) Reduction in carryover of disallowed losses and deductions. In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2) , any loss or

deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2) . For purposes of subsection (e)(6) , a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2) .

(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate.

In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.

(A) Time. An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent. An election referred to in subparagraph (A) , once made, may be revoked only with the consent of the Secretary.

(C) Manner. An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference.

For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1) .

(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency).

For purposes of this title—

(1) No other insolvency exception.

Except as otherwise provided in this section , there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions.

No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount.

The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor.

(A) Treated as acquisition by debtor. For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family. For purposes of this paragraph , sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related. For purposes of this paragraph , two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b) .

(5) Purchase-money debt reduction for solvent debtor treated as price reduction.

If—

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur—

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph , such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital.

Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital—

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

(7) Recapture of gain on subsequent sale of stock.

(A) In general. If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245 —

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor—

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange,

shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a) , 355(a) , or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers. In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation. For purposes of this paragraph , stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation. For purposes of this paragraph , the term “debtor corporation” includes a successor corporation.

(E) Partnership rule. Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporate stock or partnership interest.

For purposes of determining income of a debtor from discharge of indebtedness, if—

(A) a debtor corporation transfers stock, or

(B) a debtor partnership transfers a capital or profits interest in such partnership,

to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications.

Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c) .

(10) Indebtedness satisfied by issuance of debt instrument.

(A) In general. For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price. For purposes of subparagraph (A) , the issue price of any debt instrument shall be determined under sections 1273 and 1274 . For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(f) Student loans.

(1) In general.

In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan.

For purposes of this subsection , the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by—

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation—

(i) which is exempt from taxation under section 501(c)(3) ,

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made—

(i) pursuant to an agreement with any entity described in subparagraph (A) , (B) , or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a) .

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii) .

(3) Exception for discharges on account of services performed for certain lenders.

Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

(4) Payments under National Health Service Corps loan repayment program and certain State loan repayment programs.

In the case of an individual, gross income shall not include any amount received under section 338B(g) of the Public Health Service Act, under a State program described in section 338I of such Act, or under any other State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by such State).

(5) Special rule for discharges in 2021 through 2025.

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of—

(A) any loan provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by—

(i) the United States, or an instrumentality or agency thereof,

(ii) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or

(iii) an eligible educational institution (as defined in section 25A),

(B) any private education loan (as defined in section 140(a)(7) of the Truth in Lending Act),

(C) any loan made by any educational organization described in section 170(b)(1)(A)(ii) if such loan is made—

(i) pursuant to an agreement with any entity described in subparagraph (A) or any private education lender (as defined in section 140(a) of the Truth in Lending Act) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a) , or

(D) any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (C)(ii) .

The preceding sentence shall not apply to the discharge of a loan made by an organization described in subparagraph (C) or made by a private education lender (as

defined in section 140(a)(7) of the Truth in Lending Act) if the discharge is on account of services performed for either such organization or for such private education lender.

(g) Special rules for discharge of qualified farm indebtedness.

(1) Discharge must be by qualified person.

(A) In general. Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person. For purposes of subparagraph (A) , the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv) ; except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness.

For purposes of this section , indebtedness of a taxpayer shall be treated as qualified farm indebtedness if—

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets.

(A) In general. The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the sum of—

(i) the adjusted tax attributes of the taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(B) Adjusted tax attributes. For purposes of subparagraph (A) , the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A) , (B) , (C) , (D) , (F) , and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs

(B) , (C) , and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified property. For purposes of this paragraph , the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

(D) Coordination with insolvency exclusion. For purposes of this paragraph , the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B) .

(h) Special rules relating to qualified principal residence indebtedness.

(1) Basis reduction.

The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.

(2) Qualified principal residence indebtedness.

For purposes of this section , the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of section 163(h)(3)(B) , applied by substituting "$750,000 ($375,000" for "$1,000,000 ($500,000" in clause (ii) thereof and determined without regard to the substitution described in section 163(h)(3)(F)(i)(II)) with respect to the principal residence of the taxpayer.

(3) Exception for certain discharges not related to taxpayer's financial conditions.

Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

(4) Ordering rules.

If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness.

(5) Principal residences.

For purposes of this subsection , the term "principal residence" has the same meaning as when used in section 121 .

(i) Deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument.

(1) In general.

At the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument shall be includible in gross income ratably over the 5-taxable-year period beginning with—

(A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and

(B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs.

(2) Deferral of deduction for original issue discount in debt for debt exchanges.

(A) In general. If, as part of a reacquisition to which paragraph (1) applies, any debt instrument is issued for the applicable debt instrument being reacquired (or is treated as so issued under subsection (e)(4) and the regulations thereunder) and there is any original issue discount determined under subpart A of part V of subchapter P of this chapter with respect to the debt instrument so issued—

(i) except as provided in clause (ii) , no deduction otherwise allowable under this chapter shall be allowed to the issuer of such debt instrument with respect to the portion of such original issue discount which—

(I) accrues before the 1st taxable year in the 5-taxable-year period in which income from the discharge of indebtedness attributable to the reacquisition of the debt instrument is includible under paragraph (1) , and

(II) does not exceed the income from the discharge of indebtedness with respect to the debt instrument being reacquired, and

(ii) the aggregate amount of deductions disallowed under clause (i) shall be allowed as a deduction ratably over the 5-taxable-year period described in

clause (i)(I).

If the amount of the original issue discount accruing before such 1st taxable year exceeds the income from the discharge of indebtedness with respect to the applicable debt instrument being reacquired, the deductions shall be disallowed in the order in which the original issue discount is accrued.

(B) Deemed debt for debt exchanges. For purposes of subparagraph (A) , if any debt instrument is issued by an issuer and the proceeds of such debt instrument are used directly or indirectly by the issuer to reacquire an applicable debt instrument of the issuer, the debt instrument so issued shall be treated as issued for the debt instrument being reacquired. If only a portion of the proceeds from a debt instrument are so used, the rules of subparagraph (A) shall apply to the portion of any original issue discount on the newly issued debt instrument which is equal to the portion of the proceeds from such instrument used to reacquire the outstanding instrument.

(3) Applicable debt instrument.

For purposes of this subsection —

(A) Applicable debt instrument. The term “applicable debt instrument” means any debt instrument which was issued by—

(i) a C corporation, or

(ii) any other person in connection with the conduct of a trade or business by such person.

(B) Debt instrument. The term “debt instrument” means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1)).

(4) Reacquisition.

For purposes of this subsection —

(A) In general. The term “reacquisition” means, with respect to any applicable debt instrument, any acquisition of the debt instrument by—

(i) the debtor which issued (or is otherwise the obligor under) the debt instrument, or

(ii) a related person to such debtor.

(B) Acquisition. The term "acquisition" shall, with respect to any applicable debt instrument, include an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital. Such term shall also include the complete forgiveness of the indebtedness by the holder of the debt instrument.

(5) Other definitions and rules.

For purposes of this subsection —

(A) Related person. The determination of whether a person is related to another person shall be made in the same manner as under subsection (e)(4) .

(B) Election.

(i) In general. An election under this subsection with respect to any applicable debt instrument shall be made by including with the return of tax imposed by chapter 1 for the taxable year in which the reacquisition of the debt instrument occurs a statement which—

(I) clearly identifies such instrument, and

(II) includes the amount of income to which paragraph (1) applies and such other information as the Secretary may prescribe.

(ii) Election irrevocable. Such election, once made, is irrevocable.

(iii) Pass-thru entities. In the case of a partnership, S corporation, or other pass-thru entity, the election under this subsection shall be made by the partnership, the S corporation, or other entity involved.

(C) Coordination with other exclusions. If a taxpayer elects to have this subsection apply to an applicable debt instrument, subparagraphs (A), (B), (C), and (D) of subsection (a)(1) shall not apply to the income from the discharge of such indebtedness for the taxable year of the election or any subsequent taxable year.

(D) Acceleration of deferred items.

(i) In general. In the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 case, the day before the petition is filed).

(ii) Special rule for pass-thru entities. The rule of clause (i) shall also apply in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.

(6) Special rule for partnerships.

In the case of a partnership, any income deferred under this subsection shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge shall not be taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731 . Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.

(7) Secretarial authority.

The Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying this subsection , including—

(A) extending the application of the rules of paragraph (5)(D) to other circumstances where appropriate,

(B) requiring reporting of the election (and such other information as the Secretary may require) on returns of tax for subsequent taxable years, and

(C) rules for the application of this subsection to partnerships, S corporations, and other pass-thru entities, including for the allocation of deferred deductions.

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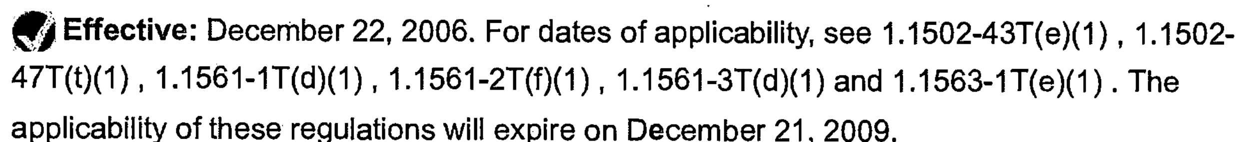
Reg §1.108-1 Stock-for-debt exception not to apply in de minimis cases.

Federal Regulations

Reg § 1.108-1. Stock-for-debt exception not to apply in de minimis cases.



Effective: December 22, 2006. For dates of applicability, see 1.1502-43T(e)(1) , 1.1502-47T(t)(1) , 1.1561-1T(d)(1) , 1.1561-2T(f)(1) , 1.1561-3T(d)(1) and 1.1563-1T(e)(1) . The applicability of these regulations will expire on December 21, 2009.

[Reserve]

T.D. 8532 , 3/17/94 , amend T.D. 9304 , 12/21/2006 .

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Reg §1.108-2 Acquisition of indebtedness by a person related to the debtor.

Federal Regulations

Reg § 1.108-2. Acquisition of indebtedness by a person related to the debtor.

Effective: December 28, 1992. Applicable to direct or indirect acquisitions of indebtedness occurring on or after March 21, 1991.

(a) General rules. The acquisition of outstanding indebtedness by a person related to the debtor from a person who is not related to the debtor results in the realization by the debtor of income from discharge of indebtedness (to the extent required by section 61(a)(12) and section 108) in an amount determined under paragraph (f) of this section. Income realized pursuant to the preceding sentence is excludible from gross income to the extent provided in section 108(a). The rules of this paragraph apply if indebtedness is acquired directly by a person related to the debtor in a direct acquisition (as defined in paragraph (b) of this section) or if a holder of indebtedness becomes related to the debtor in an indirect acquisition (as defined in paragraph (c) of this section).

(b) Direct acquisition. An acquisition of outstanding indebtedness is a direct acquisition under this section if a person related to the debtor (or a person who becomes related to the debtor on the date the indebtedness is acquired) acquires the indebtedness from a person who is not related to the debtor. Notwithstanding the foregoing, the Commissioner may provide by Revenue Procedure or other published guidance that certain acquisitions of indebtedness described in the preceding sentence are not direct acquisitions for purposes of this section.

(c) Indirect acquisition.

(1) In general. An indirect acquisition is a transaction in which a holder of outstanding indebtedness becomes related to the debtor, if the holder acquired the indebtedness in anticipation of becoming related to the debtor.

(2) Proof of anticipation of relationship. In determining whether indebtedness was acquired by a holder in anticipation of becoming related to the debtor, all relevant facts and circumstances will be considered. Such facts and circumstances include, but are not limited to, the intent of the parties at the time of the acquisition, the nature of any contacts between the parties (or their respective affiliates) before the acquisition, the period of time for which the holder held the indebtedness, and the significance of the indebtedness in proportion to the total assets of the holder group (as defined in paragraph (c)(5) of this section). For example, if a holder acquired the indebtedness in the ordinary course of its portfolio investment activities and the holder's acquisition of the indebtedness preceded any discussions concerning the acquisition of the holder by the debtor (or by a person related to the debtor) or the acquisition of the debtor by the holder (or by a person related to the holder), as the case may be, these facts, taken together, would ordinarily establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor. The absence of discussions between the debtor and the holder (or their respective affiliates), however, does not by itself establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor (if, for example, the facts and circumstances show that the holder was considering a potential acquisition of or by the debtor, or the relationship is created within a relatively short period of time of the acquisition, or the indebtedness constitutes a disproportionate portion of the holder group's assets).

(3) Indebtedness acquired within 6 months of becoming related. Notwithstanding any other provision of this paragraph (c), a holder of indebtedness is treated as having acquired the indebtedness in anticipation of becoming related to the debtor if the holder acquired the indebtedness less than 6 months before the date the holder becomes related to the debtor.

(4) Disclosure of potential indirect acquisition.

(i) In general. If a holder of outstanding indebtedness becomes related to the debtor under the circumstances described in paragraph (c)(4)(ii) or (iii) of this section, the debtor is required to attach the statement described in paragraph (c)(4)(iv) of this section to its tax return (or to a qualified amended return within the meaning of §1.6664-2(c)(3)) for the taxable year in which the debtor becomes related to the holder, unless the debtor reports its income on the basis that the holder acquired the indebtedness in anticipation of becoming related to the

debtor. Disclosure under this paragraph (c)(4) is in addition to, and is not in substitution for, any disclosure required to be made under section 6662, 6664 or 6694.

(ii) Indebtedness represents more than 25 percent of holder group's assets.

(A) In general. Disclosure under this paragraph (c)(4) is required if, on the date the holder becomes related to the debtor, indebtedness of the debtor represents more than 25 percent of the fair market value of the total gross assets of the holder group (as defined in paragraph (c)(5) of this section).

(B) Determination of total gross assets. In determining the total gross assets of the holder group, total gross assets do not include any cash, cash item, marketable stock or security, short-term indebtedness, option, futures contract, notional principal contract, or similar item (other than indebtedness of the debtor), nor do total gross assets include any asset in which the holder has substantially reduced its risk of loss. In addition, total gross assets do not include any ownership interest in or indebtedness of a member of the holder group.

(iii) Indebtedness acquired within 6 to 24 months of becoming related. Disclosure under this paragraph (c)(4) is required if the holder acquired the indebtedness 6 months or more before the date the holder becomes related to the debtor, but less than 24 months before that date.

(iv) Contents of statement. A statement under this paragraph (c)(4) must include the following—

(A) A caption identifying the statement as disclosure under § 1.108-2(c);

(B) An identification of the indebtedness with respect to which disclosure is made;

(C) The amount of such indebtedness and the amount of income from discharge of indebtedness if section 108(e)(4) were to apply;

(D) Whether paragraph (c)(4)(ii) or (iii) of this section applies to the transaction; and

(E) A statement describing the facts and circumstances supporting the debtor's position that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor.

(v) Failure to disclose. In addition to any other penalties that may apply, if a debtor fails to provide a statement required by this paragraph (c)(4), the holder is presumed to have acquired the indebtedness in anticipation of becoming related to the debtor unless the facts and circumstances clearly establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor.

(5) Holder group. For purposes of this paragraph (c), the holder group consists of the holder of the indebtedness and all persons who are both—

(i) Related to the holder before the holder becomes related to the debtor; and

(ii) Related to the debtor after the holder becomes related to the debtor.

(6) Holding period.

(i) Suspensions. The running of the holding periods set forth in paragraphs (c)(3) and (c)(4)(iii) of this section is suspended during any period in which the holder or any person related to the holder is protected (directly or indirectly) against risk of loss by an option, a short sale, or any other device or transaction.

(ii) Tacking. For purposes of paragraphs (c)(3) and (c)(4)(iii) of this section, the period for which a holder held the debtor's indebtedness includes—

(A) The period for which the indebtedness was held by a corporation to whose attributes the holder succeeded pursuant to section 381; and

(B) The period (ending on the date on which the holder becomes related to the debtor) for which the indebtedness was held continuously by members of the holder group (as defined in paragraph (c)(5) of this section).

(d) Definitions.

(1) Acquisition date. For purposes of this section, the acquisition date is the date on which a direct acquisition of indebtedness or an indirect acquisition of indebtedness occurs.

(2) Relationship. For purposes of this section, persons are considered related if they are related within the meaning of sections 267(b) or 707(b)(1). However—

(i) Sections 267(b) and 707(b)(1) are applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren; and

(ii) Two entities that are treated as a single employer under subsection (b) or (c) of section 414 are treated as having a relationship to each other that is described in section 267(b).

(e) Exceptions.

(1) Indebtedness retired within one year. This section does not apply to a direct or indirect acquisition of indebtedness with a stated maturity date on or before the date that is one year after the acquisition date, if the indebtedness is, in fact, retired on or before its stated maturity date.

(2) Acquisitions by securities dealers.

(i) This section does not apply to a direct acquisition or an indirect acquisition of indebtedness by a dealer that acquires and disposes of such indebtedness in the ordinary course of its business of dealing in securities if—

(A) The dealer accounts for the indebtedness as a security held primarily for sale to customers in the ordinary course of business;

(B) The dealer disposes of the indebtedness (or it matures while held by the dealer) within a period consistent with the holding of the indebtedness for sale to customers in the ordinary course of business, taking into account the terms of the indebtedness and the conditions and practices prevailing in the markets for similar indebtedness during the period in which it is held; and

(C) The dealer does not sell or otherwise transfer the indebtedness to a person related to the debtor (other than in a sale to a dealer that in turn meets the requirements of this paragraph (e)(2)).

(ii) A dealer will continue to satisfy the conditions of this paragraph (e)(2) with respect to indebtedness that is exchanged for successor indebtedness in a transaction in which unrelated holders also exchange indebtedness of the same issue, provided that the conditions of this paragraph (e)(2) are met with respect to the successor indebtedness.

(iii) For purposes of this paragraph (e)(2), if the period consistent with the holding of indebtedness for sale to customers in the ordinary course of business is 30 days or less, the dealer is considered to dispose of indebtedness within that period if the aggregate principal amount of indebtedness of that issue sold by the dealer to customers in the ordinary course of business (or that mature and are paid while held by the dealer) in the calendar month following the month in which

the indebtedness is acquired equals or exceeds the aggregate principal amount of indebtedness of that issue held in the dealer's inventory at the close of the month in which the indebtedness is acquired. If the period consistent with the holding of indebtedness for sale to customers in the ordinary course of business is greater than 30 days, the dealer is considered to dispose of the indebtedness within that period if the aggregate principal amount of indebtedness of that issue sold by the dealer to customers in the ordinary course of business (or that mature and are paid while held by the dealer) within that period equals or exceeds the aggregate principal amount of indebtedness of that issue held in inventory at the close of the day on which the indebtedness was acquired.

(f) Amount of discharge of indebtedness income realized.

(1) Holder acquired the indebtedness by purchase on or less than six months before the acquisition date. Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized under paragraph (a) of this section is measured by reference to the adjusted basis of the related holder (or of the holder that becomes related to the debtor) in the indebtedness on the acquisition date if the holder acquired the indebtedness by purchase on or less than six months before the acquisition date. For purposes of this paragraph (f), indebtedness is acquired "by purchase" if the indebtedness in the hands of the holder is not substituted basis property within the meaning of section 7701(a)(42). However, indebtedness is also considered acquired by purchase within six months before the acquisition date if the holder acquired the indebtedness as transferred basis property (within the meaning of section 7701(a)(43)) from a person who acquired the indebtedness by purchase on or less than six months before the acquisition date.

(2) Holder did not acquire the indebtedness by purchase on or less than six months before the acquisition date. Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized under paragraph (a) of this section is measured by reference to the fair market value of the indebtedness on the acquisition date if the holder (or the transferor to the holder in a transferred basis transaction) did not acquire the indebtedness by purchase on or less than six months before the acquisition date.

(3) Acquisitions of indebtedness in nonrecognition transactions. [Reserved]

(4) Avoidance transactions. The amount of discharge of indebtedness income realized by the debtor under paragraph (a) of this section is measured by reference to the fair market value of the indebtedness on the acquisition date if the indebtedness is

acquired in a direct or an indirect acquisition in which a principal purpose for the acquisition is the avoidance of federal income tax.

(g) Correlative adjustments.

(1) Deemed issuance. For income tax purposes, if a debtor realizes income from discharge of its indebtedness in a direct or an indirect acquisition under this section (whether or not the income is excludible under section 108(a)), the debtor's indebtedness is treated as new indebtedness issued by the debtor to the related holder on the acquisition date (the deemed issuance). The new indebtedness is deemed issued with an issue price equal to the amount used under paragraph (f) of this section to compute the amount realized by the debtor under paragraph (a) of this section (i.e., either the holder's adjusted basis or the fair market value of the indebtedness, as the case may be). Under section 1273(a)(1), the excess of the stated redemption price at maturity (as defined in section 1273(a)(2)) of the indebtedness over its issue price is original issue discount (OID) which, to the extent provided in sections 163 and 1272, is deductible by the debtor and includible in the gross income of the related holder. Notwithstanding the foregoing, the Commissioner may provide by Revenue Procedure or other published guidance that the indebtedness is not treated as newly issued indebtedness for purposes of designated provisions of the income tax laws.

(2) Treatment of related holder. The related holder does not recognize any gain or loss on the deemed issuance described in paragraph (g)(1) of this section. The related holder's adjusted basis in the indebtedness remains the same as it was immediately before the deemed issuance. The deemed issuance is treated as a purchase of the indebtedness by the related holder for purposes of section 1272(a)(7) (pertaining to reduction of original issue discount where a subsequent holder pays acquisition premium) and section 1276 (pertaining to acquisitions of debt at a market discount).

(3) Loss deferral on disposition of indebtedness acquired in certain exchanges.

(i) Any loss otherwise allowable to a related holder on the disposition at any time of indebtedness acquired in a direct or indirect acquisition (whether or not any discharge of indebtedness income was realized under paragraph (a) of this section) is deferred until the date the debtor retires the indebtedness if—

(A) The related holder acquired the debtor's indebtedness in exchange for its own indebtedness; and

(B) The issue price of the related holder's indebtedness was not determined by reference to its fair market value (e.g., the issue price was determined

under section 1273(b)(4) or 1274(a) or any other provision of applicable law).

(ii) Any comparable tax benefit that would otherwise be available to the holder, debtor, or any person related to either, in any other transaction that directly or indirectly results in the disposition of the indebtedness is also deferred until the date the debtor retires the indebtedness.

(4) Examples. The following examples illustrate the application of this paragraph (g). In each example, all taxpayers are calendar-year taxpayers, no taxpayer is insolvent or under the jurisdiction of a court in a title 11 case and no indebtedness is qualified farm indebtedness described in section 108(g).

Example (1).

(i) P, a domestic corporation, owns 70 percent of the single class of stock of S, a domestic corporation. S has outstanding indebtedness that has an issue price of $10,000,000 and provides for monthly interest payments of $80,000 payable at the end of each month and a payment at maturity of $10,000,000. The indebtedness has a stated maturity date of December 31, 1994. On January 1, 1992, P purchases S's indebtedness from I, an individual not related to S within the meaning of paragraph (d)(2) of this section, for cash in the amount of $9,000,000. S repays the indebtedness in full at maturity.

(ii) Under section 61(a)(12), section 108(e)(4), and paragraphs (a) and (f) of this section, S realizes $1,000,000 of income from discharge of indebtedness on January 1, 1992.

(iii) Under paragraph (g)(1) of this section, the indebtedness is treated as issued to P on January 1, 1992, with an issue price of $9,000,000. Under section 1273(a), the $1,000,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its issue price ($9,000,000) is original issue discount, which is includible in gross income by P and deductible by S over the remaining term of the indebtedness under sections 163(e) and 1272(a).

(iv) Accordingly, S deducts and P includes in income original issue discount, in addition to stated interest, as follows: in 1992, $289,144.88; in 1993, $331,286.06; and in 1994, $379,569.06.

Example (2). The facts are the same as in Example 1, except that on January 1, 1993, P sells S's indebtedness to J, who is not related to S within the meaning of paragraph (d)(2) of this section, for $9,400,000 in cash. J holds S's indebtedness to maturity. On

January 1, 1993, P's adjusted basis in S's indebtedness is $9,289,144.88. Accordingly, P realizes gain in the amount of $110,855.12 upon the disposition. S and J continue to deduct and include the original issue discount on the indebtedness in accordance with Example 1. The amount of original issue discount includible by J is reduced by the $110,855.12 acquisition premium as provided in section 1272(a)(7).

Example (3). The facts are the same as in Example 1, except that on February 1, 1992 (one month after P purchased S's indebtedness), S retires the indebtedness for an amount of cash equal to the fair market value of the indebtedness. Assume that the fair market value of the indebtedness is $9,022,621.41, which in this case equals the issue price of the indebtedness determined under paragraph (g)(1) of this section ($9,000,000) plus the accrued original issue discount through February 1 ($22,621.41). Section 1.61-12(c)(3) provides that if indebtedness is repurchased for a price that is exceeded by the issue price of the indebtedness plus the amount of discount already deducted, the excess is income from discharge of indebtedness. Therefore, S does not realize income from discharge of indebtedness. The result would be the same if P had contributed the indebtedness to the capital of S. Under section 108(e)(6), S would be treated as having satisfied the indebtedness with an amount of money equal to P's adjusted basis and, under section 1272(d)(2), P's adjusted basis is equal to $9,022,621.41.

Example (4).

(i) P, a domestic corporation, owns 70 percent of the single class of stock of S, a domestic corporation. On January 1, 1986, P issued indebtedness that has an issue price of $5,000,000 and provides for no stated interest payments and a payment at maturity of $10,000,000. The indebtedness has a stated maturity date of December 31, 1995. On January 1, 1992, S purchases P's indebtedness from K, a partnership not related to P within the meaning of paragraph (d)(2) of this section, for cash in the amount of $6,000,000. The sum of the debt's issue price and previously deducted original issue discount is $7,578,582.83. P repays the indebtedness in full at maturity.

(ii) Under section 61(a)(12), section 108(e)(4), and paragraphs (a) and (f) of this section, P realizes $1,578,582.83 in income from discharge of indebtedness ($7,578,582.83 minus $6,000,000) on January 1, 1992.

(iii) Under paragraph (g)(1) of this section, the indebtedness is treated as issued to S on January 1, 1992, with an issue price of $6,000,000. Under section 1273(a), the $4,000,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its issue price ($6,000,000) is original issue discount, which is

includible in gross income by S and deductible by P over the remaining term of the indebtedness under sections 163(e) and 1272(a).

(iv) Accordingly, P deducts and S includes in income original issue discount as follows: in 1992, $817,316.20; in 1993, $928,650.49; in 1994, $1,055,150.67; and in 1995, $1,198,882.64.

(h) Effective date. This section applies to any transaction described in paragraph (a) and in either paragraph (b) or (c) of this section with an acquisition date on or after March 21, 1991. Although this section does not apply to direct or indirect acquisitions occurring before March 21, 1991, section 108(e)(4) is effective for any transaction after December 31, 1980, subject to the rules of section 7 of the Bankruptcy Tax Act of 1980 (Pub. L. 96-589, 94 Stat. 3389, 3411). Taxpayers may use any reasonable method of determining the amount of discharge of indebtedness income realized and the treatment of correlative adjustments under section 108(e)(4) for acquisitions of indebtedness before March 21, 1991, if such method is applied consistently by both the debtor and related holder.

T.D. 8460 , 12/28/92 .

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Federal Regulations

Reg § 1.108-3. Intercompany losses and deductions.

Effective: July 18, 1995.

(a) General rule. This section applies to certain losses and deductions from the sale, exchange, or other transfer of property between corporations that are members of a consolidated group or a controlled group (an intercompany transaction). See section 267(f) (controlled groups) and §1.1502-13 (consolidated groups) for applicable definitions. For purposes of determining the attributes to which section 108(b) applies, a loss or deduction not yet taken into account under section 267(f) or §1.1502-13 (an intercompany loss or deduction) is treated as basis described in section 108(b) that the transferor retains in property. To the extent a loss not yet taken into account is reduced under this section, it cannot subsequently be taken into account under section 267(f) or §1.1502-13. For example, if S and B are corporations filing a consolidated return, and S sells land with a $100 basis to B for $90 and the $10 loss is deferred under section 267(f) and §1.1502-13, the deferred loss is treated for purposes of section 108(b) as $10 of basis that S has in land (even though S has no remaining interest in the land sold to B) and is subject to reduction under section 108(b)(2)(E). Similar principles apply, with appropriate adjustments, if S and B are members of a controlled group and S's loss is deferred only under section 267(f).

(b) Effective date. This section applies with respect to discharges of indebtedness occurring on or after September 11, 1995.

T.D. 8597 , 7/12/95 .

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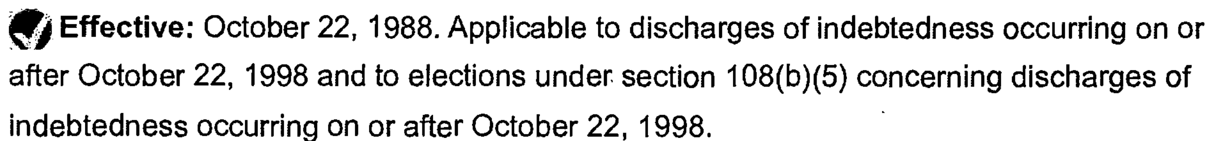
Federal Regulations

Reg § 1.108-4. Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code.



Effective: October 22, 1988. Applicable to discharges of indebtedness occurring on or after October 22, 1998 and to elections under section 108(b)(5) concerning discharges of indebtedness occurring on or after October 22, 1998.

(a) Description. An election under section 108(b)(5) is available whenever a taxpayer excludes discharge of indebtedness income (COD income) from gross income under sections 108(a)(1)(A), (B), or (C) (concerning title 11 cases, insolvency, and qualified farm indebtedness, respectively). See sections 108(d)(2) and (3) for the definitions of title 11 case and insolvent. See section 108(g)(2) for the definition of qualified farm indebtedness.

(b) Time and manner. To make an election under section 108(b)(5), a taxpayer must enter the appropriate information on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and attach the form to the timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this section may be revoked only with the consent of the Commissioner.

(c) Effective date. This section applies to elections concerning discharges of indebtedness occurring on or after October 22, 1998.

T.D. 8787 , 10/21/98 .

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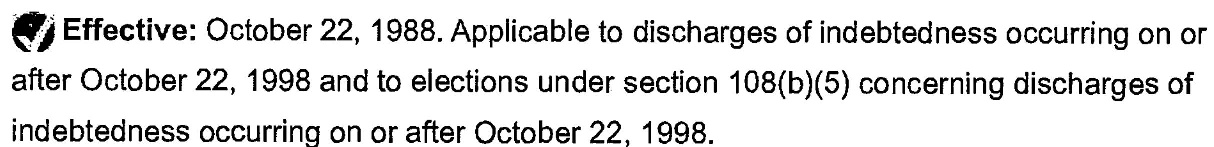
Federal Regulations

Reg § 1.108-5. Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.



Effective: October 22, 1988. Applicable to discharges of indebtedness occurring on or after October 22, 1998 and to elections under section 108(b)(5) concerning discharges of indebtedness occurring on or after October 22, 1998.

(a) Description. Section 108(c)(3)(C), as added by section 13150 of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, 107 Stat. 446), allows certain noncorporate taxpayers to elect to treat certain indebtedness described in section 108(c)(3) that is discharged after December 31, 1992, as qualified real property business indebtedness. This discharged indebtedness is excluded from gross income to the extent allowed by section 108.

(b) Time and manner for making election. The election described in this section must be made on the timely-filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible from gross income under section 108(a). The election is to be made on a completed Form 982, in accordance with that Form and its instructions.

(c) Revocability of election. The election described in this section is revocable with the consent of the Commissioner.

(d) Effective date. The rules set forth in this section are effective December 27, 1993.

T.D. 8688 , 12/11/96 , amend T.D. 8787 , 10/21/98 .

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26 CFR § 1.108-6 - Limitations on the exclusion of income from the discharge of qualified real property business indebtedness.

CFR

§ 1.108-6 Limitations on the exclusion of income from the discharge of qualified real property business indebtedness.

(a) ***Indebtedness in excess of value.*** With respect to any qualified real property business indebtedness that is discharged, the amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in § 1.1017-1(c)(1), immediately before the discharge. For purposes of this section, *net fair market value* means the fair market value of the qualifying real property (notwithstanding section 7701(g)), reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge. Also, for purposes of section 108(c)(2)(A) and this section, outstanding principal amount means the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound

in the future, except that outstanding principal amount shall not include amounts that are subject to section 108(e)(2) and shall be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).

(b) ***Overall limitation.*** The amount excluded from gross income under section 108(a)(1)(D) shall not exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any—

(1) Depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under section 108(a)(1)(D); and

(2) Reductions to the adjusted bases of depreciable real property required under section 108(b) or section 108(g) for the same taxable year.

(c) ***Effective date.*** This section applies to discharges of qualified real property business indebtedness occurring on or after October 22, 1998.

[T.D. 8787, 63 FR 56563, Oct. 22, 1998]

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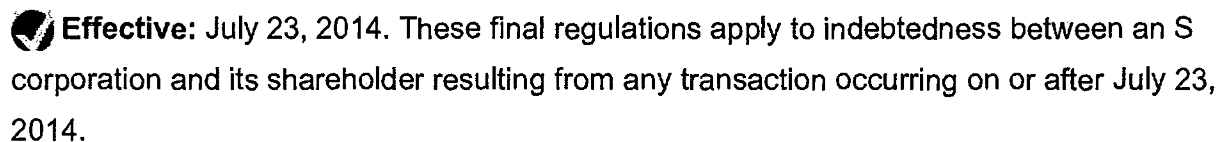
Federal Regulations

Reg § 1.108-7. Reduction of attributes.


Effective: July 23, 2014. These final regulations apply to indebtedness between an S corporation and its shareholder resulting from any transaction occurring on or after July 23, 2014.

(a) In general.

(1) If a taxpayer excludes discharge of indebtedness income (COD income) from gross income under section 108(a)(1)(A), (B), or (C), then the amount excluded shall be applied to reduce the following tax attributes of the taxpayer in the following order:

(i) Net operating losses.

(ii) General business credits.

(iii) Minimum tax credits.

(iv) Capital loss carryovers.

(v) Basis of property.

(vi) Passive activity loss and credit carryovers.

(vii) Foreign tax credit carryovers.

(2) The taxpayer may elect under section 108(b)(5), however, to apply any portion of the excluded COD income to reduce first the basis of depreciable property to the extent the excluded COD income is not so applied, the taxpayer must then reduce any remaining tax attributes in the order specified in section 108(b)(2). If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income. For rules relating to basis reductions required by sections 108(b)(2)(E) and 108(b)(5), see sections 1017 and 1.1017-1. For rules relating to the time and manner for making an election under section 108(b)(5), see § 1.108-4.

(b) Carryovers and carrybacks. The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.

(c) Transactions to which section 381 applies. If a taxpayer realizes COD income that is excluded from gross income under section 108(a) either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in section 381(a), any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the distribution or transfer of assets, including basis of property, will be available for reduction under section 108(b)(2). However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets shall not be available for reduction under section 108(b)(2).

(d) Special rules for S corporations.

(1) In general. If an S corporation excludes COD income from gross income under section 108(a)(1)(A), (B), or (C), the amount excluded shall be applied to reduce the S corporation's tax attributes under paragraph (a)(1) of this section. For purposes of paragraph (a)(1)(i) of this section, the aggregate amount of the shareholders' losses or deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), including disallowed losses or deductions of a shareholder that transfers all of the shareholder's stock in the S corporation during the taxable year of the discharge, is treated as the net operating loss tax attribute (deemed NOL) of the S corporation for the taxable year of the discharge.

(2) Allocation of excess losses or deductions.

(i) In general. If the amount of an S corporation's deemed NOL exceeds the amount of the S corporation's COD income that is excluded from gross income under section 108(a)(1)(A), (B), or (C), the excess deemed NOL shall be allocated to the shareholder or shareholders of the S corporation as a loss or deduction that is disallowed under section 1366(d) for the taxable year of the discharge.

(ii) Multiple shareholders—

(A) In general. If an S corporation has multiple shareholders, to determine the amount of the S corporation's excess deemed NOL to be allocated to each shareholder under paragraph (d)(2)(i) of this section, calculate with respect to each shareholder the shareholder's excess amount. The shareholder's excess amount is the amount (if any) by which the shareholder's losses or deductions disallowed under section 1366(d)(1) (before any reduction under paragraph (a)(1) of this section) exceed the amount of COD income that would have been taken into account by that shareholder under section 1366(a) had the COD income not been excluded under section 108(a).

(B) Shareholders with a shareholder's excess amount. Each shareholder that has a shareholder's excess amount, as determined under paragraph (d)(2)(ii)(A) of this section, is allocated an amount equal to the S corporation's excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts.

(C) Shareholders with no shareholder's excess amount. If a shareholder does not have a shareholder's excess amount as determined in paragraph (d)(2)(ii)(A) of this section, none of the S corporation's excess deemed NOL shall be allocated to that shareholder.

(iii) Terminating shareholder. Any amount of the S corporation's excess deemed NOL allocated under paragraph (d)(2) of this section to a shareholder that had transferred all of the shareholder's stock in the corporation during the taxable year of the discharge is permanently disallowed under §1.1366-2(a)(6), unless the transfer of stock is described in section 1041(a). If the transfer of stock is described in section 1041(a), the amount of the S corporation's excess deemed NOL allocated to the transferor under paragraph (d)(2) of this section shall be

treated as a loss or deduction incurred by the corporation in the succeeding taxable year with respect to the transferee. See section 1366(d)(2)(B).

(3) Character of excess losses or deductions allocated to a shareholder. The character of an S corporation's excess deemed NOL that is allocated to a shareholder under paragraph (d)(2) of this section consists of a proportionate amount of each item of the shareholder's loss or deduction that is disallowed for the taxable year of the discharge under section 1366(d)(1).

(4) Information requirements. If an S corporation excludes COD income from gross income under section 108(a) for a taxable year, each shareholder of the S corporation during the taxable year of the discharge must report to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), even if that amount is zero. If a shareholder fails to report the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1) to the S corporation, or if the S corporation knows that the amount reported by the shareholder is inaccurate, or if the information, as reported, appears to be incomplete or incorrect, the S corporation may rely on its own books and records, as well as other information available to the S corporation, to determine the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), provided that the S corporation knows or reasonably believes that its information presents an accurate reflection of the shareholder's disallowed losses and deductions under section 1366(d)(1). The S corporation must report to each shareholder the amount of the S corporation's excess deemed NOL that is allocated to that shareholder under paragraph (d)(2) of this section, even if that amount is zero, in accordance with applicable forms and instructions.

(e) Examples. The following examples illustrate the application of this section:

Example (1).

(i) Facts. In Year 4, X, a corporation in a title 11 case, is entitled under section 108(a)(1)(A) to exclude from gross income $100,000 of COD income. For Year 4, X has gross income in the amount of $50,000. In each of Years 1 and 2, X had no taxable income or loss. In Year 3, X had a net operating loss of $100,000, the use of which when carried over to Year 4 is not subject to any restrictions other than those of section 172.

(ii) Analysis. Pursuant to paragraph (b) of this section, X takes into account the net operating loss carryover from Year 3 in computing its taxable income for Year 4 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes.

Thus, the amount of the net operating loss carryover that is reduced under section 108(b)(2) and paragraph (a) of this section is $50,000.

Example (2).

(i) Facts. The facts are the same as in Example 1, except that in Year 4 X sustains a net operating loss in the amount of $100,000. In addition, in each of Years 2 and 3, X reported taxable income in the amount of $25,000.

(ii) Analysis. Pursuant to paragraph (b) of this section and section 172, the net operating loss sustained in Year 4 is carried back to Years 2 and 3 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss that is reduced under section 108(b)(2) and paragraph (a) of this section is $50,000.

Example (3).

(i) Facts. In Year 2, X, a corporation in a title 11 case, has outstanding debts of $200,000 and a depreciable asset that has an adjusted basis of $75,000 and a fair market value of $100,000. X has no other assets or liabilities. X has a net operating loss of $80,000 that is carried over to Year 2 but has no general business credit, minimum tax credit, or capital loss carryovers. Under a plan of reorganization, X transfers its asset to Corporation Y in exchange for Y stock with a value of $100,000. X distributes the Y stock to its creditors in exchange for release of their claims against X. X's shareholders receive nothing in the transaction. The transaction qualifies as a reorganization under section 368(a)(1)(G) that satisfies the requirements of section 354(b)(1)(A) and (B). For Year 2, X has gross income of $10,000 (without regard to any income from the discharge of indebtedness) and is allowed a depreciation deduction of $10,000 in respect of the asset. In addition, it generates no general business credits.

(ii) Analysis. On the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of $100,000. (Under section 108(e)(8), X is treated as satisfying $100,000 of the debt owed the creditors for $100,000, the fair market value of the Y stock transferred to those creditors.) In Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by $10,000 to $65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). Pursuant to paragraph (a) of this section, X's net operating loss carryover in the amount of $80,000 is reduced by $80,000 of the COD income excluded under section 108(a)(1). In addition, X's

basis in the asset is reduced by $20,000, the extent to which the COD income excluded under section 108(a)(1) did not reduce the net operating loss. Accordingly, as a result of the reorganization, there is no net operating loss to which Y succeeds under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is $45,000.

Example (4).

(i) Facts. The facts are the same as in Example 3, except that X elects under section 108(b)(5) to reduce first the basis of its depreciable asset.

(ii) Analysis. As in Example 3, on the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of $100,000. In addition, in Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by $10,000 to $65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). As a result of the election under section 108(b)(5), X's basis in the asset is reduced by $65,000 to $0. In addition, X's net operating loss is reduced by $35,000, the extent to which the amount excluded from income under section 108(a)(1)(A) does not reduce X's asset basis. Accordingly, as a result of the reorganization, Y succeeds to X's net operating loss in the amount of $45,000 under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is $0.

Example (5).

(i) Facts. During the entire calendar year 2009, A, B, and C each own equal shares of stock in X, a calendar year S corporation. As of December 31, 2009, A, B, and C each have a zero stock basis and X does not have any indebtedness to A, B, or C. For the 2009 taxable year, X excludes from gross income $45,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated $15,000 to A, $15,000 to B, and $15,000 to C under section 1366(a). For the 2009 taxable year, X has $30,000 of losses and deductions that X passes through pro rata to A, B, and C in the amount of $10,000 each. The losses and deductions that pass through to A, B, and C are disallowed under section 1366(d)(1). In addition, B has $10,000 of section 1366(d) losses from prior years and C has $20,000 of section 1366(d) losses from prior years. A's ($10,000), B's ($20,000) and C's ($30,000) combined $60,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute of X under section 108(d)(7)(B) (deemed NOL) for purposes of the section 108(b) reduction of tax attributes.

(ii) Allocation. Under section 108(b)(2)(A), X's $45,000 of excluded COD income reduces the $60,000 deemed NOL to $15,000. Therefore, X has a $15,000 excess net operating loss (excess deemed NOL) to allocate to its shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the $15,000 excess deemed NOL is allocated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction ($10,000) do not exceed A's share of the excluded COD income for 2008 ($15,000). Thus, A has no shareholder's excess amount. Each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2008. B's excess amount is $5,000 ($20,000 - $15,000) and C's excess amount is $15,000 ($30,000 - $15,000). Therefore, the total of all shareholders' excess amounts is $20,000. Under paragraph (d)(2) of this section, X will allocate $3,750 of the $15,000 excess deemed NOL to B ($15,000 x $5,000 / $20,000) and $11,250 of the $15,000 excess deemed NOL to C ($15,000 x $15,000 / $20,000). These amounts are treated as losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge. Accordingly, at the beginning of 2010, A has no section 1366(d)(2) carryovers, B has $3,750 of carryovers, and C has $11,250 of carryovers.

(iii) Character. Immediately prior to the section 108(b)(2)(A) reduction, B's $20,000 of section 1366(d) losses and deductions consisted of $8,000 of longterm capital losses, $7,000 of section 1231 losses, and $5,000 of ordinary losses. After the section 108(b)(2)(A) tax attribute reduction, X will allocate $3,750 of the excess deemed NOL to B. Under paragraph (d)(3) of this section, the $3,750 excess deemed NOL allocated to B consists of $1,500 of long-term capital losses (($8,000 / $20,000) x $3,750), $1,312.50 of section 1231 losses (($7,000 / $20,000) x $3,750), and $937.50 of ordinary losses (($5,000 / $20,000) x $3,750). As a result, at the beginning of 2010, B's $3,750 of section 1366(d)(2) carryovers consist of $1,500 of long-term capital losses, $1,312.50 of section 1231 losses, and $937.50 of ordinary losses.

Example (6).

(i) A and B each own 50 percent of the shares of stock in X, a calendar year S corporation. On March 1, 2009, X realizes $12,000 of COD income and excludes this amount from gross income under section 108(a)(1)(A) for X's 2009 taxable year. On June 30, 2009, A sells all of her shares of stock in X to C in a transfer not described in section 1041(a). X does not make a terminating election under section 1377(a)(2). The COD income (had it not been excluded) would have been allocated $3,000 to A, $6,000 to B, and $3,000 to C under section 1366(a). Prior to the section 108(b)(2)(A) reduction, for the taxable year of the discharge the shareholders have disallowed losses and deductions under section 1366(d) (including disallowed losses carried over to the current year under section 1366(d)(2)) in the following

amounts: A - $5,000, B - $13,000, and C - $2,000. The combined $20,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute of X under section 108(d)(7)(B) (deemed NOL).

(ii) Under section 108(b)(2)(A), X's $12,000 of excluded COD income reduces the $20,000 deemed NOL to $8,000. Therefore, X has an $8,000 excess net operating loss (excess deemed NOL) to allocate to its shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the $8,000 excess deemed NOL is allocated to C because C's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction ($2,000) do not exceed C's share of the excluded COD income for 2008 ($3,000). However, each of A's and B's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of A's and B's respective shares of the excluded COD income for 2009. A's excess amount is $2,000 ($5,000 -$3,000) and B's excess amount is $7,000 ($13,000 - $6,000). Therefore, the total of all shareholders' excess amounts is $9,000. Under paragraph (d)(2) of this section, X will allocate $1,777.78 of the $8,000 excess deemed NOL to A ($8,000 x $2,000 / $9,000) and $6,222.22 of the $8,000 excess deemed NOL to B ($8,000 x $7,000 / $9,000). However, because A transferred all of her shares of stock in X in a transaction not described in section 1041(a), A's $1,777.78 of section 1366(d) losses and deductions are permanently disallowed under paragraph (d)(2)(iii) of this section. Accordingly, at the beginning of 2010, B has $6,222.22 of section 1366(d)(2) carryovers and C has no section 1366(d)(2) carryovers.

Example (7). The facts are the same as in Example 6, except that X, with the consent of A and C, makes a terminating election under section 1377(a)(2) upon A's sale of her stock in X to C. Therefore, the COD income (had it not been excluded) would have been allocated $6,000 to A, $6,000 to B, and $0 to C. Under paragraph (d)(2)(ii)(C) of this section, none of the $8,000 excess deemed NOL is allocated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction ($5,000) do not exceed A's share of the excluded COD income for 2009 ($6,000). However, each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2009. B's excess amount is $7,000 ($13,000 -$6,000), C's excess amount is $2,000 ($2,000 - $0). Therefore, the total of all shareholders' excess amounts is $9,000. Under paragraph (d)(2) of this section, X will allocate $6,222.22 of the $8,000 excess deemed NOL to B ($8,000 x $7,000 / $9,000) and $1,777.78 of the $8,000 excess deemed NOL to C. Accordingly, at the beginning of 2010, B has $6,222.22 of section 1366(d)(2) carryovers and C has $1,777.78 of section 1366(d)(2) carryovers.

(f) Effective/applicability date

(1) Paragraphs (a), (b), (c), and Examples 1, 2, 3, and 4 of paragraph (e) of this section apply to discharges of indebtedness occurring on or after May 10, 2004.

(2) Paragraph (d) and Examples 5, 6, and 7 of paragraph (e) of this section apply to discharges of indebtedness occurring on or after October 30, 2009. Paragraph (d)(2)(iii) of this section applies on and after July 23, 2014. For rules that apply before that date, see 26 CFR part 1 (revised as of April 1, 2014).

T.D. 9080 , 7/17/2003 , amend T.D. 9127 , 5/10/2004 , T.D. 9469 , 10/29/2009 , T.D. 9682 , 7/22/2014 .

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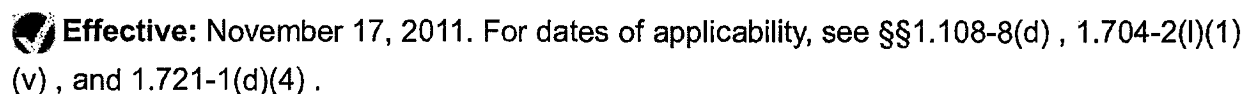
Federal Regulations

Reg § 1.108-8. Indebtedness satisfied by partnership interest.



Effective: November 17, 2011. For dates of applicability, see §§1.108-8(d) , 1.704-2(l)(1)(v) , and 1.721-1(d)(4) .

(a) In general. For purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

(b) Determination of fair market value.

(1) In general. All the facts and circumstances are considered in determining the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) for purposes of paragraph (a) of this section. If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference.

(2) Safe harbor.

(i) General rule. For purposes of paragraph (a) of this section, the fair market value of a debt-for-equity interest is deemed to be equal to the liquidation value of

the debt-for-equity interest, as defined in paragraph (b)(2)(iii) of this section, if the following requirements are satisfied—

(A) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(B) If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

(C) The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

(D) Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.

(ii) Tiered-partnership rule. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest in a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)) is determined by taking into account the liquidation value of such lower-tier partnership interests.

(iii) Definition of liquidation value. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets and then liquidated.

(c) Example. The following example illustrates the provisions of this section:

Example.

(i) AB partnership has $1,000 of outstanding indebtedness owed to C. C agrees to transfer to AB partnership the $1,000 indebtedness in a debt-for-equity exchange for a debt-for-equity interest in AB partnership. The liquidation value of C's debt-for-equity interest is $700, which is the amount of cash that C would receive with respect to that interest if, immediately after the debt-for-equity exchange, AB partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated. Each of the requirements of the liquidation value safe harbor described in paragraph (b)(2) of this section is satisfied.

(ii) Because the requirements in paragraph (b)(2) of this section are satisfied, the fair market value of C's debt-for-equity interest in AB partnership for purposes of determining AB partnership's COD income is the liquidation value of C's debt-for-equity interest, or $700. Accordingly, AB partnership is treated as satisfying the $1,000 indebtedness for $700 under section 108(e)(8).

(d) Effective/applicability date. This section applies to debt-for-equity exchanges occurring on or after November 17, 2011.

T.D. 9557 , 11/15/2011 .

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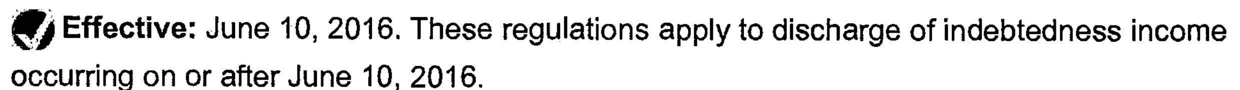
Federal Regulations

Reg § 1.108-9. Application of the bankruptcy and the insolvency provisions of section 108 to grantor trusts and disregarded entities..



Effective: June 10, 2016. These regulations apply to discharge of indebtedness income occurring on or after June 10, 2016.

(a) General rule.

(1) Owner is the taxpayer. For purposes of applying section 108(a)(1)(A) and (B) to discharge of indebtedness income of a grantor trust or a disregarded entity, neither the grantor trust nor the disregarded entity shall be considered to be the "taxpayer," as that term is used in section 108(a)(1) and (d)(1) through (3). Rather, for purposes of section 108(a)(1)(A) and (B) and (d)(1) through (3) and subject to section 108(d)(6), the owner of the grantor trust or the owner of the disregarded entity is the "taxpayer."

(2) The bankruptcy exclusion. If indebtedness of a grantor trust or a disregarded entity is discharged in a title 11 case, section 108(a)(1)(A) applies to that discharged indebtedness only if the owner of the grantor trust or the owner of the disregarded entity is under the jurisdiction of the court in a title 11 case as the title 11 debtor. If the grantor trust or the disregarded entity is under the jurisdiction of the court in a title 11 case as the title 11 debtor, but the owner of the grantor trust or the owner of the disregarded entity is not, section 108(a)(1)(A) does not apply to the discharge of indebtedness income.

(3) The insolvency exclusion. Section 108(a)(1)(B) applies to the discharged indebtedness of a grantor trust or a disregarded entity only to the extent the owner of the grantor trust or the owner of the disregarded entity is insolvent. If the grantor trust or the disregarded entity is insolvent, but the owner of the grantor trust or the owner of the disregarded entity is solvent, section 108(a)(1)(B) does not apply to the discharge of indebtedness income.

(b) Application to partnerships. Under section 108(d)(6), in the case of a partnership, section 108(a)(1)(A) and (B) applies at the partner level. If a partnership holds an interest in a grantor trust or a disregarded entity, the applicability of section 108(a)(1)(A) and (B) to the discharge of indebtedness income is tested by looking to each partner to whom the income is allocable.

(c) Definitions.

(1) Disregarded entity. For purposes of this section, a disregarded entity is an entity that is disregarded as an entity separate from its owner for Federal income tax purposes. See §301.7701-2(c)(2)(i) of this chapter, the Procedure and Administration Regulations. Examples of disregarded entities include a domestic single-member limited liability company that does not elect to be classified as a corporation for Federal income tax purposes pursuant to §301.7701-3 of this chapter, a corporation that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(2) Grantor trust. For purposes of this section, a grantor trust is any portion of a trust that is treated under subpart E of part I of subchapter J of chapter 1 of subtitle A of title 26 of the United States Code as being owned by the grantor or another person.

(3) Owner. Notwithstanding any other provision of this section to the contrary, neither a grantor trust nor a disregarded entity shall be considered an owner for purposes of this section.

(4) Title 11 debtor. For purposes of this section, a title 11 debtor is a debtor in a case under title 11 of the United States Code, as defined in 11 U.S.C. 101(13).

(d) Applicability date. The rules of this section apply to discharge of indebtedness income occurring on or after June 10, 2016.

T.D. 9771 , 6/9/2016

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§1398 Rules relating to individuals' title 11 cases.

Internal Revenue Code

§ 1398 Rules relating to individuals' title 11 cases.

(a) Cases to which section applies.

Except as provided in subsection (b) , this section shall apply to any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual.

(b) Exceptions where case is dismissed, etc.

(1) Section does not apply where case is dismissed.

This section shall not apply if the case under chapter 7 or 11 of title 11 of the United States Code is dismissed.

(2) Section does not apply at partnership level.

For purposes of subsection (a) , a partnership shall not be treated as an individual, but the interest in a partnership of a debtor who is an individual shall be taken into account under this section in the same manner as any other interest of the debtor.

(c) Computation and payment of tax; basic standard deduction.

(1) Computation and payment of tax.

Except as otherwise provided in this section , the taxable income of the estate shall be computed in the same manner as for an individual. The tax shall be computed on such taxable income and shall be paid by the trustee.

(2) Tax rates.

The tax on the taxable income of the estate shall be determined under subsection (d) of section 1 .

(3) Basic standard deduction.

In the case of an estate which does not itemize deductions, the basic standard deduction for the estate for the taxable year shall be the same as for a married individual filing a separate return for such year.

(d) Taxable year of debtors.

(1) General rule.

Except as provided in paragraph (2) , the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

(2) Election to terminate debtor's year when case commences.

(A) In general. Notwithstanding section 442 , the debtor may (without the approval of the Secretary) elect to treat the debtor's taxable year which includes the commencement date as 2 taxable years—

(i) the first of which ends on the day before the commencement date, and

(ii) the second of which begins on the commencement date.

(B) Spouse may join in election. In the case of a married individual (within the meaning of section 7703), the spouse may elect to have the debtor's election under subparagraph (A) also apply to the spouse, but only if the debtor and the spouse file a joint return for the taxable year referred to in subparagraph (A)(i) .

(C) No election where debtor has no assets. No election may be made under subparagraph (A) by a debtor who has no assets other than property which the debtor may treat as exempt property under section 522 of title 11 of the United States Code .

(D) Time for making election. An election under subparagraph (A) or (B) may be made only on or before the due date for filing the return for the taxable year referred to in subparagraph (A)(i) . Any such election, once made, shall be irrevocable.

(E) Returns. A return shall be made for each of the taxable years specified in subparagraph (A) .

(F) Annualization. For purposes of subsections (b) , (c) , and (d) of section 443 , a return filed for either of the taxable years referred to in subparagraph (A) shall be treated as a return made under paragraph (1) of subsection (a) of section 443 .

(3) Commencement date defined.

For purposes of this subsection , the term “commencement date” means the day on which the case under title 11 of the United States Code to which this section applies commences.

(e) Treatment of income, deductions, and credits.

(1) Estate's share of debtor's income.

The gross income of the estate for each taxable year shall include the gross income of the debtor to which the estate is entitled under title 11 of the United States Code. The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3)).

(2) Debtor's share of debtor's income.

The gross income of the debtor for any taxable year shall not include any item to the extent that such item is included in the gross income of the estate by reason of paragraph (1) .

(3) Rule for making determinations with respect to deductions, credits, and employment taxes.

Except as otherwise provided in this section , the determination of whether or not any amount paid or incurred by the estate—

(A) is allowable as a deduction or credit under this chapter, or

(B) is wages for purposes of subtitle C,

shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case.

(f) Treatment of transfers between debtor and estate.

(1) Transfer to estate not treated as disposition.

A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.

(2) Transfer from estate to debtor not treated as disposition.

In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

(g) Estate succeeds to tax attributes of debtor.

The estate shall succeed to and take into account the following items (determined as of the first day of the debtor's taxable year in which the case commences) of the debtor—

(1) Net operating loss carryovers.

The net operating loss carryovers determined under section 172 .

(2) Charitable contributions carryovers.

The carryover of excess charitable contributions determined under section 170(d)(1) .

(3) Recovery of tax benefit items.

Any amount to which section 111 (relating to recovery of tax benefit items) applies.

(4) Credit carryovers, etc.

The carryovers of any credit, and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit.

(5) Capital loss carryovers.

The capital loss carryover determined under section 1212 .

(6) Basis, holding period, and character of assets.

In the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, the basis, holding period, and character it had in the hands of the debtor.

(7) Method of accounting.

The method of accounting used by the debtor.

(8) Other attributes.

Other tax attributes of the debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section .

(h) Administration, liquidation, and reorganization expenses; carryovers and carrybacks of certain excess expenses.

(1) Administration, liquidation, and reorganization expenses.

Any administrative expense allowed under section 503 of title 11 of the United States Code , and any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code, to the extent not disallowed under any other provision of this title, shall be allowed as a deduction.

(2) Carryback and carryover of excess administrative costs, etc., to estate taxable years.

(A) Deduction allowed. There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (i) the administrative expense carryovers to such year, plus (ii) the administrative expense carrybacks to such year.

(B) Administrative expense loss, etc. If a net operating loss would be created or increased for any estate taxable year if section 172(c) were applied without the modification contained in paragraph (4) of section 172(d) , then the amount of the net operating loss so created (or the amount of the increase in the net operating loss) shall be an administrative expense loss for such taxable year which shall be an administrative expense carryback to each of the 3 preceding taxable years and an administrative expense carryover to each of the 7 succeeding taxable years.

(C) Determination of amount carried to each taxable year. The portion of any administrative expense loss which may be carried to any other taxable year shall be determined under section 172(b)(2) , except that for each taxable year the computation under section 172(b)(2) with respect to the net operating loss shall be made before the computation under this paragraph .

(D) Administrative expense deductions allowed only to estate. The deductions allowable under this chapter solely by reason of paragraph (1) , and the deduction provided by subparagraph (A) of this paragraph , shall be allowable only to the estate.

(i) Debtor succeeds to tax attributes of estate

In the case of a termination of an estate, the debtor shall succeed to and take into account the items referred to in paragraphs (1) , (2) , (3) , (4) , (5) , and (6) of subsection (g) in a manner similar to that provided in such paragraphs (but taking into account that the transfer is from the estate to the debtor instead of from the debtor to the estate). In addition, the debtor shall succeed to and take into account the other tax attributes of the estate, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section .

(j) Other special rules.

(1) Change of accounting period without approval.

Notwithstanding section 442 , the estate may change its annual accounting period one time without the approval of the Secretary.

(2) Treatment of certain carrybacks.

(A) Carrybacks from estate. If any carryback year of the estate is a taxable year before the estate's first taxable year, the carryback to such carryback year shall be taken into account for the debtor's taxable year corresponding to the carryback year.

(B) Carrybacks from debtor's activities. The debtor may not carry back to a taxable year before the debtor's taxable year in which the case commences any carryback from a taxable year ending after the case commences.

(C) Carryback and carryback year defined. For purposes of this paragraph —

(i) Carryback. The term “carryback” means a net operating loss carryback under section 172 or a carryback of any credit provided by part IV of

subchapter A.

(ii) Carryback year. The term “carryback year” means the taxable year to which a carryback is carried.

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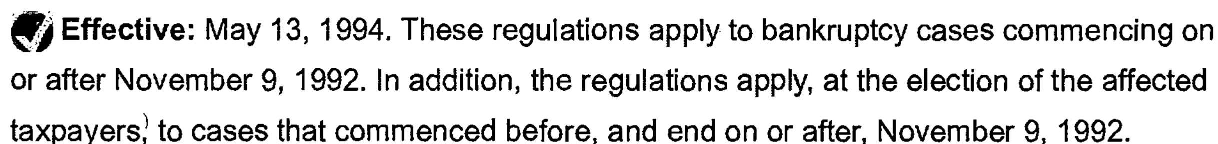
Reg §1.1398-1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.

Federal Regulations

Reg § 1.1398-1. Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.


Effective: May 13, 1994. These regulations apply to bankruptcy cases commencing on or after November 9, 1992. In addition, the regulations apply, at the election of the affected taxpayers, to cases that commenced before, and end on or after, November 9, 1992.

(a) Scope. This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) Definitions and rules of general application. For purposes of this section—

(1) Passive activity and former passive activity have the meanings given in section 469(c) and (f)(3);

(2) The unused passive activity loss (determined as of the first day of a taxable year) is the passive activity loss (as defined in section 469(d)(1)) that is disallowed under section 469 for the previous taxable year; and

(3) The unused passive activity credit (determined as of the first day of a taxable year) is the passive activity credit (as defined in section 469(d)(2)) that is disallowed under section 469 for the previous taxable year.

(c) Estate succeeds to losses and credits upon commencement of case. The bankruptcy estate (estate) succeeds to and takes into account, beginning with its first taxable

year, the debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's taxable year in which the case commences).

(d) Transfers from estate to debtor.

(1) Transfer not treated as taxable event. If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) Treatment of passive activity loss and credit. If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange)—

(i) The estate must allocate to the transferred interest, in accordance with §1.469-1(f)(4), part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's taxable year in which the transfer occurs); and

(ii) The debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the unused passive activity loss and unused passive activity credit (or part thereof) allocated to the transferred interest.

(e) Debtor succeeds to loss and credit of the estate upon its termination. Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the passive activity loss and passive activity credit disallowed under section 469 for the estate's last taxable year.

(f) Effective date.

(1) Cases commencing on or after November 9, 1992. This section applies to cases commencing on or after November 9, 1992.

(2) Cases commencing before November 9, 1992

(i) Election required.

This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption "ELECTION PURSUANT TO §1.1398-1" must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) Scope of election. This election applies to the passive and former passive activities and unused passive activity losses and passive activity credits of the taxpayers making the election.

(iii) Amendment of previously filed returns. The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction or credit is inconsistent with the succession under this section to unused losses and credits. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) Rules relating to closed years.

(A) Estate succeeds to debtor's passive activity loss and credit as of the commencement date. If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the unused passive activity loss and unused passive activity credit of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) No reduction of unused passive activity loss and credit for passive activity loss and credit not claimed for a closed year. In determining a taxpayer's carryover of a passive activity loss or credit to its taxable year following a closed year, a deduction or credit that the taxpayer failed to claim in the closed year, if attributable to an unused passive activity loss or credit to which the taxpayer succeeded under this section, is treated as a deduction or credit that was disallowed under section 469.

(C) Passive activity loss and credit to which taxpayer succeeds reflects deductions of prior holder in a closed year. A loss or credit to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss or credit was allowed to its prior holder for a closed year.

(D) Closed year. For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) Manner of making election.

(A) Chapter 7 cases. In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) Chapter 11 cases. In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) Election is binding and irrevocable. Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

T.D. 8537 , 5/12/94 .

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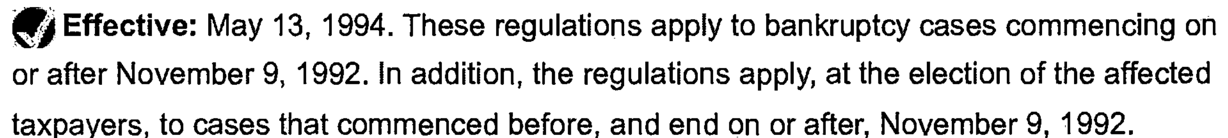
Reg §1.1398-2 Treatment of section 465 losses in individuals' title 11 cases.

Federal Regulations

Reg § 1.1398-2. Treatment of section 465 losses in individuals' title 11 cases.



Effective: May 13, 1994. These regulations apply to bankruptcy cases commencing on or after November 9, 1992. In addition, the regulations apply, at the election of the affected taxpayers, to cases that commenced before, and end on or after, November 9, 1992.

(a) Scope. This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) Definition and rules of general application. For purposes of this section—

(1) Section 465 activity means an activity to which section 465 applies; and

(2) For each section 465 activity, the unused section 465 loss from the activity (determined as of the first day of a taxable year) is the loss (as defined in section 465(d)) that is not allowed under section 465(a)(1) for the previous taxable year.

(c) Estate succeeds to losses upon commencement of case. The bankruptcy estate (the estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused section 465 losses (determined as of the first day of the debtor's taxable year in which the case commences).

(d) Transfers from estate to debtor.

(1) Transfer not treated as taxable event. If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) Treatment of section 465 losses. If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange) the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the transferred interest's share of the estate's unused section 465 loss from the activity (determined as of the first day of the estate's taxable year in which the transfer occurs). For this purpose, the transferred interest's share of such loss is the amount, if any, by which such loss would be reduced if the transfer had occurred as of the close of the preceding taxable year of the estate and been treated as a disposition on which gain or loss is recognized.

(e) Debtor succeeds to losses of the estate upon its termination. Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the losses not allowed under section 465 for the estate's last taxable year.

(f) Effective date.

(1) Cases commencing on or after November 9, 1992. This section applies to cases commencing on or after November 9, 1992.

(2) Cases commencing before November 9, 1992.

(i) Election required. This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption "ELECTION PURSUANT TO §1.1398-2" must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) Scope of election. This election applies to the section 465 activities and unused losses from section 465 activities of the taxpayers making the election.

(iii) Amendment of previously filed returns. The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction is inconsistent with the succession under this section to unused losses from section 465 activities. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) Rules relating to closed years.

(A) Estate succeeds to debtor's section 465 loss as of the commencement date. If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the section 465 losses of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) No reduction of unused section 465 loss for loss not claimed for a closed year. In determining a taxpayer's carryover of an unused section 465 loss to its taxable year following a closed year, a deduction that the taxpayer failed to claim in the closed year, if attributable to an unused section 465 loss to which the taxpayer succeeds under this section, is treated as a deduction that was not allowed under section 465.

(C) Loss to which taxpayer succeeds reflects deductions of prior holder in a closed year. A loss to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss was allowed to its prior holder for a closed year.

(D) Closed year. For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) Manner of making election.

(A) Chapter 7 cases. In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the

bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) Chapter 11 cases. In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) Election is binding and irrevocable. Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

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26 CFR § 1.1398-3 - Treatment of section 121 exclusion in individuals' title 11 cases.

CFR

§ 1.1398-3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) ***Scope.*** This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) ***Definition and rules of general application.*** For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) ***Estate succeeds to exclusion upon commencement of case.*** The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) ***Effective date.*** This section is applicable for sales or exchanges on or after December 24, 2002.

¶ C-9700 Income Taxation of Bankruptcy Estate of Bankrupt Individuals.

Federal Tax Coordinator 2d

¶ C-9700 Introduction—Income Taxation of Bankruptcy Estate of Bankrupt Individuals.

The bankruptcy estate of an individual in a Chapter 7 or Chapter 11 bankruptcy is treated under Code Sec. 1398 as a separate taxable entity. The taxable income of the estate is computed in the same manner as for an individual. Amounts paid or incurred by the estate are deductible by the estate to the same extent as the amount would be deductible by the debtor. Certain administrative expenses are deductible by the estate. The estate succeeds to certain income tax attributes of the individual debtor.[1]

For income taxation of individual debtors in bankruptcy, see ¶ C-9800 et seq.

For an individual's bankruptcy estate as a separate taxable entity, see ¶ C-9701 et seq.

For tax attribute reduction by bankruptcy estates of individual debtors, see ¶ C-9704 .

For a bankruptcy estate's tax year, see ¶ C-9705 et seq.

For tax rates of a bankruptcy estate, see ¶ C-9707 .

For computation of the taxable income of a bankruptcy estate, see ¶ C-9708 et seq.

For abandonment of property by bankruptcy estate, see ¶ C-9713 .

For business and administrative expenses of bankruptcy estate, see ¶ C-9714 et seq.

For distributions by bankruptcy estate, see ¶ C-9716 .

For carryover of tax attributes from individual debtor to bankruptcy estate, see ¶ C-9718 .

For bankruptcy estate's succeeding to the debtor's Code Sec. 121 homesale exclusion, see ¶ C-9718.01 , ¶ C-9712 .

For carryover of passive activity losses and credits, see ¶ C-9718.1 . et seq.

For carryover of unused Code Sec. 465 at-risk losses and credits, see ¶ C-9718.6 . et seq.

For treatment of the estate as the debtor regarding assets transferred from an individual debtor, see ¶ C-9719 .

For IRA received by bankruptcy estate, see ¶ C-9719.1 .

For carryback and carryover of administrative expenses of the bankruptcy estate, see ¶ C-9720 .

For carryback of net operating losses and credits of the bankruptcy estate, see ¶ C-9721 .

For transfer of a passive activity interest from the bankruptcy estate to the debtor, see ¶ C-9721.1 et seq.

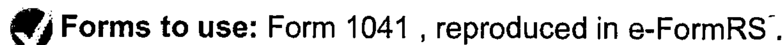
For transfer of an at-risk activity from the bankruptcy estate to the debtor, see ¶ C-9721.5 et seq.

For the effect of transfer of assets of bankruptcy estate to individual debtor on termination of estate, see ¶ C-9722 .

For trustee's duty, in a reorganization proceeding, to provide IRS with information for any year the debtor has not filed a required return, see ¶ T-1181 .

For trustee's duty to provide IRS with periodic reports when debtor's business is being operated, see ¶ V-7300 .

For the trustee's duty to file the estate's tax returns and pay the estate's taxes, see ¶ S-2016 .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1 Code Sec. 1398 .

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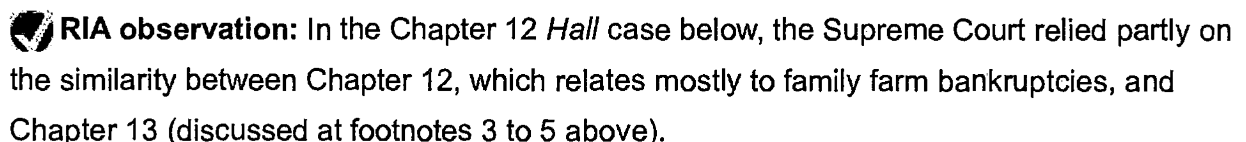
Chapter C Income Taxation of Trusts, Estates, Beneficiaries and Decedents
¶ C-9700 Income Taxation of Bankruptcy Estate of Bankrupt Individuals.
¶ C-9701 Bankruptcy estate of an individual as a separate taxable entity.

Federal Tax Coordinator 2d

¶C -9701. Bankruptcy estate of an individual as a separate taxable entity.

The bankruptcy estate of a bankrupt individual is treated as a separate entity for income tax purposes. [1] This rule applies if a bankruptcy case involving an *individual* debtor is brought under Chapter 7 (relating to liquidations) or Chapter 11 (relating to reorganizations) of Title 11 of the U.S. Code. [2] No separate taxable entity is created on commencement of a case under Chapter 13 of Title 11 (relating to adjustment of debts of an individual with regular income). [3] Therefore, where a trustee of a Chapter 13 wage earner plan received tax refunds representing overpayments by the debtors on their individual tax returns, the interest on the money was taxable to the debtors individually. [4]

The reason for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets. In a Chapter 13 case, however, both future earnings of the debtor and exempt property may be used to make payments to creditors. Therefore, the substantive bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in Chapter 7 or Chapter 11 cases. [5]

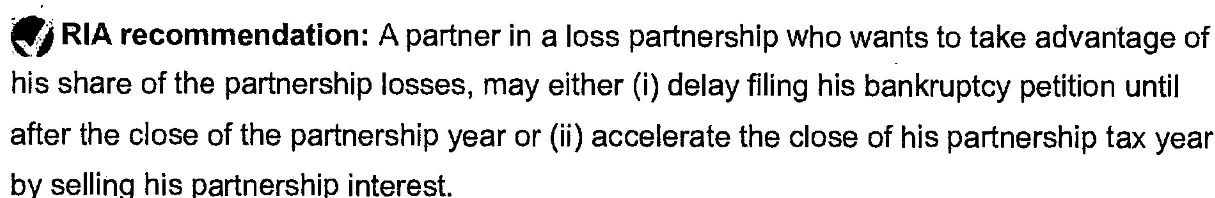


RIA observation: In the Chapter 12 *Hall* case below, the Supreme Court relied partly on the similarity between Chapter 12, which relates mostly to family farm bankruptcies, and Chapter 13 (discussed at footnotes 3 to 5 above).

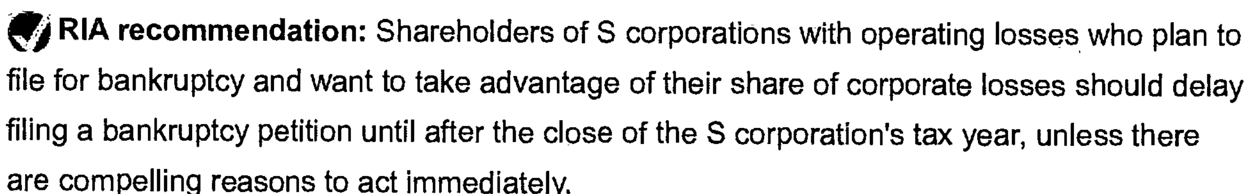
The Supreme Court held that the capital gains tax resulting from the post-petition sale of a farm by Chapter 12 debtors wasn't collectible or dischargeable in the Chapter 12 plan because it wasn't

incurred by the estate. Under 11 USC § 1222(a)(2)(A), certain governmental claims resulting from the disposition of farm assets are downgraded to general, unsecured claims that are dischargeable after less than full payment. However, this downgrade applies only to claims in the plan that are entitled to priority under 11 USC § 507. This includes administrative expenses (¶ V-7348) described at 11 USC § 507(a)(2) and includes post-petition taxes incurred by the estate. The Supreme Court held a tax incurred by the estate is a tax for which the estate itself is liable. Since a Chapter 12 estate isn't a taxable entity, the debtors, not the estate, were liable for the taxes arising from their post-petition sale. Thus, the estate didn't incur the tax, with the result that the downgrade didn't apply.[5.1]

For purposes of the separate entity rules, a partnership is not treated as an individual, but the interest in a partnership of a bankruptcy debtor who is an individual is taken into account in the same manner as any other interest of the bankruptcy debtor.[6] Thus, where an individual filed a Chapter 7 bankruptcy petition, creating a bankruptcy estate under the above rules, and where the tax year of the partnership in which the individual held an interest ended after the bankruptcy filing, partnership items of the partnership for that tax year were treated as distributed to the bankruptcy estate, not the individual, because, on the last day of the partnership tax year—when partnership items are treated as distributed to partners (see ¶ B-1701)—it was the bankruptcy estate, not the individual, who was treated as owning the partnership interest.[6.1]


RIA recommendation: A partner in a loss partnership who wants to take advantage of his share of the partnership losses, may either (i) delay filing his bankruptcy petition until after the close of the partnership year or (ii) accelerate the close of his partnership tax year by selling his partnership interest.

The Tax Court applied *Gulley* (footnote 6.1) to S corporations and held that a taxpayer's (T's) individual bankruptcy estate (E), not T, was entitled to report operating losses sustained during '90 by two S corporations (subs) wholly owned by T as of the date of the bankruptcy filing, Dec. 3, '90. T had not received or accrued any income or loss items from the subs before the bankruptcy under Code Sec. 1398(e)(1) (¶ C-9711). Under Code Sec. 1398(f)(1) , a debtor's transfer of an asset to his estate when he files for bankruptcy is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated with respect to that asset (¶ C-9719). Thus, E was treated as if it owned the subs for the entire year and was entitled to the entire loss they generated during '90, including the loss for the period Jan. 1 through Dec. 3.[6.2]


RIA recommendation: Shareholders of S corporations with operating losses who plan to file for bankruptcy and want to take advantage of their share of corporate losses should delay filing a bankruptcy petition until after the close of the S corporation's tax year, unless there are compelling reasons to act immediately.

RIA observation: In *Williams* (footnote 6.2) the taxpayer originally filed a Chapter 7 petition, then converted it to Chapter 11 in '91. The conversion is irrelevant for purposes of the above discussion because Code Sec. 1398 applies to both Chapter 7 and Chapter 11 if the debtor is an individual.

Similarly, a bankruptcy court held that where an individual owned stock of an S corporation, the stock became part of the bankruptcy estate at the time of the Chapter 7 filing. Accordingly, the income of the S corporation for the tax year ending after the filing was included by the bankruptcy estate, rather than by the individual.[6.3]

A bankruptcy court held that where a decedent's heirs filed bankruptcy petitions, the debtors had equitable interests in the decedent's estate under the then applicable state (TX) law and these interests were included in their bankruptcy estates. The debtors were personally liable for a portion of estate taxes as co-executors.[6.4]

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1 S Rept No. 96-1035 (PL 96-589) p. 25 .

2 Code Sec. 1398(a) .

3 S Rept No. 96-1035 (PL 96-589) p. 25 .

4 Elkins, William In re, (1988, Bktcy Ct VA) 71A AFTR 2d 93-3071 , 88-1 USTC ¶9338 .

5 S Rept No. 96-1035 (PL 96-589) p. 25 .

5.1 Hall, Lynwood D. In re, (2007, Bktcy Ct AZ) 100 AFTR 2d 2007-6229 , 376 BR 741 , CCH Bankr L Rptr ¶81032, 58 CBC2d 1096, revd & remd(2008, DC AZ) 393 BR 857 , 60 CBC2d 728, revd sub nom U.S. v. Hall, Brenda, (2010, CA9) 53 BCD 145, 106 AFTR 2d 2010-5848 , 617 F3d 1161, 2010-2 USTC ¶50566, 2010 Daily Journal DAR 12790, 10 CDOS 10549, CCH Bankr L Rptr ¶81830, 63 CBC2d 1786, cert granted sub nom Hall, Lynwood D. v. U.S., (2011, S Ct) 180 L Ed 2d 820, 2011 WL 2297804, 79 USLW 3696, 79 USLW 3421, 131 S Ct 2989, 79 USLW 3693, affd(2012, S Ct) 56 BCD 122, 109 AFTR 2d 2012-2020 , 2012-1 USTC ¶50345, 80 USLW 4357, 132 S Ct 1882, 23 FLW Fed S 293, 2012 Daily Journal DAR 6225, 12 CDOS 5189, CCH Bankr L Rptr ¶82212 .

6 Code Sec. 1398(b)(2) .

6.1 Gulley, Michael H., (2000) TC Memo 2000-190 , RIA TC Memo ¶2000-190, 79 CCH TCM 2171 .

6.2 Williams, Lawrence G., (2004) 123 TC 144 .

6.3 Medley, Guy F.In re , (2016, Bktcy Ct AL) 117 AFTR 2d 2016-1766 .

6.4 Ramirez, Leon Oscar, Jr.In re , (2017, Bktcy Ct TX) 120 AFTR 2d 2017-6823 .

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Federal Tax Coordinator 2d

¶C-9704. Tax attribute reduction with respect to bankruptcy estates of individual debtors.

In a Chapter 7 or Chapter 11 bankruptcy case involving an individual debtor to which Code Sec. 1398 (see ¶ C-9700 et seq. and ¶ C-9800 et seq.) applies, any tax attribute reduction (e.g., reduction of a loss or credit carryover or of basis in the debtor's property) required under the debt discharge rules (see discharge of indebtedness of bankrupt or insolvent debtors in ¶ J-7400 et seq.) applies to the attributes of the bankruptcy *estate* (except for purposes of applying the basis reduction rules of Code Sec. 1017 to property transferred by the estate to the individual), and not to those attributes of the individual debtor. [13]

If a bankruptcy estate and a taxpayer to whom Code Sec. 1398 applies hold property subject to basis reduction either under the general rule of Code Sec. 108(b)(2)(E) (see ¶ P-3005) or the election to apply reduction first against depreciable property under Code Sec. 108(b)(5) (see ¶ P-3007) on the first day of the tax year following the tax year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property. [13.1]

In one case, the bankruptcy estate improperly neglected to reduce its tax attributes—in this case, its net operating losses (NOLs)—and, at the termination of the bankruptcy estate, reported to the individual that he succeeded, under Code Sec. 1398(i) (¶ C-9812), to the unreduced NOL. The individual's argument, that he deserved to be able to use this unreduced NOL because, under the rule of Code Sec. 108(d)(8) (footnote 13), the reduction in attributes required under the rules at ¶ J-7400 et seq. apply to the estate and not to him, was rejected by the court. The court reasoned (a) taxpayer's argument put substance over form by allowing the individual the benefit of the full

NOL simply because the estate fiduciary did not make an accounting entry to reduce the NOL; and (b) to hold otherwise would defeat the intent of Code Sec. 108 and would allow the individual a double benefit, i.e., discharge of debt with no gross income consequences and no reduction in tax attributes.[13.2]

No reduction in basis is made in the basis of property which an individual debtor in a bankruptcy case treats as exempt property under Sec. 522 of Title 11 U.S. Code.[14]

For discharges of indebtedness occurring before Oct. 22, '98,[14.1] the rule in Reg § 1.1017-1(h) (footnote 13.1) did not apply.

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13 Code Sec. 108(d)(8) .

13.1 Reg § 1.1017-1(h) .

13.2 Firsdon, Jack v. U.S., (1994, DC OH) 75 AFTR 2d 95-528 , 95-1 USTC ¶50040, affd (1996, CA6) 78 AFTR 2d 96-6420 , 95 F3d 444, 96-2 USTC ¶50475 .

14 Code Sec. 1017(c)(1) .

14.1 Reg § 1.1017-1(i) .

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¶ C-9705 Selecting bankruptcy estate's tax year.

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¶C-9705. Selecting bankruptcy estate's tax year.

As a new taxable entity, the bankruptcy estate can adopt either the calendar year or any acceptable fiscal year as its tax year in its first return. [15] See establishing the tax year in ¶ G-1050 et seq.

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15 Reg § 1.441-1T(b)(2) .

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Federal Tax Coordinator 2d

¶C-9707. Tax rates for bankruptcy estates.

The tax rates applicable to bankruptcy estates are the same as for married individuals filing separate tax returns. [17] These rates are reproduced in Tables & Rates ¶ TBL-1003 .

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17 Code Sec. 1398(c)(2) .

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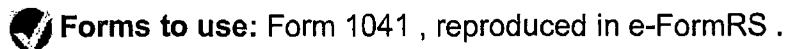
Federal Tax Coordinator 2d

¶C-9708. Computation of the taxable income of the bankruptcy estate.

Except as otherwise specifically provided in Code Sec. 1398 , taxable income of the bankruptcy estate is computed in the same manner as for an individual. The trustee of the bankruptcy estate is charged with the duty of computing (and paying) the tax on the estate's taxable income. [18]


Forms to use: Form 1041 , reproduced in e-FormRS .

A Chapter 11 debtor's wages for services provided to an international organization (specifically, the International Monetary Fund (IMF)), which are treated as self-employment income for purposes of Code Sec. 1402(c)(2)(C) (see ¶ A-6092 and ¶ A-6097), are included in his bankruptcy estate's gross income for purposes of Code Sec. 1 (see ¶ A-1101 et seq.), but not for purposes of the tax on self-employment income under Code Sec. 1401(a) (see ¶ A-6001 et seq.). The tax imposed on bankruptcy estates by Code Sec. 1398(c)(1) doesn't include the self-employment tax because that tax is on self-employment income rather than taxable income (¶ A-1100 et seq.). [19]

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18 Code Sec. 1398(c)(1) .

19 Sission, Charles A., (2016) TC Memo 2016-143 , RIA TC Memo ¶2016-143 .

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¶C-9713. Abandonment of property by bankruptcy estate.

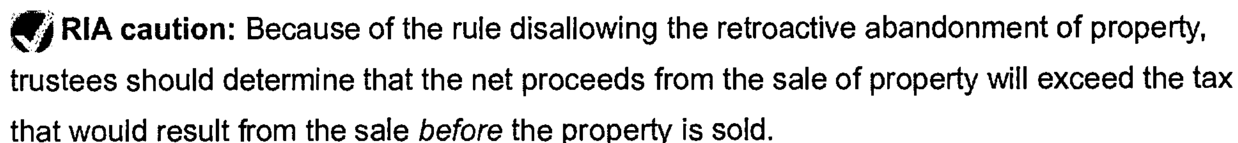
A trustee of a bankruptcy estate may abandon any property of the estate that is burdensome or of inconsequential value and benefit to the estate. [25] An abandonment is useful when there is property that has no value and is worthless to the estate. It avoids the costs of administration and other expenses and liabilities that would flow from the estate's continued interest in the property. [25.1] Thus, where the trustee of the bankruptcy estate of a partner received an amount in settlement of litigation filed by the partnership, he did not abandon the partnership interest. [25.2]

A trustee's abandonment of property during the pendency or administration of a bankruptcy case isn't a sale or exchange within the meaning of Code Sec. 1398(f)(2) (see ¶ C-9722), and therefore, isn't a taxable event giving rise to a tax liability of the bankruptcy estate. Since, on abandonment, the property ceases to be property of the estate and title reverts to the debtors, the debtors are taxable on the gain from its sale after abandonment by the trustee. [26]

A debtor's proposal that a trustee in bankruptcy "abandon" real property to him in return for a payment of $50,000 instead of selling the property in a foreclosure sale was not an abandonment, but a taxable sale. Abandonment is founded on the prospect that the property is worthless; in this case there had been an offer to purchase the property as well as the debtor's offer to make a payment for the property. [26.1]

For a discussion of the treatment of abandonment of interests in passive activities, see ¶ C-9721.1 . For a discussion of abandonment of interests in Code Sec. 465 activities (i.e., activities subject to the at-risk rules), see ¶ C-9721.5 .

However, the trustee cannot retroactively abandon property after the property is sold. Thus, where a trustee abandoned the proceeds of a sale that were subject to a creditors lien, the bankruptcy estate had to include in its gross income the gain from the sale, as well as the interest earned on the sale proceeds. Although the creditor's lien absorbed all of the proceeds of the sale, the bankruptcy estate was subject to tax because the property was sold by the estate. [27] Similarly, where a trustee did not abandon an interest in a partnership that held real property interests before the real property interests were sold, the bankruptcy estate was subject to tax on the gain on the sales of the interests, even though the tax on the gain greatly exceeded the proceeds received by the estate. [27.1]



RIA caution: Because of the rule disallowing the retroactive abandonment of property, trustees should determine that the net proceeds from the sale of property will exceed the tax that would result from the sale *before* the property is sold.

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25 11 USC 554(a) .

25.1 Ryan, John E. In re, (2001, Bktcy Ct VA) 261 BR 867 .

25.2 Gulley, Michael H., (2000) TC Memo 2000-190 , RIA TC Memo ¶2000-190, 79 CCH TCM 2171 .

26 Olson, Stanley In re, (1990, DC IA) 121 BR 346 , affd (1991, CA8) 67 AFTR 2d 91-851 , 930 F2d 6, 91-1 USTC ¶50163 .

26.1 Ryan, John E. In re, (2001, Bktcy Ct VA) 261 BR 867 .

27 Bentley, Gilbert Jr. v. U.S., (1988, DC IA) 71A AFTR 2d 93-3288 , 89-2 USTC ¶9597, revg (1987, DC IA) 79 BR 413 , affd (1990, CA8) 67 AFTR 2d 91-567 , 916 F2d 431, 90-2 USTC ¶50527 .

27.1 Perlman, Clifford In re, (1995, Bktcy Ct FL) 76 AFTR 2d 95-7989 , 188 BR 704 , 96-1 USTC ¶50116 .

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Federal Tax Coordinator 2d

¶ C -9800 Introduction—Income Taxation of Individual Debtors in Bankruptcy.

An individual debtor in a bankruptcy case may elect to close his tax year at the date of bankruptcy. The debtor's spouse may join in the election. Income received or accrued by the debtor before the bankruptcy case was begun is income of the debtor and not of the estate. Items of deduction are not allowable to the debtor if they are treated as a deduction of the bankruptcy estate.

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¶C-9802. Election by individual debtor in a bankruptcy case to close tax year.

An individual debtor is entitled to elect to close his tax year as of the day before the date on which the bankruptcy case commences. [2] If the election is made, the debtor's tax year which otherwise would include the commencement date is divided into two "short" tax years of less than 12 months. The first year ends on the day before the commencement date; the second year begins on the commencement date. [3]

As a result of the debtor's election, his income tax liability for the first short tax year becomes (under the substantive law of bankruptcy) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year is collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any tax liability for an electing debtor's first short tax year is not dischargeable, the individual debtor remains liable for any amount not collected out of the bankruptcy estate. [4]

If the election is made, the debtor is required to annualize his taxable income for each short tax year in the same manner as if a change of annual accounting period had been made. [5]

If the election is not made, no part of the individual debtor's tax liability for the year in which the bankruptcy case commences is collectible from the bankruptcy estate, [5.1] or can be assessed or claimed against the bankruptcy estate. It can only be assessed against the debtor. [6] The tax liability for the entire year is a post-petition personal liability of the debtor that is not a claim against the bankruptcy estate and is not entitled to priority as an administrative expense, [6.1] or as a pre-petition tax claim. Thus, when a debtor failed to make the election before the due date of the return for the tax year during which he filed a Chapter 11 petition, his tax liability for that year was his

personal post-petition obligation, not a claim against the estate. Since the debtor was not permitted to use property of the estate to pay his personal tax liability, the trustee was permitted to avoid the payment as an unauthorized post-petition transfer. [6.2]

Where the election was not made, but the debtor (D) filed a claim on behalf of IRS for taxes for the year in which D filed his bankruptcy petition (Year 1), the claim was disallowed as a claim for tax liabilities arising after the petition date. The fact that D was self-employed and paid estimated taxes did not alter the date on which his tax liability arose. D's taxes for Year 1 became payable on Apr. 15, Year 2, when his return was due, not when the estimated tax installments were due. [6.3]

Where the election was not made, taxes for the entire year at issue were a post-petition debt collectible outside a Chapter 11 plan, even where the plan purported to control the timing and method of collection of the taxes. IRS was not bound by the plan's terms where it did not file a proof of claim for the taxes or enter any agreement on the terms for collection. [6.4]

Where the election was not made, the debtors' tax liability (resulting from a pre-petition sale of property), although listed in their bankruptcy schedules as a priority debt, was not a claim payable from the bankruptcy estate.[6.5]

The election is available to an individual debtor in a bankruptcy case under Chapter 7 (relating to liquidation) or Chapter 11 (relating to reorganization) of Title 11 of the U.S. Code, except where a case commenced but was later dismissed by the bankruptcy court, [7] see ¶ C-9702 .

However, the election is not available to a debtor who has no assets other than property which he may treat as exempt property under 11 USC 522. [8] Here, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period before the commencement date could be collected, there is no reason to authorize termination of the tax year. [9]

RIA observation: An individual in a bankruptcy case should consider the following factors in deciding whether to make the election:

(1) Where the individual has taxable income for the tax year which would end just before the start of the bankruptcy case if he made the election, the election would generally be to his benefit. This is so because if a debtor makes an election, the debtor's tax liability for the "short" tax year ending with the commencement of the bankruptcy case becomes collectible out of the bankruptcy estate as a pre-bankruptcy liability. In addition, if the debtor has any net operating loss (NOL) carryovers from prior years he can use them against any income for the short tax year before the bankruptcy filing. If he does not make such an election, the NOL carryover transfers to the estate on the day of the filing, and he can't use it against his income for his tax year during which the petition was filed.

(2) Where the debtor has a loss for the short tax year before bankruptcy, it would generally be better *not* to make the election. The reason for not choosing to close the tax year is that the loss for the short tax year could be used by the debtor to offset income for the period *after* commencement of the bankruptcy case. If the election were to be made, the tax benefit of the loss would belong to the bankruptcy estate, not the individual debtor, since the debtor's tax attributes carry over to the estate (see ¶ C-9718).

RIA statement to use: A sample election appears in Elections and Compliance Statements ¶ 1500 .

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2 Code Sec. 1398(d)(2)(A) ; Code Sec. 1398(d)(3) .

3 Code Sec. 1398(d)(2)(A) .

4 S Rept No. 96-1035 (PL 96-589) p. 26 ; 11 USC 523(a)(1) .

5 Code Sec. 1398(d)(2)(F) .

5.1 S Rept No. 96-1035 (PL 96-589) p. 26 ; Moore, William In re, (1991, Bktcy Ct PA) 71A AFTR 2d 93-4429 , 132 BR 533 , 91-2 USTC ¶50390 .

6 Prativadi, Seshadri N. In re, (2002, Bktcy Ct NY) 90 AFTR 2d 2002-5233 , 281 BR 816 , 2002-2 USTC ¶50645 .

6.1 Johnson, Walter Roland In re, (1995, Bktcy Ct MA) 76 AFTR 2d 95-7090 , 190 BR 724 , 95-2 USTC ¶50611 ; Smith, Theodore In re, (1997, Bktcy Ct MD) 210 BR 689 .

6.2 Smith, Theodore In re, (1997, Bktcy Ct MD) 210 BR 689 .

6.3 Fleming, Mark D. Sr., (2002, Bktcy Ct OH) 89 AFTR 2d 2002-2514 , 277 BR 751 , 2002-2 USTC ¶50497 .

6.4 U.S. v. Wood, Lee Ardell, (1999, DC CA) 84 AFTR 2d 99-5486 , 240 BR 609 , 99-2 USTC ¶50730 .

6.5 Skiba, Gary V. v. Cecil Keith Knee, (2006, Bktcy Ct PA) 2006 WL 3087689 .

7 Code Sec. 1398(b)(1) .

8 Code Sec. 1398(d)(2)(C) .

9 S Rept No. 96-1035 (PL 96-589) p. 27 .

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¶C-9803. Due date for making the election to close the debtor's tax year.

The election must be made on or before the 15th day of the fourth month following the commencement date, i.e., by the date on which a return would be due for the first short tax year if the election were made. [10] The due date is determined without regard to any extension of time for filing the return. [11]

RIA illustration: A bankruptcy case commences on Mar. 10. The election must be made by the following July 15.

In determining that a timely election was made, a bankruptcy court held that an *involuntary* bankruptcy case "commences" for purposes of this election upon entry of an Order for Relief, and not by the filing of the involuntary petition. The court noted that a debtor may not know that an involuntary petition has been filed or that a deadline is running which may significantly affect his substantive rights to make the election. [11.1]

Where the return is not filed on time to effect the required election, no portion of the debtor's tax liability can be disposed of as part of the bankruptcy settlement. [12]

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10 Code Sec. 1398(d)(2)(D) .

11 S Rept No. 96-1035 (PL 96-589) p. 27 .

11.1 Kreidle, James In re, (1991, Bktcy Ct CO) 71A AFTR 2d 93-4408 , 146 BR 464 , 91-2 USTC ¶50371 .

12 Vela, Francisco Santiago In re, (1988, Bktcy Ct PR) 61 AFTR 2d 88-698 , 87 BR 229 , 88-1 USTC ¶9253 .

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¶C-9805. Election by debtor's spouse to close tax year.

If the debtor making the election discussed at ¶ C-9802 was married on the date the bankruptcy case involving him commenced, the debtor's spouse can join in the election to close the tax year. [1] The spouse makes the election by filing a joint return with the debtor for the first short tax year. Where the election is made with an application for extension (see ¶ C-9804), the spouse must join in the application for extension and in the statement of election. [2] In order for the election to be effective, it must be made on or before the due date for filing the return for the short tax year, see ¶ C-9803 . The filing of a joint return for the first short tax year does not require the debtor and the spouse to file a joint return for the second short tax year. [3]

> **Illustration:** Husband and wife are calendar-year taxpayers. A bankruptcy case involving only the husband starts on Mar. 4.
>
> If the husband does not make an election, his tax year is not affected, i.e., it does not terminate on Mar. 3. If the husband does make an election, his first tax year is Jan. 1–Mar. 3 and his second short tax year begins Mar. 4. The wife could join in the husband's election, but only if they file a joint return for the tax year Jan. 1–Mar. 4. The election must be made on or before the due date for filing the joint return, i.e., on or before July 15. [4]

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1 Code Sec. 1398(d)(2)(B) .

2 Reg § 301.9100-14T(d) .

3 S Rept No. 96-1035 (PL 96-589) p. 27 .

4 IRS Pub No. 908 , (2/2022) , p. 4 , Ex. 1 .

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¶C-9806. Bankruptcy of debtor's spouse after debtor's election.

If later in the same year, a bankruptcy case involving the bankrupt debtor's spouse is commenced, the spouse may also elect to terminate his or her tax year as of the day before the commencement date whether or not the spouse previously joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor can join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor cannot join in the spouse's election, inasmuch as the debtor and the spouse, having different tax years, could not file a joint return for a year ending with the spouse's commencement date, [5] see joint returns in ¶ S-1804 .

> **Illustration:** Husband and wife are calendar-year taxpayers. A bankruptcy case involving only the husband starts on May 6, and a bankruptcy case involving only the wife starts on Nov. 1 of the same year.
>
> (1) The wife could elect to terminate her tax year on Oct. 31. If the husband had not made an election to terminate *his* tax year on May 5 or if he *had* made the election but his wife had not joined in the husband's election, the wife would have two tax years within the calendar year if she decided to close her tax year. The wife's first tax year is Jan. 1–Oct. 31, and the second from Nov. 1–Dec. 31.
>
> (2) If the husband had not made an election to terminate his tax year as of May 5, he could join in an election by his wife to close her tax year on Oct. 31, but only if they file a joint return for the tax year Jan. 1–Oct. 31. If the husband had made an election to close his tax year as of May 5, but the wife had not joined in the husband's election, the

husband could not join in an election by the wife to terminate her tax year on Oct. 31, since they could not file a joint return for that short year. They could not file a joint return because their tax years preceding Oct. 31 were not the same. [6]

Illustration: Husband and wife are calendar-year taxpayers. A bankruptcy case involving only the husband starts Apr. 10, and a bankruptcy case involving only the wife starts Oct. 3 of the same year. The husband elects to close his tax year on Apr. 9 and the wife joins in this election.

Under these facts, the wife would have three tax years for the same calendar year if she makes the election relating to her own bankruptcy case: (1) Jan. 1–Apr. 9, (2) Apr. 10–Oct. 2, (3) Oct. 3–Dec. 31.

The husband is permitted (but not required) to join in the wife's election if they file a joint return for the *second* short tax year (Apr. 10–Oct. 2). If the husband does join in, he would have the same three short tax years as his wife. If the husband joined in his wife's election, they would be permitted to file a joint return for the third tax year (Oct. 3–Dec. 31), but would not be required to do so. [7]

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5 S Rept No. 96-1035 (PL 96-589) p. 27 .

6 IRS Pub No. 908 , (2/2022) , p. 4 , Ex. 2 .

7 IRS Pub No. 908 , (2/2022) , p. 4 , Ex. 3 .

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¶C-9805. Election by debtor's spouse to close tax year.

If the debtor making the election discussed at ¶ C-9802 was married on the date the bankruptcy case involving him commenced, the debtor's spouse can join in the election to close the tax year. [1] The spouse makes the election by filing a joint return with the debtor for the first short tax year. Where the election is made with an application for extension (see ¶ C-9804), the spouse must join in the application for extension and in the statement of election. [2] In order for the election to be effective, it must be made on or before the due date for filing the return for the short tax year, see ¶ C-9803 . The filing of a joint return for the first short tax year does not require the debtor and the spouse to file a joint return for the second short tax year. [3]

> **Illustration:** Husband and wife are calendar-year taxpayers. A bankruptcy case involving only the husband starts on Mar. 4.
>
> If the husband does not make an election, his tax year is not affected, i.e., it does not terminate on Mar. 3. If the husband does make an election, his first tax year is Jan. 1–Mar. 3 and his second short tax year begins Mar. 4. The wife could join in the husband's election, but only if they file a joint return for the tax year Jan. 1–Mar. 4. The election must be made on or before the due date for filing the joint return, i.e., on or before July 15. [4]

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1 Code Sec. 1398(d)(2)(B) .

2 Reg § 301.9100-14T(d) .

3 S Rept No. 96-1035 (PL 96-589) p. 27 .

4 IRS Pub No. 908 , (2/2022) , p. 4 , Ex. 1 .

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¶C-9811.4. Status in bankruptcy of earned income credits and child tax credits.

The earned income credit (EIC, see ¶ A-4201 et seq.) portion of a tax refund is property of the bankruptcy estate when the EIC accrued to the debtor before the bankruptcy petition was filed. [1]

The Sixth Circuit held that a debtor's EIC was property of the bankruptcy estate, even where she filed her bankruptcy petition before the end of the tax year in which the credit was earned. She had an interest in the property at the time of the filing. [2]

The Tenth Circuit held that a bankruptcy debtor's EIC for a tax year, as pro-rated to the date the bankruptcy petition was filed, is property of the bankruptcy estate regardless of whether the petition was filed before the end of the tax year. The EIC is treated as a tax refund, and the fact that a debtor's interest in it is not finalized until the end of the tax year is not an impediment to inclusion in the estate. [3] A bankruptcy court in the Tenth Circuit followed this rule in a case where the debtor (D) argued the EIC should be his property because he would not have received it but for a post-petition accident. It was equally true that D wouldn't have qualified for the EIC but for the pre-petition income E earned.[4]

However, a bankruptcy court in the Eleventh Circuit held that where a couple filed a bankruptcy petition on June 1 and thus had a child living with them for five months in their tax year rather than the six months they needed to get the EIC (¶ A-4213), they were ineligible for the EIC at the time of the filing. Thus, the estate could not compel turnover of a five-month share of the portion of their refund attributable to the EIC. [5]

"Plain vanilla" income tax refunds weren't exempted from the bankruptcy estate under a provision of then-applicable state (FL) law that covered only debtors' interests in refunds or credits paid under Code Sec. 32 (relating to EICs, see ¶ A-4201). The provision was not intended to exempt ordinary income tax refunds due to a debtor who was ineligible for any EIC. [6]

Where a state (KS) opted out of federal bankruptcy exemptions and provided a specific exemption for the EIC, a debtor's entire EIC for Year 1 wasn't property of the estate when he filed for bankruptcy on June 22 of Year 1 and claimed as exempt an EIC with a current value of "Unknown." The bankruptcy court said: (a) a pro-rata division of the EIC wasn't appropriate because KS exempted the EIC from the estate entirely and (b) the KS exemption was constitutional and didn't conflict with Code Sec. 1398(g)(4) (¶ C-9718) or the offset scheme of Code Sec. 6402 (¶ T-6001). KS provides an exemption only if the individual has a right to a refund based on the EIC. If the debtor has no such right, due to offsets or for any reason, there's no refund available to which the exemption can apply. The Tenth Circuit Bankruptcy Appellate Panel agreed with the bankruptcy court's opinion and rejected an argument that the trustee could avoid the exemption based on 11 USC § 544 (¶ V-6417) because the trustee was dilatory in raising the argument.[7]

The Tenth Circuit Bankruptcy Appellate Panel later rejected an argument that a trustee could avoid the KS exemption of the EIC based on 11 USC § 544. The trustee's rights under that provision don't apply to property that is exempt under state law, even if the exemption applies only in bankruptcy. The Tenth Circuit agreed, holding that 11 USC § 544 didn't preempt the KS exemption and rejecting the trustee's argument that bankruptcy-specific exemptions are unconstitutional.[8] Likewise, the exemption didn't violate the priority of claims in 11 USC § 507 because it is only nonexempt property a trustee is charged with distributing under that provision. [9]

Likewise, a district court held that the KS bankruptcy EIC exemption is constitutionally valid and enforceable and doesn't conflict with the Bankruptcy Code or federal tax policy.[10]

An EIC claim was exempt property under then-applicable state (AL) law, even where the debtor elected to receive it as a lump-sum refund. The EIC qualified for the "public assistance" exemption under AL law, since it provided relief for low-income families. [11] But, despite this exemption, an AL debtor's (D's) plan couldn't be confirmed in a Chapter 13 case. Under 11 USC §1325(b)(1), Chapter 13 plans can't be confirmed over trustee objections unless the debtor is paying unsecured creditors in full or contributing all disposable income to the plan and any part of a refund attributable to the EIC is disposable income for this purpose.[12]

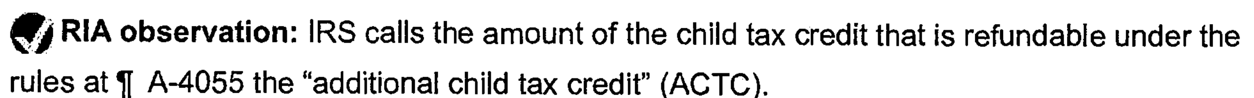
However, some bankruptcy decisions allowed debtors in Chapter 13 cases to prorate refunds that they received due to the EIC, the CTC, education credits and overwithholding by employers and use the refunds for their expenses or to support dependents. Under 11 USC §1325(b)(2), disposable income is calculated by taking current monthly income and deducting reasonable costs for the maintenance or support of the debtor or any dependents.[13]

A district court in the Sixth Circuit declined to rule on whether EIC payments were exempt under then-applicable state (KY) law in all cases or only on a case-by-case basis. Bankruptcy Code Chapter 7 allows debtors to exempt property from the estate and allows states to opt out of default exemptions in favor of state exemptions. Since KY was an opt-out state, KY law governed whether a KY debtor's EIC fell within an exemption. The district court said that the EIC was a public assistance grant but remanded the case to the bankruptcy court to decide whether the exemption applies in every case or only where the debtor meets the KY statute's definition of "public assistance." [14]

Where a state (MO) had opted out of federal bankruptcy exemptions and the MO exemption statute was amended to eliminate the word "local" from the MO exemption for "local public assistance benefits" a debtor could use this exemption to claim the portion of her income tax refund traceable to the federal EIC as an exempt public assistance benefit.[15]

But, where a MO debtor received an EIC before filing for bankruptcy, the EIC wasn't exempt. MO law only exempted the "right to receive" a public assistance benefit and, under MO law, after the benefit was already received, it was no longer exempt.[16]

ME was also an opt-out state and, because the child tax credit (CTC, see ¶ A-4051 et seq.) wasn't within any public assistance exemption from the bankruptcy estate under then-applicable ME law, ME debtors' refunds resulting from CTCs for tax years during which their bankruptcy petitions were filed weren't exempt from the estate.[17] This was true even after ME law was changed to include the EIC and the additional CTC (ACTC) in exempt public assistance benefits. The debtor claimed a CTC but no ACTC.[18]


RIA observation: IRS calls the amount of the child tax credit that is refundable under the rules at ¶ A-4055 the "additional child tax credit" (ACTC).

Bankruptcy estate property was held to include the portion of a debtor's refund claim attributable to a CTC for the year during which his bankruptcy petition was filed, [19] and the portion of another debtor's refund claim attributable to an ACTC for the year preceding the year during which his bankruptcy petition was filed. [20] These credits were not covered by the exemption from the bankruptcy estate for "public assistance" under then-applicable state (ID) law. [21]

Likewise a CTC was not covered by the exemption from the bankruptcy estate for "public assistance" under then-applicable state (KY) law. [22]

However, an Illinois bankruptcy court held that the portion of a debtor's refund claim attributable to the ACTC for a year ending before her bankruptcy petition was filed could be exempted as a public assistance benefit. The court held that the general CTC could not be claimed exempt as public assistance, but noted that, since *Steinmetz* (see above), the ACTC had been made available to

more taxpayers. The court said that the ACTC was refundable to taxpayers of limited means and would rarely go the middle and upper income taxpayers. [23]

Similarly, a district court in Idaho cited *Hardy* (see below) in concluding that tax refunds paid to a debtor attributable to the ACTC could be exempted as benefits received under public assistance. The court said that amendments to the ACTC were clearly intended to benefit low-income families despite the fact that some refund recipients have significant incomes.[24]

For similar cases on adoption credits, see ¶ C-9811.3 .

The Eighth Circuit held that the portion of a debtor's refund claim attributable to the ACTC was exempt under Missouri law as a public assistance benefit, which the court interpreted as "government benefits provided to the needy." The court based its conclusion principally on changes to the credit since its enactment that have expanded its size and availability and that have been accompanied by statements from senators and presidents Bush and Obama indicating that the changes were intended to benefit "low-income" families.[25]

Likewise, a MO debtor could exempt the portion of his refund attributable to the EIC as a public assistance benefit but not the portion attributable to the ACTC and the American Opportunity Tax Credit (AOTC, see ¶ A-4500 et seq.). The AOTC is more like the ACTC than the EIC. Although it is at least partially refundable the AOTC has the primary purpose of encouraging college attendance, not helping the working poor. Also, it is available to a far broader range of families, based on income, than is the EIC.[26]

However, a bankruptcy court in the Eighth Circuit followed *Koch* (see above) and distinguished *Hardy* (see above) in holding that a part of a debtor's refund claim that was attributable to the ACTC for the year in which her bankruptcy petition was filed could be exempted as a public assistance benefit. The court said the *Hardy* opinion didn't fully consider the effects of '97 changes in the Code as to child care credits. The court also said that Eighth Circuit Bankruptcy Appellate Panel holdings aren't binding on bankruptcy courts in the Eighth Circuit.[27]

Another bankruptcy court didn't rely on a public assistance exemption in holding a taxpayer's (T's) CTC in her federal refund, and any state tax refund attributable to it, weren't bankruptcy estate property subject to turnover to the Chapter 7 trustee. The CTC was after-acquired property, which didn't come into existence until the end of the calendar year tax year at issue, after T's Dec. 27 bankruptcy petition filing. The remaining amounts of the refunds attributable to pre-petition income, which were based on an EIC and overpaid withholdings, were estate property. The CTC and EIC are treated differently for tax purposes. Under *Montgomery* (see above), T's EIC, as pro-rated to the bankruptcy petition filing date, was estate property. [28]

But, the Ninth Circuit Bankruptcy Appellate Panel disagreed with *Schwarz* (see above) and held that an ACTC for the year in which a debtor filed for bankruptcy was a contingent interest on the petition date and thus became part of the bankruptcy estate.[29]

A bankruptcy court held that an ACTC for the year in which a debtor filed for bankruptcy had to be divided between the estate and the debtor (D) on a pro rata basis from the petition date. It made no difference that D's second child was born post-petition.[30]

A provision in an opt-out state (OH) allowing debtors to exempt their interest in payments under Code Sec. 24 (which authorizes CTCs), didn't cover nonrefundable CTCs. A debtor could only use the nonrefundable CTC to offset income tax and had no interest in a *payment* from IRS. A nonrefundable CTC isn't property of the estate and isn't subject to collection and liquidation by the trustee. Thus, a debtor couldn't claim it as an exemption from property of the estate.[31] Likewise, then-applicable OH law didn't make the nonrefundable CTC "exempt property of the estate" because it wasn't property of the estate.[32]

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4 Krahn, Joseph Aaron In re, (2009, Bktcy Ct KS) 104 AFTR 2d 2009-7797 , 2010-1 USTC ¶50123 .

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20 Steinmetz, Larry D. In re, (2001, Bktcy Ct ID) 87 AFTR 2d 2001-1915 , 261 BR 32 , 2001-2 USTC ¶50477 .

21 Dever, Thomas In re, (2000, Bktcy Ct ID) 87 AFTR 2d 2001-1072 , 250 BR 701 , 2000-2 USTC ¶50616 ; Steinmetz, Larry D. In re, (2001, Bktcy Ct ID) 87 AFTR 2d 2001-1915 , 261 BR 32 , 2001-2 USTC ¶50477 .

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28 Schwarz, Kristi In re, (2004, Bktcy Ct NE) 94 AFTR 2d 2004-5547 , 314 BR 433 .

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31 Ruhl, Renee L. In re, (2009, Bktcy Ct OH) 104 AFTR 2d 2009-5692 .

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GITLITZ, ET AL. v. COMM., Cite as 87 AFTR 2d 2001-417 (531 U.S. 206, 121 S Ct 701), Code Sec(s) 108; 1366; 61; 108; 1367, (S Ct), 01/09/2001

David A. GITLITZ, ET AL., PETITIONERS v. COMMISSIONER of Internal Revenue.

Case Information:

[pg. 2001-417]

Code Sec(s):	108; 1366, 61; 108; 1367
Court Name:	U.S. Supreme Court,
Docket No.:	Docket No. 99-1295,
Date Decided:	01/09/2001.
Prior History:	Court of Appeals, (1999, CA10) 84 AFTR 2d 99-5059, 182 F3d 1143, affirming *Winn, Philip, et al* (1998) TC Memo 1998-71 [1998 RIA TC Memo ¶98,071], RIA TC Memo ¶98071, 75 CCH TCM 1840 [1998 RIA TC Memo ¶98,071], withdrawing (1997) TC Memo 1997-286 [1997 RIA TC Memo ¶97,286], RIA TC Memo ¶97286, 73 CCH TCM 3167 [1997 RIA TC Memo ¶97,286] (opinions by Cohen, *Ch.J.*), reversed.
Tax Year(s):	Years 1991, 1992.
Disposition:	Decision for Taxpayers. 531 U.S. 206.
Cites:	531 US 206, ,121 S Ct 701.

HEADNOTE

1. S corp. loss deductions—discharge of indebtedness income—insolvency exception —"items of income." For passthrough loss computation purposes, Supreme Court held that insolvent S corp.'s **Code Sec. 108** -excluded DOI income was "item of income" subject to

passthrough: under statute's plain language, insolvency merely caused DOI income to be excluded from gross income, but didn't alter its character. Fact that not all income items were includible in gross income under **Code Sec. 1366(a)(1)** and other IRC sections supported conclusion that exclusion in itself didn't imply recharacterization; lack of economic outlay in DOI situation wasn't material distinction; **Code Sec. 108(e)** , which limited prior judicial insolvency exception, presumed DOI to always be income; Reg. §1.61-12(b) said nothing about DOI's passthrough; and whether DOI income was tax-deferred vs tax-exempt was irrelevant since **Code Sec. 1366(a)(1)(A)** encompassed any income item.

Reference(s): ¶ 13,665;¶ 1085.04**Code Sec. 108**;**Code Sec. 1366**

2. S corp. loss deductions—increase in stock basis—discharge of indebtedness income —insolvency exception. For passthrough loss computation purposes, Supreme Court reversed 10th Cir.'s decision that NOL reduction preceded rather than followed passthrough of insolvent S corp.'s **Code Sec. 108** excluded DOI income: **Code Sec. 108(b)(4)(A)** 's express sequencing provisions required that tax determination precede attribute reduction; and passthrough and basis adjustment were necessary to such determination; so, 10th Cir.'s conclusion that DOI was absorbed before [pg. 2001-418] passthrough and unavailable for basis increase was incorrect. Also, **Code Sec. 108(d)(7)(A)** didn't abrogate ordinary passthrough rules; and whether sequencing scheme resulted in "double windfall" was irrelevant since result was mandated by statute.

Reference(s): ¶ 13,675;¶ 1085.02(30);¶ 615.116(7)**Code Sec. 61**;**Code Sec. 108**;**Code Sec. 1367**

OPINION

Supreme Court of the United States, Certiorari To the United States Court of Appeals for the Tenth Circuit.

Judge: THOMAS, Judge:

> Shareholders of a corporation taxed under Subchapter S of the Internal Revenue Code may elect a "pass-through" taxation system, under which the corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. 26 U.S.C. section 1366(a)(1)(A). To prevent double taxation of distributed income, shareholders may increase their corporate bases by certain items of income. Section 1367(a)(1)(A). Corporate losses and deductions are passed through in a similar manner, section 1366(a)(1)(A), and the shareholders' bases in the S corporation's stock and debt are decreased accordingly, sections 1367(a)(2)(B), 1367(b)(2)(A). However, to the extent that such losses and deductions exceed a shareholder's basis

in the S corporation's stock and debt, the excess is "suspended" until that basis becomes large enough to permit the deduction. Sections 1366(d)(1)-(2). In 1991, an insolvent S corporation in which petitioners David Gitlitz and Philip Winn were shareholders excluded its entire discharge of indebtedness amount from gross income. On their tax returns, petitioners used their pro rata share of the discharge amount to increase their bases in the corporation's stock on the theory that it was an "item of income" subject to pass-through. They used their increased bases to deduct corporate losses and deductions, including suspended ones from previous years. With the upward basis adjustments, they were each able to deduct the full amount of their pro rata share of the corporation's losses. The Commissioner determined that they could not use the corporation's discharge of indebtedness to increase their bases in the stock and denied their loss deductions. The Tax Court ultimately agreed. In affirming, the Tenth Circuit assumed that excluded discharge of indebtedness is an item of income subject to pass-through, but held that the discharge amount first had to be used to reduce certain tax attributes of the S corporation under section 108(b) and that only the leftover amount could be used to increase basis. Because the tax attribute to be reduced here (the corporation's net operating loss) equaled the discharged debt amount, that entire amount was absorbed by the reduction at the corporate level and nothing remained to be passed through to the shareholders.

Held:

1. The statute's plain language establishes that excluded discharged debt is an "item of income," which passes through to shareholders and increases their bases in an S corporation's stock. Section 61(a)(12) states that discharge of indebtedness is included in gross income. And section 108(a) provides only that the discharge ceases to be included in gross income when the S corporation is insolvent, not that it ceases to be an item of income, as the Commissioner contends. Not all items of income are included in gross income, see section 1366(a)(1), so an item's mere exclusion from gross income does not imply that the amount ceases to be an item of income. Moreover, sections 101 through 136 employ the same construction to exclude various items from gross income, but not even the Commissioner encour[pg. 2001-419] ages a reading that would exempt all such items from pass-through. Instead the Commissioner asserts that discharge of indebtedness is unique because it requires no economic outlay on the taxpayer's part, but can identify no statutory language that makes this distinction relevant. On the contrary, the statute makes clear that section 108(a)'s exclusion does not alter the character of discharge of indebtedness as an item of income. Specifically, section 108(e) presumes that such discharge is always "income," and that the only question for section 108 purposes is whether it is includible in gross income. The Commissioner's contentions that, notwithstanding the statute's plain language, excluded discharge of indebtedness is not

income and, specifically, that it is not "tax-exempt income" under section 1366(a)(1)(A) do not alter the conclusion reached here. Pp. 5-9.

2. Pass-through is performed before the reduction of an S corporation's tax attributes under section 108(b). The sequencing question presented here is important. If attribute reduction is performed before the discharge of indebtedness is passed through to the shareholders, the shareholders' losses that exceed basis are treated as the corporation's net operating loss and are then reduced by the amount of the discharged debt; in this case no suspended losses would remain that would permit petitioners to take deductions. However, if it is performed after the discharged debt income is passed through, then the shareholders would be able to deduct their losses (up to the amount of the increase in basis caused by the discharged debt). Any suspended losses remaining then will be treated as the S corporation's net operating loss and reduced by the discharged debt amount. Section 108(b)(4)(A) expressly addresses the sequencing question, directing that the attribute reductions "shall be made after the determination of the tax imposed...for the taxable year of the discharge." (Emphases added.) In order to determine the "tax imposed," a shareholder must adjust his basis in S corporation stock and pass through all items of income and loss. Consequently the attribute reduction must be made after the basis adjustment and pass-through. Petitioners must pass through the discharged debt, increase corporate bases, and then deduct their losses, all before any attribute reduction could occur. Because their basis increase is equal to their losses, they have no suspended losses remaining and thus have no net operating losses to reduce. The primary arguments made in Courts of Appeals against this reading of the sequencing provision are rejected. Pp. 9-13.

182 F.3d 1143 [84 AFTR 2d 99-5059], reversed.

Judge: THOMAS, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and STEVENS, O'CONNOR, SCALIA, KENNEDY, SOUTER, and GINSBURG, JJ., joined. BREYER, J., filed a dissenting opinion.

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Opinion of the Court

[January 9, 2001]

Justice THOMAS delivered the opinion of the Court.

The Commissioner of Internal Revenue assessed tax deficiencies against petitioners David and Louise Gitlitz and Philip and Eleanor Winn because they used nontaxed discharge of

indebtedness to increase their bases in S corporation stock and to deduct suspended losses. In this case we must answer two questions. First, we must decide whether the Internal Revenue Code (Code) permits taxpayers to increase bases in their S corporation stock by the amount of an S corporation's discharge of indebtedness excluded from gross income. And, second, if the Code permits such an increase, we [pg. 2001-420] must decide whether the increase occurs before or after taxpayers are required to reduce the S corporation's tax attributes.

I

David Gitlitz and Philip Winn [1] were shareholders of P.D.W.&A., Inc., a corporation that had elected to be taxed under subchapter S of the Code, 26 U.S.C. sections 1361-1379 (1994 ed. and Supp. III). Subchapter S allows shareholders of qualified corporations to elect a "pass-through" taxation system under which income is subjected to only one level of taxation. See Bufferd v. Commissioner, 506 U.S. 523, 525 [71 AFTR 2d 93-573] (1993). The corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. See section 1366(a)(1)(A). [2] To prevent double taxation of income upon distribution from the corporation to the shareholders, section 1367(a)(1)(A) permits shareholders to increase their corporate bases by items of income identified in section 1366(a) (1994 ed. and Supp. III). Corporate losses and deductions are passed through in a similar manner, see section 1366(a)(1)(A), and the shareholders' bases in the S corporation's stock and debt are decreased accordingly, see section 1367(a)(2)(B), 1367(b)(2)(A). However, a shareholder cannot take corporate losses and deductions into account on his personal tax return to the extent that such items exceed his basis in the stock and debt of the S corporation. See section 1366(d)(1) (Supp. III). If those items exceed the basis, the excess is "suspended" until the shareholder's basis becomes large enough to permit the deduction. See sections 1366(d)(1)-(2) (1994 ed. and Supp. III).

In 1991, P.D.W.&A. realized $2,021,296 of discharged indebtedness. At the time, the corporation was insolvent in the amount of $2,181,748. Because it was insolvent even after the discharge of indebtedness was added to its balance sheet, P.D.W.&A. excluded the entire discharge of indebtedness amount from gross income under 26 U.S.C. sections 108(a) and 108(d)(7)(A). On their tax returns, Gitlitz and Winn increased their bases in P.D.W.&A. stock by their pro rata share (50 percent each) of the amount of the corporation's discharge of indebtedness. Petitioners' theory was that the discharge of indebtedness was an "item of income" subject to pass-through under section 1366(a)(1)(A). They used their increased bases to deduct on their personal tax returns corporate losses and deductions, including losses and deductions from previous years that had been suspended under section 1366(d). Gitlitz and Winn each had losses (including suspended losses and operating losses) that totaled $1,010,648. With the upward basis adjustments of $1,010,648 each, Gitlitz and Winn were each able to deduct the full amount of their pro rata share of P.D.W.&A.'s losses.

The Commissioner determined that petitioners could not use P.D.W.&A.'s discharge of indebtedness to increase their bases in the stock and denied petitioners' loss deductions. Petitioners petitioned the Tax Court to review the deficiency determinations. The Tax Court, in its initial opinion, granted relief to petitioners and held that the discharge of indebtedness was an "item of income" and therefore could support a basis increase. See Winn v. Commissioner, 73 TCM 3167 (1997), paragraph 97,286 RIA Memo withdrawn and reissued, 75 TCM 1840 (1998), paragraph 98,071 RIA Memo TC. In light of the Tax Court's decision in Nelson v. Commissioner, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 [84 AFTR 2d 99-5067] (CA10 [pg. 2001-421] 1999), [3] however, the Tax Court granted the Commissioner's motion for reconsideration and held that shareholders may not use an S corporation's untaxed discharge of indebtedness to increase their bases in corporate stock. See Winn v. Commissioner, 75 TCM 1840 (1998), paragraph 98,071 RIA Memo TC.

The Court of Appeals affirmed. See 182 F.3d 1143 [84 AFTR 2d 99-5059] (CA10 1999). It assumed that excluded discharge of indebtedness is an item of income subject to passthrough to shareholders pursuant to section 1366(a)(1)(A), id., at 1148, 1151, n.7, but held that the discharge of indebtedness amount first had to be used to reduce certain tax attributes of the S corporation under section 108(b), and that only the leftover amount could be used to increase basis. [4] The Court of Appeals explained that, because the tax attribute to be reduced (in this case the corporation's net operating loss) was equal to the amount of discharged debt, the entire amount of discharged debt was absorbed by the reduction at the corporate level, and nothing remained of the discharge of indebtedness to be passed through to the shareholders under section 1366(a)(1)(A). Id., at 1151. Because Courts of Appeals have disagreed on how to treat discharge of indebtedness of an insolvent S corporation, compare Gaudiano v. Commissioner, 216 F.3d 524, 535 [86 AFTR 2d 2000-5065] (CA6 2000) (holding that tax attributes are reduced before excluded discharged debt income is passed through to shareholders), cert. pending, No. 00-459, Witzel v. Commissioner, 200 F.3d 496, 498 [85 AFTR 2d 2000-483] (CA7 2000) (same), cert. pending, No. 99-1693, and 182 F.3d, at 1150 (case below), with United States v. Farley, 202 F.3d 198, 206 [85 AFTR 2d 2000-615] (CA3 2000) (holding that excluded discharged debt income is passed through to shareholders before tax attributes are reduced), cert. pending, No. 99-1675; see also Pugh v. Commissioner, 213 F.3d 1324, 1330 [85 AFTR 2d 2000-1986] (CA11 2000) (holding that excluded discharged debt income is subject to passthrough and can increase basis), cert. pending, No. 00-242, we granted certiorari. 529 U.S. 1097 (2000).

II

[1] Before we can reach the issue addressed by the Court of Appeals — whether the increase in the taxpayers' corporate bases occurs before or after the taxpayers are required to reduce the S corporation's tax attributes — we must address the argument raised by the Commissioner. [5]

The Commissioner argues that the discharge of indebtedness of an insolvent S corporation is not an "item of income" and thus never passes through to shareholders. Under a plain reading of the statute, we reject this argument and conclude that excluded discharged debt is indeed an "item of income," which passes through to the shareholders and increases their bases in the stock of the S corporation.

Section 61(a)(12) states that discharge of indebtedness generally is included in gross income. Section 108(a)(1) provides an express exception to this general rule:

> "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge...of indebtedness of the taxpayer if —...."

[pg. 2001-422]

> "(B) the discharge occurs when the taxpayer is insolvent."

The Commissioner contends that this exclusion from gross income alters the character of the discharge of indebtedness so that it is no longer an "item of income." However, the text and structure of the statute do not support the Commissioner's theory. Section 108(a) simply does not say that discharge of indebtedness ceases to be an item of income when the S corporation is insolvent. Instead it provides only that discharge of indebtedness ceases to be included in gross income. Not all items of income are included in gross income, see section 1366(a)(1) (providing that "items of income," including "tax-exempt" income, are passed through to shareholders), so mere exclusion of an amount from gross income does not imply that the amount ceases to be an item of income. Moreover, sections 101 through 136 employ the same construction to exclude various items from gross income: "Gross income does not include...." The consequence of reading this language in the manner suggested by the Commissioner would be to exempt all items in these sections from pass-through under section 1366. However, not even the Commissioner encourages us to reach this sweeping conclusion. Instead the Commissioner asserts that discharge of indebtedness is unique among the types of items excluded from gross income because no economic outlay is required of the taxpayer receiving discharge of indebtedness. But the Commissioner is unable to identify language in the statute that makes this distinction relevant, and we certainly find none.

On the contrary, the statute makes clear that section 108(a)'s exclusion does not alter the character of discharge of indebtedness as an item of income. Specifically, section 108(e)(1) reads:

> "Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness."

This provision presumes that discharge of indebtedness is always "income," and that the only question for purposes of section 108 is whether it is includible in gross income. If discharge of indebtedness of insolvent entities were not actually "income," there would be no need to provide an exception to its inclusion in gross income; quite simply, if discharge of indebtedness of an insolvent entity were not "income," it would necessarily not be included in gross income.

Notwithstanding the plain language of the statute, the Commissioner argues, generally, that excluded discharge of indebtedness is not income and, specifically, that it is not "tax-exempt income" under section 1366(a)(1)(A). [6] First, the Commissioner argues that section 108 merely codified the "judicial insolvency exception," and that, under this exception, discharge of indebtedness of an insolvent taxpayer was not considered income. The insolvency exception was a rule that the discharge of indebtedness of an insolvent taxpayer was not taxable income. See, e.g., Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 [13 AFTR 930] (CA5 1934); Astoria Marine Construction Co. v. Commissioner, 12 T.C. 798 (1949). But the exception has since been limited by section 108(e). Section 108(e) precludes us from relying on any understanding of the judicial insolvency exception that was not codified in section 108. And as ex[pg. 2001-423] plained above, the language and logic of section 108 clearly establish that, although discharge of indebtedness of an insolvent taxpayer is not included in gross income, it is nevertheless income.

The Commissioner also relies on a Treasury Regulation to support his theory that no income is realized from the discharge of the debt of an insolvent:

"Proceedings under **Bankruptcy** Act."

> "(1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the **Bankruptcy** Act (11 U.S.C. 32), of his indebtedness as the result of an adjudication in **bankruptcy**, or by virtue of an agreement among his creditors not consummated under any provision of the **Bankruptcy** Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets." 26 CFR section 1.61-12(b) (2000).

Even if this regulation could be read (countertextually) to apply outside the **bankruptcy** context, it merely states that "[i]ncome is not realized." The regulation says nothing about whether discharge of indebtedness is income subject to pass-through under section 1366.

Second, the Commissioner argues that excluded discharge of indebtedness is not "tax-exempt" income under section 1366(a)(1)(A), but rather "tax-deferred" income. According to the Commissioner, because the taxpayer is required to reduce tax attributes that could have provided future tax benefits, the taxpayer will pay taxes on future income that otherwise would have been absorbed by the forfeited tax attributes. Implicit in the Commissioner's labeling of such income as "tax-deferred," however, is the erroneous assumption that section 1366(a)(1)(A)

does not include “taxdeferred” income. Section 1366 applies to “items of income.” This section expressly includes “tax-exempt” income, but this inclusion does not mean that the statute must therefore exclude “tax-deferred” income. The section is worded broadly enough to include any item of income, even tax-deferred income, that “could affect the liability for tax of any shareholder.” Section 1366(a)(1)(A). Thus, none of the Commissioner's contentions alters our conclusion that discharge of indebtedness of an insolvent S corporation is an item of income for purposes of section 1366(a)(1)(A).

III

[2] Having concluded that excluded discharge of indebtedness is an “item of income” and is therefore subject to pass-through to shareholders under section 1366, we must resolve the sequencing question addressed by the Court of Appeals — whether pass-through is performed before or after the reduction of the S corporation's tax attributes under section 108(b). Section 108(b)(1) provides that “[t]he amount excluded from gross income under [section 108(a)] shall be applied to reduce the tax attributes of the taxpayer as provided [in this section].” Section 108(b)(2) then lists the various tax attributes to be reduced in the order of reduction. The first tax attribute to be reduced, and the one at issue in this case, is the net operating loss. See section 108(b)(2)(A). Section 108(d)(7)(B) specifies that, for purposes of attribute reduction, the shareholders' suspended losses for the taxable year of discharge are to be treated as the S corporation's net operating loss. If tax attribute reduction is performed before the discharge of indebtedness is passed through to the shareholders (as the Court of Appeals held), the shareholders' losses that exceed basis are treated as the corporation's net operating loss and are then reduced by the amount of the discharged debt. In this case, no suspended losses would remain that would permit petitioners [pg. 2001-424] to take deductions. [7] If, however, attribute reduction is performed after the discharged debt income is passed through (as petitioners argue), then the shareholders would be able to deduct their losses (up to the amount of the increase in basis caused by the discharged debt). Any suspended losses remaining then will be treated as the S corporation's net operating loss and will be reduced by the amount of the discharged debt. Therefore, the sequence of the steps of pass-through and attribute reduction determines whether petitioners here were deficient when they increased their bases by the discharged debt amount and deducted their losses.

The sequencing question is expressly addressed in the statute. Section 108(b)(4)(A) directs that the attribute reductions “shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.” (Emphases added.) See also section 1017(a) (applying the same sequencing when section 108 attribute reduction affects basis of corporate property). In order to determine the “tax imposed,” an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss. See sections 1366, 1367 (1994 ed. and Supp III). Consequently, the attribute reduction must be made after the basis

adjustment and pass-through. In the case of petitioners, they must pass through the discharged debt, increase corporate bases, and then deduct their losses, all before any attribute reduction could occur. Because their basis increase is equal to their losses, petitioners have no suspended losses remaining. They, therefore, have no net operating losses to reduce.

Although the Commissioner has now abandoned the reasoning of the Court of Appeals below, [8] we address the primary arguments made in the Courts of Appeals against petitioners' reading of the sequencing provision. First, one court has expressed the concern that, if the discharge of indebtedness is passed through to the shareholder before the tax attributes are reduced, then there can never be any discharge of indebtedness remaining “at [the] corporate level,” section 108(d)(7)(A), by which to reduce tax attributes. [9] Gaudiano, 216 F.3d, at 533. This concern presumes that tax attributes can be reduced only if the discharge of indebtedness itself remains at the corporate level. The statute, however, does not impose this restriction. Section 108(b)(1) requires only that the tax attributes be reduced by “[t]he amount excluded from gross income,” (emphasis added), and that amount is not altered by [pg. 2001-425] the mere pass-through of the income to the shareholder.

Second, courts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a “double windfall”: They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses. See, e.g., 182 F.3d, at 1147-1148. Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern. [10]

***

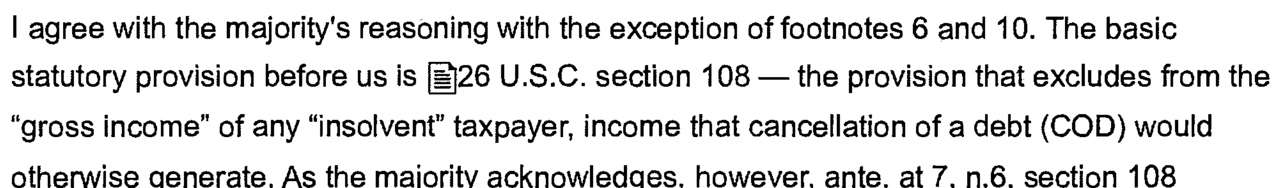
The judgment of the Court of Appeals, accordingly, is reversed.

It Is So Ordered.

*****

[January 9, 2000]

Justice BREYER, Dissenting.


I agree with the majority's reasoning with the exception of footnotes 6 and 10. The basic statutory provision before us is 26 U.S.C. section 108 — the provision that excludes from the “gross income” of any “insolvent” taxpayer, income that cancellation of a debt (COD) would otherwise generate. As the majority acknowledges, however, ante, at 7, n.6, section 108

contains a subsection that sets forth a special exception. The exception, entitled "Special rules for S corporation," says:

> "(A) Certain provisions to be applied at corporate level."
>
> "In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level." 26 U.S.C. section 108(d)(7)(A).

If one reads this language literally as exclusive, both the COD exclusion (section 108(a)) and the tax attribute reduction (section 108(b)) would apply only "at the corporate level." Hence the COD income would not flow through to S corporation shareholders. Consequently, the insolvent S corporation's COD income would not increase the shareholder's basis and would not help the shareholder take otherwise unavailable deductions for suspended losses.

The Commissioner argues that we should read the language in this way as preventing the flow-through of the corporation's COD income. Brief for United States 27. He points to the language of a House Committee, which apparently thought, when Congress passed an amendment to section 108, that the Commissioner's reading is correct. H. R. Rep. No. 103-111, pp. 624-625 (1993) ("[T]he exclusion and basis reduction are both made at the S corporation level (sec. 108(d)(7)). The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level"). At least one commentator believes the same. See Loebl, Does the Excluded COD Income of an Insolvent S Corporation Increase the Basis of the Shareholders' Stock?, 52 U. Fla. L. Rev. 957, 981-988 (2000). But see Lockhart & Duffy, Tax Court Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 25 Wm. Mitchell L. Rev. 287 (1999).

The Commissioner finds support for his literal, exclusive reading of section 108(d)(7)(A)'s language in the fact that his reading would close a significant tax loophole. That loophole — preserved by the majority — would grant a solvent shareholder of an insolvent S corporation a tax [pg. 2001-426] benefit in the form of permission to take an otherwise unavailable deduction, thereby sheltering other, unrelated income from tax. See Witzel v. Commissioner, 200 F.3d 496, 497 [85 AFTR 2d 2000-483] (CA7 2000) (Posner, C.J.) ("It is hard to understand the rationale for using a tax exemption to avoid taxation not only on the income covered by the exemption but also on unrelated income that is not tax exempt"). Moreover, the benefit often would increase in value as the amount of COD income increases, a result inconsistent with congressional intent to impose a "price" (attribute reduction), see Lipton, Different Courts Adopt Different Approaches to the Impact of COD Income on S Corporations, 92 J. Tax. 207 (2000), on excluded COD. Further, this deduction-related tax benefit would have very different tax consequences for identically situated taxpayers, depending only upon whether a single debt can be split into segments, each of which is canceled in a different year. For example, under the majority's interpretation, a $1 million debt canceled in one year would permit Taxpayer A to

deduct $1 million of suspended losses in that year, thereby permitting A to shelter $1 million of unrelated income in that year. But because section 108 reduces tax attributes after the first year, five annual cancellations of $200,000 will not create a $1 million shelter. Timing is all important.

The majority acknowledges some of these policy concerns and confesses ignorance of any "other instance in which section 108 directly benefits a solvent entity," but claims that its reading is mandated by the plain text of section 108(d)(7)(A) and therefore that the Court may disregard the policy consequences. Ante, at 13, and n.10. It is difficult, however, to see why we should interpret that language as treating different solvent shareholders differently, given that the words "at the corporate level" were added "[i]n order to treat all shareholders in the same manner." H.R. Rep. No. 98-432, pt. 2, p. 1640 (1984). And it is more difficult to see why, given the fact that the "plain language" admits either interpretation, we should ignore the policy consequences. See Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134-135 [5 AFTR 2d 1770] (1960) (abandoning literal meaning of 26 U.S.C. section 1221 (1958 ed.) for a reading more consistent with congressional intent). Accord, Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 264-267 [1 AFTR 2d 1394] (1958); Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 51-52 [47 AFTR 1789] (1955); Hort v. Commissioner, 313 U.S. 28, 30-31 [25 AFTR 1207] (1941).

The arguments from plain text on both sides here produce ambiguity, not certainty. And other things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes. Such is an appropriate understanding of Congress' likely intent. Here, other things are equal, for, as far as I am aware, the Commissioner's literal interpretation of section 108(d)(7)(A) as exclusive would neither cause any tax-related harm nor create any statutory anomaly. Petitioners argue that it would create a linguistic inconsistency, for they point to a Treasury Regulation that says that the Commissioner will apply hobby loss limitations under section 183 "at the corporate level in determining" allowable deductions, while, presumably, nonetheless permitting the deduction so limited to flow through to the shareholder. Treas. Reg. section 1.183-1(f), 26 CFR section 1.183-1(f) (2000). But we are concerned here with the "application" of an exclusion, not with "determining" the amount of a deduction. Regardless, the regulation's use of the words "at the corporate level," like the three other appearances of the formulation "applied" or "determined" "at the corporate level" in the Code, occur in contexts that are so very different from this one that nothing we say here need affect their interpretation. See 26 U.S.C. section 49(a)(1)(E)(ii)(I) (determining whether financing is recourse financing); 26 U.S.C. section 264(f)(5)(B) [pg. 2001-427] (1994 ed., Supp. IV) (determining how to allocate interest expense to portions of insurance policies); 26 U.S.C. section 302(e)(1)(A) (determining whether a stock distribution shall be treated as a partial liquidation). If there are other arguments militating in favor of the majority's interpretation, I have not found them.

The majority, in footnote 6, says that the words “at the corporate level” in section 108(d)(7)(A) apply to the exclusion of COD income from corporate income and to “tax attribute reduction” but do not “suspen[d] the operation of ...ordinary pass-through rules” because section 108(d)(7)(A) “does not state or imply that the debt discharge provisions shall apply only “at the corporate level.”” It is the majority, however, that should explain why it reads the provision as nonexclusive (where, as here, its interpretation of the Code results in the “practical equivalent of [a] double deduction,” Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 [13 AFTR 881] (1934)). See United States v. Skelly Oil Co., 394 U.S. 678, 684 [23 AFTR 2d 69-1186] (1969) (requiring “clear declaration of intent by Congress” in such circumstances). I do not contend that section 108(d)(7)(A) must be read as having exclusive effect, only that, given the alternative, this interpretation provides the best reading of section 108 as a whole. And I can find no “clear declaration of intent by Congress” to support the majority's contrary conclusion regarding section 108(d)(7)(A)'s effect. It is that conclusion from which, for the reasons stated, I respectfully dissent.

---

1 Each man filed a joint tax return with his wife.

2 Section 1366(a)(1) provides:

> “In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends..., there shall be taken into account the shareholder's pro rata share of the corporation's —”
>
> “(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder....”

3 In Nelson, the Tax Court held that excluded discharge of indebtedness does not pass through to an S corporation's shareholders because section 108 is an exception to normal S corporation pass-through rules. Specifically, the court held that, because section 108(d)(7)(A) requires that “subsections (a) [and (b) of section 108] shall be applied at the corporate level” in the case of an S corporation, it precludes any pass-through of the discharge of indebtedness to the shareholder level. See Nelson, 110 T.C., at 121-124.

4 Section 108(b)(1) reads: “The amount excluded from gross income under [section 108(a)(1)] shall be applied to reduce the tax attributes of the taxpayer....”

5 The Commissioner has altered his arguments throughout the course of this litigation. According to the Tax Court, during the first iteration of this case the Commissioner made several arguments but then settled on a “final” one — that the discharge of indebtedness of the insolvent S corporation was not an “item of income,” see 73 TCM 3167 (1997),

paragraph 97,286 RIA Memo TC. In the Court of Appeals, the Commissioner argued instead that, because any pass-through of excluded discharge of indebtedness to petitioners took place after any reduction of tax attributes and by then the income would have been fully absorbed by the tax attributes, no discharged debt remained to flow through to petitioners. The Commissioner relegated to a footnote his argument that discharge of indebtedness is not an "item of income." See Brief for Appellee in Nos. 98-9009 and 98-9010 (CA10), p. 33, n.14.

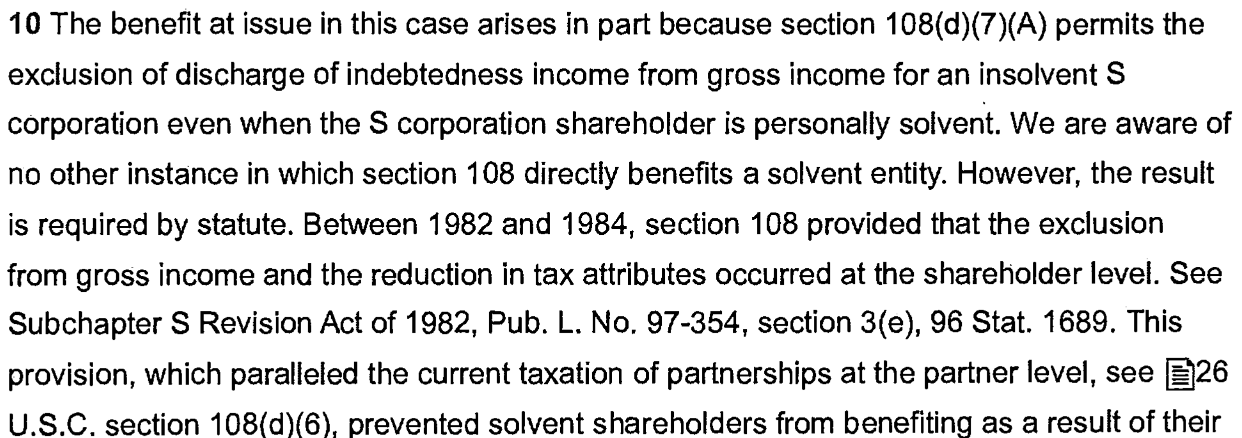
6 The Commissioner also contends, as does the dissent, that because section 108(d)(7)(A) mandates that the discharged debt amount be determined and applied to reduce tax attributes "at the corporate level," rather than at the shareholder level, the discharged debt, even if it is some type of income, simply cannot pass through to shareholders. In other words, the Commissioner contends that section 108(d)(7)(A) excepts excluded discharged debt from the general pass-through provisions for S corporations. However, section 108(d)(7)(A) merely directs that the exclusion from gross income and the tax attribute reduction be made at the corporate level. Section 108(d)(7)(A) does not state or imply that the debt discharge provisions shall apply only "at the corporate level." The very purpose of Subchapter S is to tax at the shareholder level, not the corporate level. Income is determined at the S corporation level, see section 1363(b), not in order to tax the corporation, see section 1363(a) (exempting an S corporation from income tax), but solely to pass through to the S corporation's shareholders the corporation's income. Thus, the controlling provision states that, in determining a shareholder's liability, "there shall be taken into account the shareholder's pro rata share of the corporation's...items of income (including tax-exempt income)...." section 1366(a)(1). Nothing in section 108(d)(7)(A) suspends the operation of these ordinary pass-through rules.

7 Under this scenario, the shareholders' losses would be reduced by the discharge of indebtedness. However, it is unclear precisely what would happen to the discharge of indebtedness. The Court of Appeals below stated that the discharged debt would be "absorbed" by the reduction to the extent of the net operating loss and that therefore only the excess excluded discharged debt would remain to pass through to the shareholders. 182 F.3d, at 1149. In contrast, another Court of Appeals suggested, albeit in dictum, that the full amount of the discharge might still pass through to the shareholder and be used to increase basis; the discharged debt amount would reduce the net operating loss but would not be absorbed by it. Witzel v. Commissioner, 200 F.3d 496, 498 [85 AFTR 2d 2000-483] (CA7 2000). We need not resolve this issue because we conclude that the discharge of indebtedness passes through before any attribute reduction takes place.

8 The Commissioner has abandoned his argument related to the sequencing issue before this Court. This abandonment is particularly odd given that the sequencing issue

predominated in the Commissioner's argument to the Court of Appeals. Notwithstanding the Commissioner's attempt at oral argument to distance himself from the reasoning of the Court of Appeals on this issue — the Commissioner represented to us that the Court of Appeals developed its reading of the statute sua sponte, Tr. of Oral Arg. 22-24, 27 — it is apparent from the Commissioner's brief in the Court of Appeals that the Commissioner supplied the very sequencing theory that the Court of Appeals adopted. Compare, e.g., Brief for Appellee in Nos. 98-9009 and 98-9010 (CA10), p. 28 ("First, the discharge of indebtedness income that is excluded under Section 108(a) at the corporate level is temporarily set aside and has no tax consequences....Second, PDW & A. computes its tax attributes, i.e., taxpayers' suspended losses. Third, the excluded discharge of indebtedness income is applied against and eliminates the suspended losses. Because the excluded income is applied against — and offset by — the suspended losses, no item of income flows through to taxpayers under Section 1366(a), and no upward basis adjustment is made under Section 1367(a)" (citations omitted)), with, e.g., 182 F.3d, at 1151 ("PDW & A first must compute its discharge of indebtedness income and set this figure aside temporarily. The corporation then must calculate its net operating loss tax attribute....Finally, the corporation must apply the excluded discharged debt to reduce its tax attributes. In this case, the net operating loss tax attribute fully absorbs the corporation's excluded discharge of indebtedness income. Thus, there are no items of income to pass through to Gitlitz and Winn").

9 Similar to this argument is the contention that, in cases such as this one in which the shareholders' suspended losses are fully deducted before attribute reduction could take place, no net operating loss remains and no attribute reduction can occur, thus rendering section 108(b) inoperative. However, there will be other cases in which section 108(b) will be inoperative. In particular, if a taxpayer has no tax attributes at all, there will be no reduction. Certainly the statute does not condition the exclusion under section 108(a) on the ability of the taxpayer to reduce attributes under section 108(b). Likewise, in the case of shareholders similarly situated to petitioners in this case, there is also the possibility that other attributes, see sections 108(b)(2)(B)-(G), could be reduced.



10 The benefit at issue in this case arises in part because section 108(d)(7)(A) permits the exclusion of discharge of indebtedness income from gross income for an insolvent S corporation even when the S corporation shareholder is personally solvent. We are aware of no other instance in which section 108 directly benefits a solvent entity. However, the result is required by statute. Between 1982 and 1984, section 108 provided that the exclusion from gross income and the reduction in tax attributes occurred at the shareholder level. See Subchapter S Revision Act of 1982, Pub. L. No. 97-354, section 3(e), 96 Stat. 1689. This provision, which paralleled the current taxation of partnerships at the partner level, see 26 U.S.C. section 108(d)(6), prevented solvent shareholders from benefiting as a result of their

S corporation's insolvency. In 1984, however, Congress amended the Code to provide that section 108 be applied "at the corporate level." Tax Reform Act of 1984, Pub. L. No. 98-369, section 721(b), 98 Stat. 966. It is as a direct result of this amendment that the solvent petitioners in this case are able to benefit from section 108's exclusion.

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d) Meaning of terms; special rules relating to certain provisions.

(1) Indebtedness of taxpayer.

For purposes of this section , the term "indebtedness of the taxpayer" means any indebtedness—

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case.

For purposes of this section , the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent.

For purposes of this section , the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

(4) Repealed.

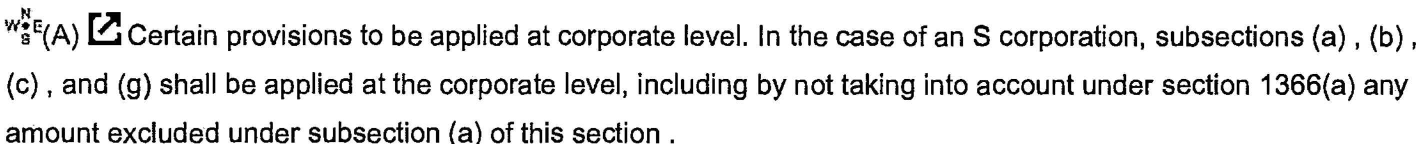
(5) Depreciable property.

The term "depreciable property" has the same meaning as when used in section 1017 .

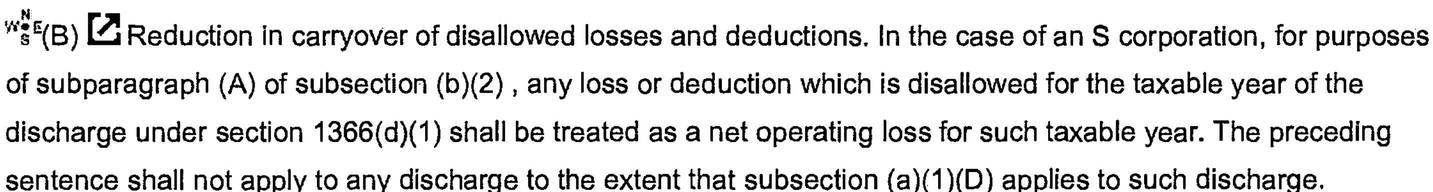
(6) Certain provisions to be applied at partner level.

In the case of a partnership, subsections (a) , (b) , (c) and (g) shall be applied at the partner level.

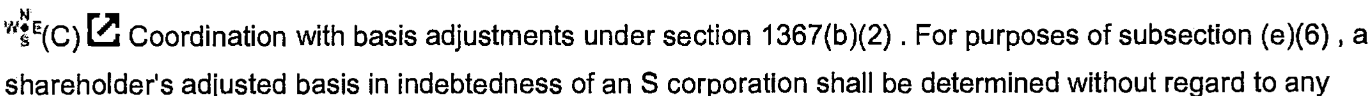
(7) Special rules for S corporation.



(A) Certain provisions to be applied at corporate level. In the case of an S corporation, subsections (a) , (b) , (c) , and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section .



(B) Reduction in carryover of disallowed losses and deductions. In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2) , any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.



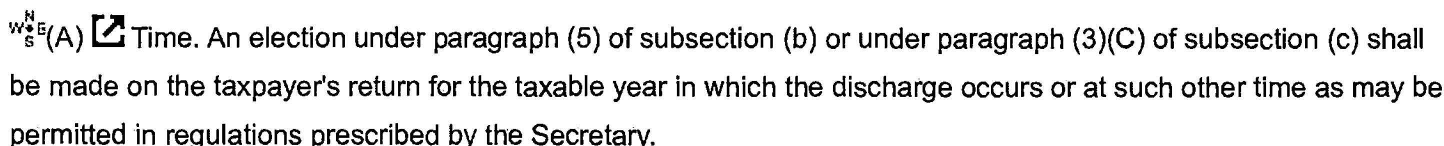
(C) Coordination with basis adjustments under section 1367(b)(2) . For purposes of subsection (e)(6) , a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any

adjustments made under section 1367(b)(2) .

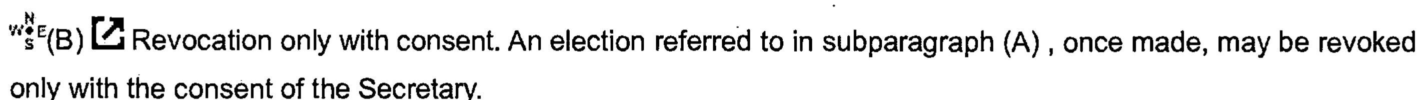
(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate.

In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

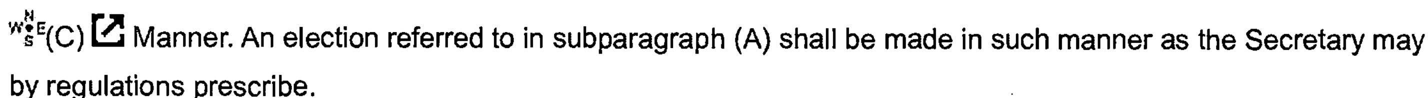
(9) Time for making election, etc.



(A) Time. An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.



(B) Revocation only with consent. An election referred to in subparagraph (A) , once made, may be revoked only with the consent of the Secretary.



(C) Manner. An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference.

For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1) .

(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or

Document Header:
Checkpoint Contents
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Chapter 1 NORMAL TAXES AND SURTAXES §§1-1400Z-2
Subchapter B Computation of Taxable Income §§61-291
Part III ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME §§101-140
§108 Income from discharge of indebtedness.

Selected Text Starting At: 108(f)(2)(C)

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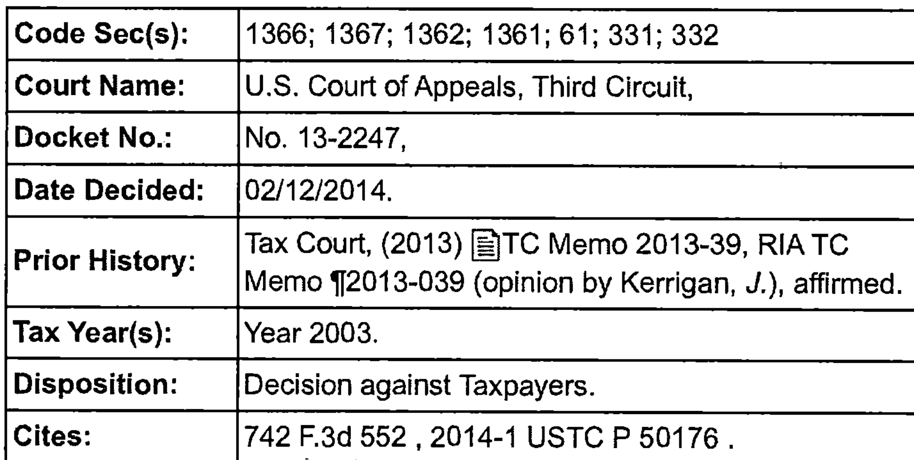
American Federal Tax Reports

R BALL FOR R BALL III BY APPT. v. COMM., Cite as 113 AFTR 2d 2014-907 (742 F.3d 552), Code Sec(s) 1366; 1367; 1362; 1361; 61; 331; 332, (CA3), 02/12/2014

R BALL FOR R BALL III BY APPT., APPELLEE v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17593); R BALL CHILDREN TRUST 9/9/1969 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17594); ETHEL BALL FOR R BALL III APT 2/9/1967 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17595); ETHEL BALL FOR A L BALL AS APPT. v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17596); R BALL JR. CHILDRENTRUST 1/29/1970 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17597); R BALL JR. F/B/O R BALL III 12/22/1976 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17598); R BALL FOR A L BALL BY APPT. v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17599); R BALL CHILDREN TRUST 1/24/1973 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17600); RUSSELL BALL JR. SEC. FIRST 9/9/1967 v. COMMISSIONER of Internal Revenue (Tax Court No. 11-17601); R BALL FOR R BALL III BY APPT.; R Ball Children Trust 9/9/1969; Ethel Ball for R Ball III APT 2/9/1967; Ethel Ball for A L Ball as Appt.; R Ball Jr. Childrentrust 1/29/1970; R Ball Jr., f/b/o R Ball III 12/22/1976; R Ball for A L Ball by Appt; R Ball Children Trust 1/24/1973; Russell Ball Jr. Sec First 9/9/1967, APPELLANTS.

Case Information:

[pg. 2014-907]



Code Sec(s):	1366; 1367; 1362; 1361; 61; 331; 332
Court Name:	U.S. Court of Appeals, Third Circuit,
Docket No.:	No. 13-2247,
Date Decided:	02/12/2014.
Prior History:	Tax Court, (2013) TC Memo 2013-39, RIA TC Memo ¶2013-039 (opinion by Kerrigan, *J.*), affirmed.
Tax Year(s):	Year 2003.
Disposition:	Decision against Taxpayers.
Cites:	742 F.3d 552 , 2014-1 USTC P 50176 .

HEADNOTE

1. S corps.—electing small business trusts—shareholder liability—items of income—basis adjustments—QSub elections—unrecognized gain; gross income; liquidations. In consolidated cases involving series of trust-shareholders in parent S corp., Tax Court properly determined that parent's QSub election for its sub., and sub.'s resulting deemed Code Sec. 332 liquidation into parent, didn't create item of income under Code Sec. 1366(a)(1)(A) that would support trusts' claims for basis adjustments and attendant losses on parent's subsequent sale to outside party. Notably, there was no accession to wealth here, but merely change in treatment of income flowing from QSub. Moreover, while transaction did result in gain, that gain wasn't per Code Sec. 332 *recognized.* Trusts' arguments that gain's realization was sufficient to qualify it as income mistakenly conflated Code Sec. 332 [pg. 2014-908] and Code Sec. 331 and were otherwise off base since "item of income" for these purposes required that there be recognition of income.

Reference(s): ¶ 13,665;¶ 13,625.01(10) Code Sec. 1366;Code Sec. 1367;Code Sec. 1362;Code Sec. 1361;Code Sec. 61;Code Sec. 331;Code Sec. 332

OPINION

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UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT,

On Appeal from the United States Tax Court (Tax Court Nos. 17593-11, 17594-11, 17595-11, 17596-11, 17597-11, 17598-11, 17599-11, 17600-11, 17601-11) Tax Court Judge: Honorable Kathleen Kerrigan

Before: JORDAN, VANASKIE, and VAN ANTWERPEN, *Circuit Judges.*

OPINION OF THE COURT

Judge: VAN ANTWERPEN, *Circuit Judge.*

PRECEDENTIAL

I. INTRODUCTION

An S corporation ("S Corp.") is a small business corporation that is permitted to have its corporate income, losses, deductions, and credits attributed to its shareholders. This appeal arises out of nine consolidated cases before the United States Tax Court regarding the tax implications of an S Corp.'s election to treat its subsidiary as a "qualified subchapter S subsidiary" ("Qsub") under Internal Revenue Code § 1361.[1] Specifically, the parties disagree as to whether the Qsub election and subsequent sale of the S Corp. parent creates an "item of income" under § 1366(a)(1)(A)[2] thereby requiring the parties who held stock in the parent S Corp. to adjust their bases in stock under § 1367(a)(1)(A).[3] For reasons which follow, we affirm the decision of the Tax Court, finding an increase in stock bases and declared losses to be improper.

II. FACTS

In June 1997, ten trusts for the benefit of the Ball family ("Trusts")[4] acquired direct ownership of all shares of American Insurance Service, Inc. ("AIS")[5] with an aggregate basis in AIS stock totaling $5,612,555. In 1999, the Trusts formed Wind River Investment Corporation ("Wind River"), a Delaware corporation. The Trusts then contributed their shares in AIS in exchange for all of the shares of Wind River. This resulted in Wind River owning all of the shares of AIS. Effective June 4, 1999, Wind River designated itself a subchapter S Corporation. On February 28, 2003, Wind River elected to treat AIS as a Qsub under § **1361** (**b**)(3).[6] Prior to the Qsub election, the Trusts' aggregate adjusted basis in the Wind River stock was $15,246,099. Following the Qsub election, the Trusts increased their bases in the Wind River stock from $15,246,099 to a new basis of $242,481,544.[7]

Following the Qsub election and stock basis adjustments, the Trusts sold their interests in Wind River to a third party, Fox Paine, on September 5, 2003. After transaction costs, this sale yielded $230,111,857 in cash and securities in exchange for all of the Wind River stock.[8] Even though

they had received $230,111,857 [pg. 2014-909] from the sale, the Trusts claimed a loss in the amount of $12,247,229.[9] This was calculated as the difference between the amount actually received for the sale and the new basis in the Wind River stock. The Trusts shareholders' 2003 tax returns were filed citing the aforementioned capital loss.

The Internal Revenue Service ("IRS") determined the Trusts should not have increased their bases in the Wind River stock to $242,481,544 following the Qsub election. The IRS determined instead that a capital gain of approximately $214 million had been realized from the sale of Wind River to Fox Paine. This resulted in a cumulative tax deficiency of $33,747,858 for the nine trusts that have filed appeals in this case. Deficiency notices were sent to the Trusts on May 18 and 19, 2011, stating "the Qsub election and the resulting deemed I.R.C. § 332[10] liquidation did not give rise to an item of income under I.R.C. § 1366(a)(1)(A); therefore, [the Trusts] could not increase the basis of their [Wind River] stock under I.R.C. [§] 1367(a)(1)(A)." (Appendix ("App.") at A373.) The Trusts filed petitions with the United States Tax Court seeking a redetermination of deficiencies under the jurisdiction of §§ 6213(a) and 7442. The cases were consolidated and submitted for decision on stipulated facts, under Tax Court Rule 122,[11] as *R. Ball for R. Ball III By Appt., et al. v. Commissioner*, 105 T.C.M. (CCH) 1257, 2013 WL 452722 (2013). As previously noted, the Tax Court found the increase in stock basis and declared loss to be improper.

III. TAX COURT PROCEEDINGS

The main issue before the Tax Court and now on appeal is whether or not a Qsub election creates an "item of income" for the parent corporation under § 1366(a)(1)(A). The Trusts relied on their assertion that the election "resulted in a gain derived from dealings in property and, therefore, created an item of income under § 61(a)."[12] *R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 4. If the election resulted in an "item of income," the new higher bases and resulting tax losses are proper. If it did not result in an "item of income," the increase in stock bases and declared tax losses are improper.

More specifically, before the Tax Court, the Trusts argued that the deemed liquidation of AIS was, under § 331, a sale or exchange of property creating a realized gain to Wind River. They further claimed that gains from dealings in property are expressly included in gross income under § 61(a). They then contended that, although § 332 provides for the nonrecognition of that gain, it was still "an item of income (including tax exempt income)" under § 1366(a)(1)(A), which passed through to them and increased their bases in Wind River stock under § 1367(a)(1)(A). To support their position, the Trusts raised several contentions to the Commissioner's deficiency finding: (1) their bases were properly adjusted pursuant to § 1367(a)(1)(A), (2) the losses were properly claimed from the sale of Wind River, and (3) "the Qsub election resulted in an item of income pursuant to [§] 1366(a)(1)(A)." *See R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 4. Lastly, the Trusts cited *United States v. Farley*[13] and ***Gitlitz*** *v. Commissioner*,[14] arguing that the

"realized" liquidation gain under §§ 331 and 61(a)(3), allowed an increase in basis, but that gain is not taxable under the non-recognition provision of § 332(a). The Commissioner responded to the Trusts' arguments by asserting that the Qsub election did not create an "item of income (including tax exempt income)" under § 1366(a)(1)(A).

The Tax Court rejected the Trusts' arguments, relying on the differences between "realization" and "recognition" of income in determining what constitutes an "item of income" under § 1366 as it relates to §§ 1367, 331, 332, and 61(a). *R. Ball*, 2013 WL 452772, at 4–5 (2013). The Tax Court held that gain from a Qsub election is "realized" and calculated under § 1001,[15] yet it is not "recognized" due to the nonrecognition provision of § 332. *Id.* ("Once the amount of the realized gain has been calculated, the entire amount of the realized gain is recognized unless a Code section provides for nonrecognition treatment."). Furthermore, the Court found, under § 1366, [pg. 2014-910] that when a gain is unrecognized, it "does not rise to the level of income" and is not an "item of income for tax purposes."[16] *Id.* at 7. Finally, the Court distinguished ***Gitlitz*** and *Farley* and determined that "neither case is squarely on point." *R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 8. The Court reasoned that ***Gitlitz*** and *Farley* only established that the nature of "discharge of indebtedness" as income is not affected by an exclusion elsewhere in the Code. *See id.* Here, however, "realized gain from the Qsub election was never included explicitly in gross income and was never excluded from gross income." *Id.* Therefore, the Tax Court determined ***Gitlitz*** and *Farley* were unpersuasive in qualifying the Qsub election as an "item of income" under § 1366.[17] *Id.*

In sum, the Court held that "unrecognized gain resulting from the Qsub election did not create an item of income or tax exempt income pursuant to section1366(a)(1)(A)." *Id.* at 10. Accordingly, the Trusts were found deficient for improperly adjusting their bases in Wind River stock following the Qsub election and this appeal followed. *Id.*.

IV. JURISDICTION

Section 7482(a) provides exclusive jurisdiction by this Court over decisions before the United States Tax Court. Our review of the Tax Court's construction of the Internal Revenue Code is plenary. *Nat'l Starch & Chem. Corp. v. Comm'r*, 918 F.2d 426, 428 [66 AFTR 2d 90-5844] (3d Cir. 1990).

V. DISCUSSION

A. Items of Income

[1] As previously noted, the main issue before us is whether or not the Qsub election created an "item of income." An "item of income" is required for a shareholder of an S Corp. to increase the

basis in his or her of the S Corp.. *See* § 1366(a)(1)(A).[18] Despite use of the term "item of income" in § 1366, it is not defined in the Internal Revenue Code and the Treasury regulations provide only guidance.[19] *See* 26 C.F.R. § 1.1366-1(a)(2); *see also Comm'r v. Glenshaw Glass Co.,* 348 U.S. 426 [47 AFTR 162] (1955). "Gross income," however, is defined. It is governed by § 61, and includes "[g]ains derived from dealings in property," as well as "[i]ncome from discharge of indebtedness."[20] *Id.* § 61(a)(3), (12). Further, the Supreme Court has defined "gross income" as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Glenshaw Glass*, 348 U.S. at 431. Gains derived from the property obtained by electing and liquidating the Qsub are claimed by the Trusts to be "items of income" for the purpose of § 1366. Fundamentally, the Trusts claim there was a gain from liquidation (§ 61(a)), that gain was "realized" (§ 331) and calculated (§ 1001), and thus is an "item of income" (§ 1366). (Appellant Br. at 17.) The Trusts summarily dismiss the effect of non-recognition on whether a gain is income; however, this premise is undermined by regulations corresponding to § 61(a).[21] Under the § 61(a) Treasury Regulations, gains from the sale or exchange of property, including those derived under § 331, are not "recognized," and thus "not included in or deducted from gross income at the time the transaction occurs."[22] 26 C.F.R. § 1.61-6(b)(1). [pg. 2014-911]

While "item of income" is a broad and undefined term, it is not one without limits. § 61(a) provides a "broad definition of "gross income,"" that is "sweeping [in] scope," unless "excepted by another provision in the tax code." *Comm'r v. Schleier*, 515 U.S. 323, 328 [75 AFTR 2d 95-2675]–29 (1995). The Supreme Court concluded that "income" requires an "accession to wealth." *Glenshaw Glass*, 348 U.S. at 431. The Qsub election did not add wealth, it merely changed the tax treatment of the income flowing from the Qsub. This reformation by liquidation did not provide an "accession to wealth" for the corporation and therefore could not create "income" for the Trusts.

B. Realization and Recognition of Gains

The Internal Revenue Code

> defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. The realization requirement is implicit in § 1001(a) of the Code, which defines "[t]he gain [or loss] from the sale or other disposition of property" as the difference between "the amount realized" from the sale or disposition of the property and its "adjusted basis."

Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) (quoting 26 U.S.C. § 1001(a–b)). "To realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property."" *Id.* (quoting § 1001(a)). The Commissioner and the Trusts differ as to whether "realizing" a gain is enough to create an "item of income" under §1366, or whether this section requires the gain to be "recognized." The Tax Court concluded that "nonrecognition

provisions prevent realized gain from being included in a taxpayer's gross income." *R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 5. The Trusts contend that the Tax Court "confused the concepts of realization and recognition." (Appellants' Opening Br. at 14.) They argue that the Tax Court reached the "unprecedented conclusion that because "no gain was recognized, ... the unrecognized gain did not create an item of income under § 61(a)(3)," or § 1355(a)(1)(A)." (*Id.* at 15 (quoting App. at 24.) The Trusts assert that the "crux of the Tax Court's error" is its determination that "unrecognized gain does not rise to the level of income." (*Id.*) They argue that the Code cannot be parsed to create some realized gain that is income and some realized gain that, by virtue of nonrecognition, is not. According to the Trusts, realized gain is always income, a categorization that does not change if that realized gain is then unrecognized.

Inherent in this conflict is which statutory provision, §§ 331 or 332, applies to the liquidation of AIS via Qsub election. Section 331, governing "gain or loss to shareholders in corporate liquidations," states "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." The payment via liquidation is realized and calculated by adding "any money received plus the fair market value of the property (other than money) received." 26 U.S.C. § 1001(b). At this point, the Trusts argue that the realized gain becomes an "item of income" by way of §61(a)(3) and the Supreme Court's holding in ***Gitlitz*** . *Id.* § 61(a)(3) ("[G]ross income means all income from whatever source derived, including ... [g]ains derived from dealings in property...."); 531 U.S. at 213. The Trusts argue § 331 applies to "realize" the gain. The Trusts claim the gain is defined in § 61(a) and that it is then calculated under § 1001(a). The Trusts deem § 332's non-recognition provision to apply only after realization under § 331, without effect on whether the gain is an "item of income." 26 U.S.C. § 331. The Trusts position is that this realized but unrecognized gain is considered an "item of income" and they are permitted to increase their bases in their Wind River stock.

In contrast, the Commissioner claims the gain must first be "recognized" to qualify as an "item of income," and the gain in this case is not recognized due to § 332's nonrecognition provision. Section 332 governs "complete liquidations of *subsidiaries.* " *Id.* § 332 (emphasis added). An S Corp. may elect Qsub status for its subsidiary if "(1) the [S Corp.] parent holds 100 percent of the subsidiary's stock, (2) the subsidiary is otherwise eligible to qualify as an [S Corp.] on its own, but for the fact that it has a corporate shareholder, and (3) the [S Corp.] parent makes the appropriate election...." In re *Majestic Star Casino, LLC*, 716 F.3d 736, 743 [111 AFTR 2d 2013-2028] n.6 (2013) After a Qsub election, for tax purposes, "the subsidiary is deemed to have liquidated into the parent under I.R.C. §§ 332 and 337." 26 C.F.R. § 1.1361-4 (2012). Thus, "[a] Qsub does not even exist for federal tax purposes." *Majestic Star Casino* , 716 F.3d at 759. Section 332 then states "[n]o gain or loss shall be *recognized* on the receipt by a corporation of property distributed in complete liquidation of another corporation." 26 U.S.C. § 332(a) (emphasis added); *see also* § 337(a) ("No gain or loss shall be recognized to the liquidating corporation on the

distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies."). [pg. 2014-912]

The Treasury Regulations further distinguish between §§ 331 and 332.[23] "Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation."[24] 26 C.F.R. § 1.332-2(b).

Ultimately, the Tax Court rejected the Trusts' arguments under § 331, specifically noting that § 332, which governs the liquidation of a subsidiary of which the parent corporation owns eighty percent or more, applies here, not §331, which governs "all other liquidations." *R. Ball* , 2013 WL 452722 [TC Memo 2013-39], at 6. The Court held that a liquidation cannot be governed by both § 331 and § 332, thereby foreclosing the Trusts' argument that the gain was first realized under § 331 and then subject to nonrecognition treatment under §332.

The Tax Court is correct. The Trusts fail to address the fact that § 332, by its plain text, applies to a special set of liquidations that are treated under a different statutory scheme and do not create "items of income." Under the Internal Revenue Code, a Qsub election results in a § 332 liquidation. *See* 26 C.F.R. § 1.1361-4 (providing that a Qsub election is a deemed liquidation into the parent corporation); 26 U.S.C. §332 (covering the complete liquidation of a wholly owned subsidiary). Section 332 applies to the liquidation of a "controlled subsidiary" into its parent. Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders* ¶ 10.20 (7th ed. 2006). A Qsub is a wholly owned subsidiary under § **1361** (**b**)(**3**)(B)(i) ("[one hundred] percent of the stock of such corporation is held by the S corporation.").

The Trusts argue that § 332(d) ("Recognition of gain on liquidation of certain holding companies") provides that "subsection (a) and section 331 shall not apply to such distribution." 26 U.S.C § 332(d)(1)(A). This, according to them, is proof that the sections are not mutually exclusive, because, if they were, there would be no need for the exception. That subsection, however, does not affect the analysis of a Qsub liquidation at issue here. Instead, it focuses on "distribution[s] to foreign corporation in complete liquidation of an applicable holding company." *Id.* It is not incongruous to say that a Qsub liquidation, governed by § 1361, is only covered by § 332 but that other liquidations, covered by other sections of the Code, may be covered by both § 332 and § 331. Rather, the complexities of intersecting provisions should be maintained. The tax treatise cited by both parties states that § 332 is an "important exception" to the general rule provided in § 331. Bittker & Eustice ¶ 10.20. As such, a liquidation is either governed by the general rule in § 331, or it is covered by the exception in § 332. As the Tax Court correctly held, "[a] liquidation cannot be governed by both." *R. Ball,* 2013 WL 452722 [TC Memo 2013-39], at 6.

C. Gitlitz and Farley

The Trusts contend, however, regardless of "whether or not Sections 331 and 332 are viewed as separate corporate liquidation schemes does not alter the result." (Appellants' Opening Br. at 42.) Rather, the results of ***Gitlitz*** and *Farley* and the treatment of gains as income under § 61(a) are dispositive.

The Trusts rely on the holdings of ***Gitlitz*** and *Farley* , allowing a discharge of indebtedness to pass through to shareholders as an "item of income," as justification for their own "items of income" argument.[25] Specifically, the Trusts argue that an "item of income" may be defined as gross income under one provision of the Code, yet not recognized under another provision, and still remain an "item of income" for the purpose of § 1366. In ***Gitlitz***, petitioners were shareholders of an insolvent S corporation, which realized over two million dollars of discharge of indebtedness income in 1991. 531 U.S. at 208. Even after the discharge of indebtedness income, the S Corp. was still insolvent and so the entire discharge of indebtedness was excluded from gross income under §§ 108(a) [pg. 2014-913] and 108(d)(7)(A). *Id.* at 209–10. On their tax returns, the ***Gitlitz*** petitioners increased their bases in the S corp.'s stock by their pro rata share of the discharge of indebtedness income under the theory that the discharge of indebtedness income was an "item of income" that was passed through to the taxpayers under § 1366(a)(1)(A). *Id.* at 210. The petitioners in ***Gitlitz*** then used the increased bases to deduct their total losses. *Id.* The Supreme Court agreed, finding "[that] section [1366] is worded broadly enough to include any item of income, even tax-deferred income, that "could affect the liability for tax of any shareholder."" *Id.* at 216 (quoting § 1366(a)(1)(A)).

This Circuit in *Farley* issued a similar, and even more expanded, holding. 202 F.3d at 206.

> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Id. The Supreme Court in ***Gitlitz*** acknowledged that all "items of income" need not qualify as gross income and the indebtedness in ***Gitlitz*** still was "income" as included under § 61(a)(12). *Id.* at 213. In contrast to ***Gitlitz***, a similar inclusion under § 61(a) is not present in the "gain" in the appeal before us. *See Nathel v. Comm'r*, 615 F.3d 83, 91 [105 AFTR 2d 2010-2699] (2d Cir. 2010) ("The argument ignores the crucial difference between ***Gitlitz*** and this case: ***Gitlitz*** addressed payments that explicitly were included in gross income under § 61(a)."). Rather, the "gain" under § 61(a) is not recognized nor is it income, and thus it cannot be an "item of income."

The Tax Court noted that any conclusion other than a holding that "unrecognized gain from a Qsub election does not constitute an item of income or tax-exempt income under § 1366(a)(1)(A)," would lead to "absurd results" and "open the door to a myriad of abusive transactions." *R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 9–10. The Supreme Court in ***Gitlitz***, however, refused to address this policy argument when the text of the Code was clear. ***Gitlitz***, 531 U.S. at 220 ("Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."). Although statutory text cannot be read in a way that creates an absurdity, the payment of some taxes and not others is not an absurdity, but rather a policy choice rightly left to Congress. *Id.* Indeed, Congress, subsequent to ***Gitlitz***, made changes to the statute at issue in that case to prevent further uses of the tax code loophole.[26]

Interconnecting these regulations demonstrates that the gain is not recognized and under the definition of the Supreme Court is not income, and therefore if not income, cannot be deemed an "item of income" under § 1366. In sum, the S Corp. shareholders could not increase their bases under § 1367. The Trusts fail to cite any authority for the alternative.

For the foregoing reasons, we will affirm the Order of the Tax Court.

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1 26 U.S.C. § 1361. All statutory citations refer to the Internal Revenue Code unless otherwise noted.

2 The relevant portion stating:

> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's— (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder....

26 U.S.C. § 1366(a)(1)(A).

3 "The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: (A) the items of income described in subparagraph (A) of section 1366(a)(1).... " *Id.* § 1367(a)(1)(A).

4 The named Trusts are nine of ten total trusts: R. Ball for R. Ball III, By Appt.; R. Ball Children Trust 9/9/1969; Ethel Ball for R. Ball III Apt. 2/9/1967; Ethel Ball for A.L. Ball as Appt.; R. Ball Jr. F/B/O R. Ball III 12/22/1976; R. Ball for A. L. Ball By Appt.; R Ball Jr. Children Trust

1/29/1970; R. Ball For Children Trust 1/24/1973; Russell Ball Jr. Sec. First 9/9/1967. The tenth trust has a related case stayed in the United States District Court for the Eastern District of Pennsylvania pending this appeal. *See R. Ball, Jr. For A. L. Ball Trust, December 22, 1976 v. United States*, 2:12-cv-921 (E.D. Pa. Feb. 22, 2012). For purposes of this appeal, the term "Trusts" will include the tenth trust, though not a party, except that, in section V of this opinion, our use of the term generally refers only to the nine Appellants.

5 AIS is a Pennsylvania corporation. Although it became a subsidiary of Wind River, AIS was also the parent company of a group of insurance-affiliated corporations. Prior to acquiring direct ownership of all AIS shares, the Trusts had previously indirectly owned shares in AIS.

6 26 U.S.C. § **1361** (**b**)(**3**). A Qsub is a wholly owned subsidiary of a parent S Corp., and as such, "all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation." *Id.* § (b)(3)(A)(ii).

7 The fair market value of AIS's assets at the time it was absorbed by Wind River was $232,848,000 and by subtracting the prior aggregate basis of AIS stock of $5,612,555, an increase of $227,235,445 results. When this increase is added to the prior basis of $15,246,099, a new basis of $242,481,544 is arrived at for Wind River. This basis increase and its tax consequences are the subject of this appeal.

8 The amount received individually by the Trusts was divided based on percentage of ownership.

9 The figures stated for the new basis, sale proceeds, and tax loss are totals for all ten trusts. As mentioned above, only nine trusts are parties to this suit and, accordingly, the actual figures for the new basis and stock sale proceeds are somewhat less, being approximately $240,080,978 for the new basis and $227,833,750 for the sale proceeds. Subtracting one from the other yields the loss of $12,247,228.

10 26 U.S.C. § 332. § 332 governs the liquidation of a wholly-owned subsidiary into its parent corporation. "(a) General rule.--No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation." *Id.*

11 "Any case not requiring a trial for the submission of evidence (as, for example, where sufficient facts have been admitted [or] stipulated ...) may be submitted at any time after joinder of issue (see Rule 38) by motion of the parties filed with the Court." T.C. Rule 122(a).

12 The relevant sections state: "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: ... (3) Gains derived from dealings in property...." 26 U.S.C. § 61(a)(3).

13 202 F.3d 198 [85 AFTR 2d 2000-615] (3d Cir. 2000).

14 531 U.S. 206 [87 AFTR 2d 2001-417] (2001).

15 "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." § 1001(b).

16 In addition the Tax Court found no cases in which a Qsub election created an item of income for the parent S Corp. *R. Ball*, 2013 WL 452722 [TC Memo 2013-39], at 4.

17 The Court also noted that the cases have since been overridden by Congressional action amending 26 U.S.C. § 108(d)(7)(A). *Id.* at 8; *see also* Job Creation and Worker Assistance Act of 2002, Pub.L. No. 107-147, 116 Stat. at 40.

18 "To prevent double taxation of income upon distribution from the corporation to the shareholders, § 1367(a)(1)(A) permits shareholders to increase their corporate bases by items of income identified in § 1366(a)." ***Gitlitz***, 531 U.S. at 209.

19 The separately stated items [of income] of the S corporation include, but are not limited to, the following items—

> (i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets ...
>
> (ii) The corporation's combined net amount of gains and losses from sales or exchanges of property ...
>
> (iii) Charitable contributions ...
>
> (vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213) ...
>
> ....
>
> (vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto ... (viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies....

26 C.F.R. § 1.1366-1(a)(2).

20 Other gross income measurements are:

> Compensation for services, including fees, commissions, fringe benefits, and similar items; Gross income derived from business; Interest; Rents; Royalties; Dividends; Alimony and separate maintenance payments; Annuities; Income from life insurance and endowment contracts; Pensions; Income from discharge of indebtedness; Distributive share of partnership gross income; Income in respect of a decedent; and Income from an interest in an estate or trust.

26 U.S.C. § 61(a).

21 The Trusts state, "[i]n sum, that realized gain is not recognized does not alter the fact that the realized gain is income...." (Appellant Br. at 18.)

22 Appellants assert that the quoted language from 26 C.F.R. § 1.61-6(b)(1) only addresses issues of timing, namely that realized but unrecognized gain is not taken into account when the transaction occurs. They support that assertion with examples of income defined under subsections of § 61(a) but then subject to nonrecognition treatment elsewhere. Those examples are distinguishable from the gains at issue here because the examples of income are expressly provided for under § 61(a) and are not analogous to the unique treatment of Qsub liquidations under the Code.

23 The relevant distinguishing language states:

> Under the general rule prescribed by section 331 for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 1001. Section 332 excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of the stock of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirements.

26 C.F.R. § 1.332-1.

24 The regulations further state:

> The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in the liquidating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends).

> The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

26 C.F.R. § 1.332-2(a).

25 The Trusts state "[t]his case falls squarely within ***Gitlitz*** and *Farley.* " (Reply Brief at 9.)

26 *See* supra note 17. "As a general matter, the Committee believes that where, as in the case of the present statute under section 108, the plain text of a provision of the Internal Revenue Code produces an ambiguity, the provision should be read as closing, not maintaining, a loophole that would result in an inappropriate reduction of tax liability." H.R. Rep. No. 107-251, at 52 (2002). Congress provides a further illustration of why the change, similar to issues presented on appeal.

> To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows $100 from a third party and loses the entire $100. Because the shareholder has no basis in its stock, the $100 loss is "suspended" at the corporate level. If the $100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the $100 income from the discharge of indebtedness is excluded from income, and the $100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Id.

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573 U.S. 122
134 S.Ct. 2242
189 L.Ed.2d 157

Brandon C. CLARK et ux., Petitioners
v.
William J. RAMEKER, Trustee, et al.

No. 13–299.

Supreme Court of the United States

Argued March 24, 2014.
Decided June 12, 2014.

Kannon K. Shanmugam, Washington, DC, for Petitioners.

Danielle Spinelli, Washington, DC, for Respondents.

Denis P. Bartell, S. Michael Murphy, DeWitt Ross & Stevens S.C., Madison, WI, Kannon K. Shanmugam, Counsel of Record, Thomas G. Ward, Allison B. Jones, Julia H. Pudlin, Matthew C. Monahan, Williams & Connolly LLP, Washington, DC, for Petitioners.

William J. Rameker, Stephen L. Morgan, Jane F. Zimmerman, Jennifer M. Krueger, Erin A. West, Murphy Desmond S.C., Madison, WI, Danielle Spinelli, Counsel of Record, Craig Goldblatt, Kelly P. Dunbar, Daniel T. Deacon, Wilmer Cutler Pickering Hale and Dorr LLP, Washington, DC, Counsel for Respondent William J. Rameker.

Roger Sage, Madison, WI, Counsel for Respondents Resul and Zinije Adili.

Justice SOTOMAYOR delivered the opinion of the Court.

[573 U.S. 124]

When an individual files for bankruptcy, she may exempt particular categories of assets from the bankruptcy estate. One such category includes certain "retirement funds." 11 U.S.C. § 522(b)(3)(C). The question presented is whether funds contained in an inherited individual retirement account (IRA) qualify as "retirement funds" within the meaning of this bankruptcy exemption. We hold that they do not.

I

A

When an individual debtor files a bankruptcy petition, her "legal or equitable interests ... in property" become part of the bankruptcy estate. § 541(a)(1). "To help the debtor obtain a fresh start," however, the Bankruptcy Code allows debtors to exempt from the estate limited interests in certain kinds of property. *Rousey v. Jacoway,* 544 U.S. 320, 325, 125 S.Ct. 1561, 161 L.Ed.2d 563 (2005). The exemption at issue in this case allows debtors to protect "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code." §§ 522(b)(3)(C), (d)(12).[1] The enumerated sections of the

[134 S.Ct. 2245]

Internal Revenue Code cover many types of accounts, three of which are relevant here.

The first two are traditional and Roth IRAs, which are created by 26 U.S.C. § 408 and § 408A, respectively. Both types of accounts offer tax advantages to encourage individuals to save for retirement. Qualified contributions to traditional IRAs, for example, are tax-deductible. § 219(a). Roth IRAs offer the opposite benefit: Although contributions are not tax-deductible, qualified distributions are tax-free.

[573 U.S. 125]

§§ 408A(c)(1), (d)(1). To ensure that both types of IRAs are used for retirement purposes and not as general tax-advantaged savings vehicles, Congress made certain withdrawals from both types of accounts subject to a 10 percent penalty if taken before an accountholder reaches the age of 59 ½. See §§ 72(t)(1)-(2); see also n. 4, *infra* .

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The third type of account relevant here is an inherited IRA. An inherited IRA is a traditional or Roth IRA that has been inherited after its owner's death. See §§ 408(d)(3)(C)(ii), 408A(a). If the heir is the owner's spouse, as is often the case, the spouse has a choice: He or she may "roll over" the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA (subject to the rules discussed below). See Internal Revenue Service, Publication 590: Individual Retirement Arrangements (IRAs), p. 18 (Jan. 5, 2014). When anyone other than the owner's spouse inherits the IRA, he or she may not roll over the funds; the only option is to hold the IRA as an inherited account.

Inherited IRAs do not operate like ordinary IRAs. Unlike with a traditional or Roth IRA, an individual may withdraw funds from an inherited IRA at any time, without paying a tax penalty. § 72(t)(2)(A)(ii). Indeed, the owner of an inherited IRA not only may but *must* withdraw its funds: The owner must either withdraw the entire balance in the account within five years of the original owner's death or take minimum distributions on an annual basis. See §§ 408(a)(6), 401(a)(9)(B) ; 26 CFR § 1.408–8 (2013) (Q–1 and A–1(a) incorporating § 1.401(a)(9)–3 (Q–1 and A–1(a))); see generally D. Cartano, Taxation of Individual Retirement Accounts § 32.02[A] (2013). And unlike with a traditional or Roth IRA, the owner of an inherited IRA may never make contributions to the account. 26 U.S.C. § 219(d)(4).

B

In 2000, Ruth Heffron established a traditional IRA and named her daughter, Heidi Heffron–Clark, as the sole beneficiary of the account. When Ms. Heffron died in 2001, her IRA—which

[573 U.S. 126]

was then worth just over $450,000—passed to her daughter and became an inherited IRA. Ms. Heffron–Clark elected to take monthly distributions from the account.

In October 2010, Ms. Heffron–Clark and her husband, petitioners in this Court, filed a Chapter 7 bankruptcy petition. They identified the inherited IRA, by then worth roughly $300,000, as exempt from the bankruptcy estate under 11 U.S.C. § 522(b)(3)(C). Respondents, the bankruptcy trustee and unsecured creditors of the estate, objected to the claimed exemption on the ground that the funds in the inherited IRA were not "retirement funds" within the meaning of the statute.

[134 S.Ct. 2246]

The Bankruptcy Court agreed, disallowing the exemption. *In re Clark,* 450 B.R. 858, 866 (W.D.Wisc.2011). Relying on the "plain language of § 522(b)(3)(C)," the court concluded that an inherited IRA "does not contain *anyone's* 'retirement funds,' " because unlike with a traditional IRA, the funds are not "segregated to meet the needs of, nor distributed on the occasion of, any person's retirement." *Id.,* at 863.[2] The District Court reversed, explaining that the exemption covers any account containing funds "originally" "accumulated for retirement purposes." *In re Clark,* 466 B.R. 135, 139 (W.D.Wisc.2012). The Seventh Circuit reversed the District Court's judgment. *In re Clark,* 714 F.3d 559 (2013). Pointing to the "[d]ifferent rules govern[ing] inherited" and noninherited IRAs, the court concluded that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings." *Id.,* at 560, 562.

We granted certiorari to resolve a conflict between the Seventh Circuit's ruling and the Fifth Circuit's decision in

[573 U.S. 127]

In re Chilton, 674 F.3d 486 (2012). 571 U.S. ––––, 134 S.Ct. 678, 187 L.Ed.2d 544 (2013). We now affirm.

II

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The text and purpose of the Bankruptcy Code make clear that funds held in inherited IRAs are not "retirement funds" within the meaning of § 522(b)(3)(C)'s bankruptcy exemption.

A

The Bankruptcy Code does not define "retirement funds," so we give the term its ordinary meaning. See *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 572 U.S. ----, ----, 134 S.Ct. 1749, 1755–1756, 188L.Ed.2d 816 (2014). The ordinary meaning of "fund[s]" is "sum[s] of money ... set aside for a specific purpose." American Heritage Dictionary 712 (4th ed. 2000). And "retirement" means "[w]ithdrawal from one's occupation, business, or office." *Id.*, at 1489. Section 522(b)(3)(C)'s reference to "retirement funds" is therefore properly understood to mean sums of money set aside for the day an individual stops working.

The parties agree that, in deciding whether a given set of funds falls within this definition, the inquiry must be an objective one, not one that "turns on the debtor's subjective purpose." Brief for Petitioners 43–44; see also Brief for Respondents 26. In other words, to determine whether funds in an account qualify as "retirement funds," courts should not engage in a case-by-case, fact-intensive examination into whether the debtor actually planned to use the funds for retirement purposes as opposed to current consumption. Instead, we look to the legal characteristics of the account in which the funds are held, asking whether, as an objective matter, the account is one set aside for the day when an individual stops working. Cf. *Rousey*, 544 U.S., at 332, 125 S.Ct. 1561 (holding that traditional IRAs are included within § 522(d)(10)(E)'s exemption for "a payment under a stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of ... age" based on the legal characteristics of traditional IRAs).

[134 S.Ct. 2247]

[573 U.S. 128]

Three legal characteristics of inherited IRAs lead us to conclude that funds held in such accounts are not objectively set aside for the purpose of retirement. First, the holder of an inherited IRA may never invest additional money in the account. 26 U.S.C. § 219(d)(4). Inherited IRAs are thus unlike traditional and Roth IRAs, both of which are quintessential "retirement funds." For where inherited IRAs categorically prohibit contributions, the entire purpose of traditional and Roth IRAs is to provide tax incentives for accountholders to contribute regularly and over time to their retirement savings.

Second, holders of inherited IRAs are required to withdraw money from such accounts, no matter how many years they may be from retirement. Under the Tax Code, the beneficiary of an inherited IRA must either withdraw all of the funds in the IRA within five years after the year of the owner's death or take minimum annual distributions every year. See § 408(a)(6) ; § 401(a)(9)(B) ; 26 CFR § 1.408–8 (Q–1 and A–1(a) incorporating § 1.401(a)(9)–3 (Q–1 and A–1(a))). Here, for example, petitioners elected to take yearly distributions from the inherited IRA; as a result, the account decreased in value from roughly $450,000 to less than $300,000 within 10 years. That the tax rules governing inherited IRAs routinely lead to their diminution over time, regardless of their holders' proximity to retirement, is hardly a feature one would expect of an account set aside for retirement.

Finally, the holder of an inherited IRA may withdraw the entire balance of the account at any time—and for any purpose—without penalty. Whereas a withdrawal from a traditional or Roth IRA prior to the age of 59 ½ triggers a 10 percent tax penalty subject to narrow exceptions, see n. 4, *infra* —a rule that encourages individuals to leave such funds untouched until retirement age—there is no similar limit on the holder of an inherited IRA. Funds held in inherited IRAs accordingly constitute "a pot of money that can be

[573 U.S. 129]

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freely used for current consumption," 714 F.3d, at 561, not funds objectively set aside for one's retirement.

B

Our reading of the text is consistent with the purpose of the Bankruptcy Code's exemption provisions. As a general matter, those provisions effectuate a careful balance between the interests of creditors and debtors. On the one hand, we have noted that "every asset the Code permits a debtor to withdraw from the estate is an asset that is not available to ... creditors." *Schwab v. Reilly,* 560 U.S. 770, 791, 130 S.Ct. 2652, 177 L.Ed.2d 234 (2010). On the other hand, exemptions serve the important purpose of "protect[ing] the debtor's essential needs." *United States v. Security Industrial Bank,* 459 U.S. 70, 83, 103 S.Ct. 407, 74 L.Ed.2d 235 (1982) (Blackmun, J., concurring in judgment).[3]

Allowing debtors to protect funds held in traditional and Roth IRAs comports with this purpose by helping to ensure that debtors will be able to meet their basic needs during their retirement years. At the same time, the legal limitations on traditional and Roth IRAs ensure that debtors who hold such accounts (but who have not yet reached retirement age) do not enjoy a cash windfall by virtue of the exemption—such debtors are instead required

[134 S.Ct. 2248]

to wait until age 59 ½ before they may withdraw the funds penalty-free.

The same cannot be said of an inherited IRA. For if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption

[573 U.S. 130]

would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a "fresh start," *Rousey,* 544 U.S., at 325, 125 S.Ct. 1561, into a "free pass," *Schwab,* 560 U.S., at 791, 130 S.Ct. 2652. We decline to read the retirement funds provision in that manner.

III

Although petitioners' counterarguments are not without force, they do not overcome the statute's text and purpose.

Petitioners' primary argument is that funds in an inherited IRA are retirement funds because—regardless of whether they currently sit in an account bearing the legal characteristics of a fund set aside for retirement—they did so at an earlier moment in time. After all, petitioners point out, "the initial owner" of the account "set aside the funds in question for retirement by depositing them in a" traditional or Roth IRA. Brief for Petitioners 21. And "[t]he [initial] owner's death does not in any way affect the funds in the account." *Ibid.*

We disagree. In ordinary usage, to speak of a person's "retirement funds" implies that the funds are currently in an account set aside for retirement, not that they were set aside for that purpose at some prior date by an entirely different person. Under petitioners' contrary logic, if an individual withdraws money from a traditional IRA and gives it to a friend who then deposits it into a checking account, that money should be forever deemed "retirement funds" because it was originally set aside for retirement. That is plainly incorrect.

More fundamentally, the backward-looking inquiry urged by petitioners would render a substantial portion of 11 U.S.C. § 522(b)(3)(C)'s text superfluous. The funds contained in every individual-held account exempt from taxation under the Tax Code provisions enumerated in § 522(b)(3)(C) have been, at some point in time, "retirement funds." So on petitioners' view, rather than defining the exemption to

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[573 U.S. 131]

cover "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under [the enumerated sections] of the Internal Revenue Code," Congress could have achieved the exact same result through a provision covering any "fund or account that is exempt from taxation under [the enumerated sections]." In other words, § 522(b)(3)(C) requires that funds satisfy not one but two conditions in order to be exempt: the funds must be "retirement funds," and they must be held in a covered account. Petitioners' reading would write out of the statute the first element. It therefore flouts the rule that " 'a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous.' " *Corley v. United States,* 556 U.S. 303, 314, 129 S.Ct. 1558, 173 L.Ed.2d 443 (2009).

Petitioners respond that many of § 522's other exemptions refer to the "debtor's interest" in various kinds of property. See, *e.g.*, § 522(d)(2) (exempting "[t]he debtor's interest, not to exceed [$3,675] in value, in one motor vehicle"). Section 522(b)(3)(C)'s retirement funds exemption,

[134 S.Ct. 2249]

by contrast, includes no such reference. As a result, petitioners surmise, Congress must have meant the provision to cover funds that were at one time retirement accounts, even if they were for someone else's retirement. Brief for Petitioners 33–34. But Congress used the phrase "debtor's interest" in the other exemptions in a different manner—not to distinguish between a debtor's assets and the assets of another person but to set a limit on the value of the particular asset that a debtor may exempt. For example, the statute allows a debtor to protect "[t]he debtor's aggregate interest, not to exceed [$1,550] in value, in jewelry." § 522(d)(4). The phrase "[t]he debtor's aggregate interest" in this provision is just a means of introducing the $1,550 limit; it is not a means of preventing debtors from exempting other persons' jewelry from their own bankruptcy proceedings (an interpretation that would serve little apparent purpose). And Congress had no need to use the same "debtor's interest" formulation

[573 U.S. 132]

in § 522(b)(3)(C) for the simple reason that it imposed a value limitation on the amount of exemptible retirement funds in a separate provision, § 522(n).

Petitioners next contend that even if their interpretation of " 'retirement funds' does not independently *exclude* anything from the scope of the statute," that poses no problem because Congress actually intended that result. Reply Brief 5–6. In particular, petitioners suggest that when a sentence is structured as § 522(b)(3)(C) is—starting with a broad category ("retirement funds"), then winnowing it down through limiting language ("to the extent that" the funds are held in a particular type of account)—it is often the case that the broad category does no independent limiting work. As counsel for petitioners noted at oral argument, if a tax were to apply to "sports teams to the extent that they are members of the major professional sports leagues," the phrase "sports teams" would not provide any additional limitation on the covered entities. Tr. of Oral Arg. 15.

There are two problems with this argument. First, while it is possible to conceive of sentences that use § 522(b)(3)(C)'s "to the extent that" construction in a manner where the initial broad category serves no exclusionary purpose, that is not the only way in which the phrase may be used. For example, a tax break that applies to "nonprofit organizations to the extent that they are medical or scientific" would not apply to a for-profit pharmaceutical company because the initial broad category ("nonprofit organizations") provides its own limitation. Just so here; in order to qualify for bankruptcy protection under § 522(b)(3)(C), funds must be both "retirement funds" and in an account exempt from taxation under one of the enumerated Tax Code sections.

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Second, to accept petitioners' argument would reintroduce the surplusage problem already discussed. *Supra,* at 2248 – 2249. And although petitioners are correct that "the only effect of respondents' interpretation of 'retirement

[573 U.S. 133]

funds' would seemingly be to deny bankruptcy exemption to inherited IRAs," Reply Brief 2, as between one interpretation that would render statutory text superfluous and another that would render it meaningful yet limited, we think the latter more faithful to the statute Congress wrote.

Finally, petitioners argue that even under the inquiry we have described, funds in inherited IRAs should still qualify as "retirement funds" because the holder of such an account can leave much of its value intact until her retirement if she invests wisely and chooses to take only the minimum annual distributions required by law. See Brief for Petitioners 27–28. But

[134 S.Ct. 2250]

the possibility that some investors may use their inherited IRAs for retirement purposes does not mean that inherited IRAs bear the defining legal characteristics of retirement funds. Were it any other way, money in an ordinary checking account (or, for that matter, an envelope of $20 bills) would also amount to "retirement funds" because it is possible for an owner to use those funds for retirement.[4]

For the foregoing reasons, the judgment of the United States Court of Appeals for the Seventh Circuit is affirmed.

It is so ordered.

Notes:

[1] Under § 522, debtors may elect to claim exemptions either under federal law, see § 522(b)(2), or state law, see § 522(b)(3). Both tracks permit debtors to exempt "retirement funds." See § 522(b)(3)(C) (retirement funds exemption for debtors proceeding under state law); § 522(d)(12) (identical exemption for debtors proceeding under federal law). Petitioners elected to proceed under state law, so we refer to § 522(b)(3)(C) throughout.

[2] The Bankruptcy Court also concluded in the alternative that, even if funds in an inherited IRA qualify as retirement funds within the meaning of § 522(b)(3)(C), an inherited IRA is not exempt from taxation under any of the Internal Revenue Code sections listed in the provision. See 450 B.R., at 865. Because we hold that inherited IRAs are not retirement funds to begin with, we have no occasion to pass on the Bankruptcy Court's alternative ground for disallowing petitioners' exemption.

[3] As the House Judiciary Committee explained in the process of enacting § 522, "[t]he historical purpose" of bankruptcy exemptions has been to provide a debtor "with the basic necessities of life" so that she "will not be left destitute and a public charge." H.R.Rep. No. 95–595, p. 126 (1977).

[4] Petitioners also argue that inherited IRAs are similar enough to Roth IRAs to qualify as retirement funds because "the owner of a Roth IRA may withdraw his contributions ... without penalty." Brief for Petitioners 44. But that argument fails to recognize that withdrawals of contributions to a Roth IRA are not subject to the 10 percent tax penalty for the unique reason that the contributions have already been taxed. By contrast, all capital gains and investment income in a Roth IRA are subject to the pre–59 ½ withdrawal penalty (with narrow exceptions for, for example, medical expenses), which incentivizes use of those funds only in one's retirement years.

* * *

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458 U.S. 50
102 S.Ct. 2858
73 L.Ed.2d 598

NORTHERN PIPELINE CONSTRUCTION CO., Appellant,

v.

MARATHON PIPE LINE COMPANY and United States. UNITED STATES, Appellant, v. MARATHON PIPE LINE CO. et al.

Nos. 81-150, 81-546.

Argued April 27, 1982.
Decided June 28, 1982.
Judgment Stayed Oct. 4, 1982.

See 459 U.S. 813, 103 S.Ct. 199, 200.

Syllabus

The Bankruptcy Act of 1978 (Act) established a United States bankruptcy court in each judicial district as an adjunct to the district court for such district. The bankruptcy court judges are appointed for 14-year terms, subject to removal by the judicial council of the circuit in which they serve on grounds of incompetence, misconduct, neglect of duty, or disability. Their salaries are set by statute and are subject to adjustment. The Act grants the bankruptcy courts jurisdiction over "all civil proceedings arising under title 11 [bankruptcy] [of the United States Code] or arising in or related to cases under title 11." See 28 U.S.C. § 1471(b) (1976 ed., Supp.IV). After it had filed a petition for reorganization in a Bankruptcy Court, appellant Northern Pipeline Construction Co. (Northern) filed in that court a suit against appellee Marathon Pipe Line Co. (Marathon) seeking damages for an alleged breach of contract and warranty, as well as for misrepresentation, coercion, and duress. Marathon sought dismissal of the suit on the ground that the Act unconstitutionally conferred Art. III judicial power upon judges who lacked life tenure and protection against salary diminution. The Bankruptcy Court denied the motion to dismiss, but on appeal the District Court granted the motion.

Held: The judgment is affirmed.

D.C., 12 B.R. 946, affirmed.

Justice BRENNAN, joined by Justice MARSHALL, Justice BLACKMUN, and Justice STEVENS, concluded that:

1. Section 1471's broad grant of jurisdiction to bankruptcy judges violates Art. III. Pp. 57-87.

(a) The judicial power of the United States must be exercised by judges who have the attributes of life tenure and protection against salary diminution specified by Art. III. These attributes were incorporated into the Constitution to ensure the independence of the Judiciary from the control of the Executive and Legislative Branches. There is

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no doubt that bankruptcy judges created by the Act are not Art. III judges. Pp. 57-62.

(b) Article III bars Congress from establishing under its Art. I powers legislative courts to exercise jurisdiction over all matters arising under the bankruptcy laws. The establishment of such courts does not fall within any of the historically recognized situations—non-Art. III courts of the Territories or of the District of Columbia, courts-martial, and resolution of "public rights" issues—in which the principle of independent adjudication commanded by Art. III does not apply. The bankruptcy courts do not lie exclusively outside the States, like the courts of the Territories or of the District of Columbia, or bear any resemblance to courts-martial, nor can the substantive legal rights at issue in the present action—the right to recover contract damages to augment Northern's estate—be deemed "public rights." There is no persuasive reason in logic, history, or the Constitution, why bankruptcy courts lie beyond the reach of Art. III. Pp. 63-76.

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(c) Section 1471 impermissibly removed most, if not all, of the essential attributes of the judicial power from the Art. III district court and vested those attributes in a non-Art. III adjunct. *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 and *United States v. Raddatz*, 447 U.S. 667, 100 S.Ct. 2406, 65 L.Ed.2d 424 distinguished. Congress does not have the same power to create adjuncts to adjudicate constitutionally recognized rights and state-created rights as it does to adjudicate rights that it creates. The grant of jurisdiction to bankruptcy courts cannot be sustained as an exercise of Congress' power to create adjuncts to Art. III courts. Pp. 76-87.

2. The above holding that the broad grant of jurisdiction in § 1471 is unconstitutional shall not apply retroactively but only prospectively. Such grant of jurisdiction presents an unprecedented question of interpretation of Art. III, and retroactive application would not further the operation of the holding but would visit substantial injustice and hardship upon those litigants who relied upon the Act's vesting of jurisdiction in the bankruptcy courts. Pp.87-88

Justice REHNQUIST, joined by Justice O'CONNOR, concluded that where appellee Marathon Pipe Line Co. has simply been named defendant in appellant Northern Pipeline Construction Co.'s suit on a contract claim arising under state law, the constitutionality of the Bankruptcy Court's exercise of jurisdiction over that kind of suit is all that need be decided in this case; that resolution of any objections Marathon might make to the exercise of authority conferred on bankruptcy courts by the Bankruptcy Act of 1978, on the ground that the suit must be decided by an Art. III court, should await the exercise of such authority; that so much of that Act as enables a Bankruptcy Court to entertain and decide

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Northern's suit over Marathon's objection violates Art. III; and that the Court's judgment should not be applied retroactively. Pp. 89-92.

Sol. Gen. Rex E. Lee, Washington, D. C., for United States.

John L. Devney, St. Paul, Minn., for Northern Pipeline Const. Co.

Melvin I. Orenstein, Minneapolis, Minn., for Marathon Pipe Line Co.

Justice BRENNAN announced the judgment of the Court and delivered an opinion in which Justice MARSHALL, Justice BLACKMUN, and Justice STEVENS joined.

The question presented is whether the assignment by Congress to bankruptcy judges of the jurisdiction granted in 28 U.S.C. § 1471 (1976 ed., Supp.IV) by § 241(a) of the Bankruptcy Act of 1978 violates Art. III of the Constitution.

I

A.

In 1978, after almost 10 years of study and investigation, Congress enacted a comprehensive revision of the bank-

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ruptcy laws. The Bankruptcy Act of 1978 (Act) [1] made significant changes in both the substantive and procedural law of bankruptcy. It is the changes in the latter that are at issue in this case.

Before the Act, federal district courts served as bankruptcy courts and employed a "referee" system. Bankruptcy proceedings were generally conducted before referees,[2] except in those instances in which the district court elected to withdraw a case from a referee. See Bkrtcy. Rule 102. The referee's final order was appealable to the district court. Bkrtcy. Rule 801. The bankruptcy courts were vested with "summary jurisdiction"—that is, with jurisdiction over controversies involving property in the actual or constructive possession of the court. And, with consent, the bankruptcy court also had jurisdiction over some "plenary" matters—such as

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disputes involving property in the possession of a third person.

The Act eliminates the referee system and establishes "in each judicial district, as an adjunct to the district court for such district, a bankruptcy court which shall be a court of record known as the United States Bankruptcy Court for the district." 28 U.S.C. § 151(a) (1976 ed., Supp.IV). The judges of these courts are appointed to office for 14-year terms by the President, with the advice and consent of the Senate. §§ 152, 153(a) (1976 ed., Supp.IV). They are subject to removal by the "judicial council of the circuit" on account of "incompetency, misconduct, neglect of duty or physical or mental disability." § 153(b) (1976 ed., Supp.IV). In addition, the salaries of the bankruptcy judges are set by statute and are subject to adjustment under the Federal Salary Act, 2 U.S.C. §§ 351-361 (1976 ed. and Supp.IV). 28 U.S.C. § 154 (1976 ed., Supp.IV).

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The jurisdiction of the bankruptcy courts created by the Act is much broader than that exercised under the former referee system. Eliminating the distinction between "summary" and "plenary" jurisdiction, the Act grants the new courts jurisdiction over all "civil proceedings arising under title 11 [the Bankruptcy title] or arising in or *related to* cases under title 11." 28 U.S.C. § 1471(b) (1976 ed., Supp.IV) (emphasis added).[3] This jurisdictional grant empowers bankruptcy courts to entertain a wide variety of cases involving claims that may affect the property of the estate once a petition has been filed under Title 11. Included within the bankruptcy courts' jurisdiction are suits to recover accounts, controversies involving exempt property, actions to avoid transfers and payments as preferences or fraudulent conveyances, and causes of action owned by the debtor at the time of the petition for bankruptcy. The bankruptcy courts can hear claims based on state law as well as those based on federal law. See 1 W. Collier, Bankruptcy ¶ 3.01, pp. 3-47 to 3-48 (15th ed. 1982).[4]

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The judges of the bankruptcy courts are vested with all of the "powers of a court of equity, law, and admiralty," except that they "may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment." 28 U.S.C. § 1481 (1976 ed., Supp.IV). In addition to this broad grant of power, Congress has allowed bankruptcy judges the power to hold jury trials, § 1480; to issue declaratory judgments, § 2201; to issue writs of habeas corpus under certain circumstances, § 2256; to issue all writs necessary in aid of the bankruptcy court's expanded jurisdiction, § 451 (1976 ed. and Supp.IV); see 28 U.S.C. § 1651; and to issue any order, process or judgment that is necessary or appropriate to carry out the provisions of Title 11, 11 U.S.C. § 105(a) (1976 ed., Supp.IV).

The Act also establishes a special procedure for appeals from orders of bankruptcy courts. The circuit council is empowered to direct the chief judge of the circuit to designate panels of three bankruptcy judges to hear appeals. 28 U.S.C. § 160 (1976 ed., Supp.IV). These panels have jurisdiction of all appeals from final judgments, orders, and decrees of bankruptcy courts, and, with leave of the panel, of interlocutory appeals. § 1482. If no such appeals panel is designated, the district court is empowered to exercise appellate jurisdiction. § 1334. The court of appeals is given jurisdiction over appeals from the appellate panels or from the district court. § 1293. If the parties agree, a direct appeal to the court of appeals may be taken from a final judgment of a bankruptcy court. § 1293(b).[5]

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The Act provides for a transition period before the new provisions take full effect in April 1984. §§ 401-411, 92 Stat. 2682-2688. During the transition period, previously existing bankruptcy courts continue in existence. § 404(a), 92 Stat. 2683. Incumbent bankruptcy referees, who served 6-year terms for compensation subject to

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adjustment by Congress, are to serve as bankruptcy judges until March 31, 1984, or until their successors take office. § 404(b), 92 Stat. 2683.[6] During this period they are empowered to exercise essentially all of the jurisdiction and powers discussed above. See §§ 404, 405, 92 Stat. 2683-2685. See generally 1 Collier, *supra*, &Par; 7.04-7.05, pp. 7-23 to 7-65. The procedure for taking appeals is similar to that provided after the transition period. See § 405(c)(1), 92 Stat. 2685.[7]

B

This case arises out of proceedings initiated in the United States Bankruptcy Court for the District of Minnesota after appellant Northern Pipeline Construction Co. (Northern) filed a petition for reorganization in January 1980. In March 1980 Northern, pursuant to the Act, filed in that court a suit against appellee Marathon Pipe Line Co. (Marathon). Appellant sought damages for alleged breaches of contract and warranty, as well as for alleged misrepresentation, coercion, and duress. Marathon sought dismissal of the suit, on the ground that the Act unconstitutionally conferred Art. III ju-

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dicial power upon judges who lacked life tenure and protection against salary diminution. The United States intervened to defend the validity of the statute.

The Bankruptcy Judge denied the motion to dismiss. 6 B.R. 928 (1980). But on appeal the District Court entered an order granting the motion, on the ground that "the delegation of authority in 28 U.S.C. § 1471 to the Bankruptcy Judges to try cases which are otherwise relegated under the Constitution to Article III judges" was unconstitutional. Both the United States and Northern filed notices of appeal in this Court.[8] We noted probable jurisdiction. 454 U.S. 1029, 102 S.Ct. 564, 70 L.Ed.2d 472 (1981).[9]

II

A.

Basic to the constitutional structure established by the Framers was their recognition that "[t]he accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny." The Federalist No. 47, p. 300 (H. Lodge ed. 1888) (J. Madison). To ensure against such tyranny, the Framers provided that the Federal Government would consist of three distinct Branches, each to exercise one of the governmental powers recognized by the Framers as inherently distinct. "The Framers regarded the checks and balances that they had built into the tripartite Federal Government as a self-executing safeguard against the encroachment or aggrandizement of one branch at the

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expense of the other." *Buckley v. Valeo*, 424 U.S. 1, 122, 96 S.Ct. 612, 683, 46 L.Ed.2d 659 (1976) (*per curiam*).

The Federal Judiciary was therefore designed by the Framers to stand independent of the Executive and Legislature—to maintain the checks and balances of the constitutional structure, and also to guarantee that the process of adjudication itself remained impartial. Hamilton explained the importance of an independent Judiciary:

"Periodical appointments, however regulated, or by whomsoever made, would, in some way or other, be fatal to [the courts'] necessary independence. If the power of making them was committed either to the Executive or legislature, there would be danger of an improper complaisance to the branch which possessed it; if to both, there would be an unwillingness to hazard the displeasure of either; if to the people, or to persons chosen by them for the special purpose, there would be too great a disposition to consult popularity, to justify a reliance that nothing would be consulted but the Constitution and the laws." The Federalist No. 78, p. 489 (H. Lodge ed. 1888).

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The Court has only recently reaffirmed the significance of this feature of the Framers' design: "A Judiciary free from control by the Executive and Legislature is essential if there is a right to have claims decided by judges who are free from potential domination by other branches of government." *United States v. Will*, 449 U.S. 200, 217-218, 101 S.Ct. 471, 481-482, 66 L.Ed.2d 392 (1980).

As an inseparable element of the constitutional system of checks and balances, and as a guarantee of judicial impartiality, Art. III both defines the power and protects the independence of the Judicial Branch. It provides that "The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." Art. III, § 1. The inexorable command of this provision is clear and defi-

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nites The judicial power of the United States must be exercised by courts having the attributes prescribed in Art. III. Those attributes are also clearly set forth:

"The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office." Art. III, § 1.

The "good Behaviour" Clause guarantees that Art. III judges shall enjoy life tenure, subject only to removal by impeachment. *United States ex rel. Toth v. Quarles*, 350 U.S. 11, 16, 76 S.Ct. 1, 4, 100 L.Ed. 8 (1955). The Compensation Clause guarantees Art. III judges a fixed and irreducible compensation for their services. *United States v. Will, supra*, 449 U.S., at 218-221, 101 S.Ct., at 482-483. Both of these provisions were incorporated into the Constitution to ensure the independence of the Judiciary from the control of the Executive and Legislative Branches of government.[10] As we have only recently emphasized, "[t]he Compensation Clause has its roots in the longstanding Anglo-American tradition of an independent Judiciary," 449 U.S., at 217, 101 S.Ct. at 482, while the principle of life tenure can be traced back at least as far as the Act of Settlement in 1701, *id.*, at 218, 101 S.Ct., at 482. To be sure, both principles were eroded during the late colonial period, but that departure did not escape notice and indignant rejection by the Revolutionary generation. Indeed, the guarantees eventually included

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in Art. III were clearly foreshadowed in the Declaration of Independence, "which, among the injuries and usurpations recited against the King of Great Britain, declared that he had 'made judges dependent on his will alone, for the tenure of their offices, and the amount and payment of their salaries.' " *O'Donoghue v. United States*, 289 U.S. 516, 531, 53 S.Ct. 740, 743, 77 L.Ed. 1356 (1933). The Framers thus recognized:

"Next to permanency in office, nothing can contribute more to the independence of the judges than a fixed provision for their support.... In the general course of human nature, *a power over a man's subsistence amounts to a power over his will.*" The Federalist No. 79, p. 491 (H. Lodge ed. 1888) (A. Hamilton) (emphasis in original).[11]

In sum, our Constitution unambiguously enunciates a fundamental principle—that the "judicial Power of the United States" must be reposed in an independent Judiciary. It commands that the independence of the Judiciary be jealously guarded, and it provides clear institutional protections for that independence.

B

It is undisputed that the bankruptcy judges whose offices were created by the Bankruptcy Act of 1978 do not enjoy the protections constitutionally afforded to Art. III judges. The bankruptcy judges do not serve for life subject to

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their continued "good Behaviour." Rather, they are appointed for

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14-year terms, and can be removed by the judicial council of the circuit in which they serve on grounds of "incompetency, misconduct, neglect of duty, or physical or mental disability." Second, the salaries of the bankruptcy judges are not immune from diminution by Congress. See *supra*, at 53. In short, there is no doubt that the bankruptcy judges created by the Act are not Art. III judges.

That Congress chose to vest such broad jurisdiction in non-Art. III bankruptcy courts, after giving substantial consideration to the constitutionality of the Act, is of course reason to respect the congressional conclusion. See *Fullilove v. Klutznick*, 448 U.S. 448, 472-473, 100 S.Ct. 2758, 2771-2772, 65 L.Ed.2d 902 (1980) (opinion of BURGER, C. J.); *Palmore v. United States*, 411 U.S. 389, 409, 93 S.Ct. 1670, 1682, 36 L.Ed.2d 342 (1973). See also *National Ins. Co. v. Tidewater Co.*, 337 U.S. 582, 655, 69 S.Ct. 1173, 1199, 93 L.Ed. 1556 (1949) (Frankfurter, J., dissenting).[12] But at the same time,

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"[d]eciding whether a matter has in any measure been committed by the Constitution to another branch of government, or whether the action of that branch exceeds whatever authority has been committed, is itself a delicate exercise in constitutional interpretation, and is a responsibility of this Court as ultimate interpreter of the Constitution." *Baker v. Carr*, 369 U.S. 186, 211, 82 S.Ct. 691, 706, 7 L.Ed.2d 663 (1962).

With these principles in mind, we turn to the question presented for decision: whether the Bankruptcy Act of 1978 violates the command of Art. III that the judicial power of the United States must be vested in courts whose judges enjoy the protections and safeguards specified in that Article.

Appellants suggest two grounds for upholding the Act's conferral of broad adjudicative powers upon judges unprotected by Art. III. First, it is urged that "pursuant to its enumerated Article I powers, Congress may establish legislative courts that have jurisdiction to decide cases to which the Article III judicial power of the United States extends." Brief for United States 9. Referring to our precedents upholding the validity of "legislative courts," appellants suggest that "the plenary grants of power in Article I permit Congress to establish non-Article III tribunals in 'specialized areas having particularized needs and warranting distinctive treatment,' " such as the area of bankruptcy law. *Ibid.*, quoting *Palmore v. United States, supra*, at 389, 408, 93 S.Ct., at 1681. Second, appellants contend that even if the Constitution does require that this bankruptcy-related action be adjudicated in an Art. III court, the Act in fact satisfies that requirement. "Bank-

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ruptcy jurisdiction was vested in the district court" of the judicial district in which the bankruptcy court is located, "and the exercise of that jurisdiction by the adjunct bankruptcy court was made subject to appeal as of right to an Article III court." Brief for United States 12. Analogizing the role of the bankruptcy court to that of a special master, appellants urge us to conclude that this "adjunct" system established by Congress satisfies the requirements of Art. III. We consider these arguments in turn.

III

Congress did not constitute the bankruptcy courts as legislative courts.[13] Appellants contend, however, that the bankruptcy courts could have been so constituted, and that as a result the "adjunct" system in fact chosen by Congress does not impermissibly encroach upon the judicial power. In advancing this argument, appellants rely upon cases in which we have identified certain matters that "congress may or may not bring within the cognizance of [Art. III courts], as it may deem proper." *Murray's Lessee v.*

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Hoboken Land & Improvement Co., 18 How. 272, 284, 15 L.Ed. 372 (1856).[14] But when properly understood, these precedents represent no broad departure from the constitutional command that the judicial power of the United States must be vested in Art. III-

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courts.[15] Rather, they reduce to three narrow situations not subject to that command, each recognizing a circumstance in which the grant of power to the Legislative and Executive Branches was historically and constitutionally so exceptional that the congressional assertion of a power to create legislative courts was consistent with, rather than threatening to, the constitutional mandate of separation of powers. These precedents simply acknowledge that the literal command of Art. III, assigning the judicial power of the United States to courts insulated from Legislative or Executive interference, must be interpreted in light of the historical context in which the Constitution was written, and of the structural imperatives of the Constitution as a whole.

Appellants first rely upon a series of cases in which this Court has upheld the creation by Congress of non-Art. III "territorial courts." This exception from the general prescription of Art. III dates from the earliest days of the Republic, when it was perceived that the Framers intended that as to certain geographical areas, in which no State operated as sovereign, Congress was to exercise the general powers of government. For example, in *American Ins. Co. v. Canter*, 1 Pet. 511, 7 L.Ed. 242 (1828), the Court observed that Art. IV bestowed upon Congress alone a complete power of government over

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territories not within the States that constituted the United States. The Court then acknowledged Congress' authority to create courts for those territories that were not in conformity with Art. III. Such courts were

"created in virtue of the general right of sovereignty which exists in the government, or in virtue of that clause which enables Congress to make all needful rules and regulations, respecting the territory belonging to the United States. The jurisdiction with which they are invested . . . is conferred by Congress, in the execution of those general powers which that body possesses over the territories of the United States. Although admiralty jurisdiction can be exercised in the states in those Courts, only, which are established in pursuance of the third article of the Constitution; the same limitation does not extend to the territories. In legislating for them, Congress exercises the combined powers of the general, and of a state government." 1 Pet., at 546.

The Court followed the same reasoning when it reviewed Congress' creation of non-Art. III courts in the District of Columbia. It noted that there was in the District

"no division of powers between the general and state governments. Congress has the entire control over the district for every purpose of government; and it is reasonable to suppose, that in organizing a judicial department here, all judicial power necessary for the purposes of government would be vested in the courts of justice." *Kendall v. United States*, 12 Pet. 524, 619, 9 L.Ed. 1181 (1838).[16]

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Appellants next advert to a second class of cases—those in which this Court has sustained the exercise by Congress and the Executive of the power to establish and administer courts-martial. The situation in these cases strongly resembles the situation with respect to territorial courts: It too involves a constitutional grant of power that has been historically understood as giving the political Branches of Government extraordinary control over the precise subject matter at issue. Article I, § 8, cls. 13, 14, confer upon Congress the power "[t]o provide and maintain a Navy," and "[t]o make Rules for the Government and Regulation of the land and naval Forces." The Fifth Amendment, which requires a presentment

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or indictment of a grand jury before a person may be held to answer for a capital or otherwise infamous crime, contains an express exception for "cases arising in the land or naval forces." And Art. II, § 2, cl. 1, provides that "The President shall be Commander in Chief of the Army and Navy of the United States, and of the Militia of the several States, when called into the actual Service of the United States." Noting these constitutional directives, the Court in *Dynes v. Hoover*, 20 How. 65, 15 L.Ed. 838 (1857), explained:

"These provisions show that Congress has the power to provide for the trial and punishment of military and naval offences in the manner then and now practiced by civilized nations; and that the power to do so is given without any connection between it and the 3d article of the Constitution defining the judicial power of the United States; indeed, that the two powers are entirely independent of each other." *Id.*, at 79.[17]

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Finally, appellants rely on a third group of cases, in which this Court has upheld the constitutionality of legislative courts and administrative agencies created by Congress to adjudicate cases involving "public rights." [18] The "public rights" doctrine was first set forth in *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 15 L.Ed. 372 (1856):

"[W]e do not consider congress can either withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty; nor, on the other hand, can it bring under the judicial power a matter which, from its nature, is not a subject for judicial determination. At the same time there are matters, *involving public rights*, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination, but which congress may or may not bring within the cognizance of the courts of the United States, as it may deem proper." *Id.*, at 284 (emphasis added).

This doctrine may be explained in part by reference to the traditional principle of sovereign immunity, which recognizes that the Government may attach conditions to its consent to be sued. See *id.*, at 283-285; see also *Ex parte Bakelite Corp.*, 279 U.S. 438, 452, 49 S.Ct. 411, 413, 73 L.Ed. 789 (1929). But the public-rights doctrine also draws upon the principle of separation of powers, and a historical understanding that certain prerogatives were reserved to the political Branches of Government. The doctrine extends only to matters arising "between the Gov-

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ernment and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments," *Crowell v. Benson*, 285 U.S. 22, 50, 52 S.Ct. 285, 292, 76 L.Ed. 598 (1932), and only to matters that historically could have been determined exclusively by those departments, see *Ex parte Bakelite Corp., supra*, 279 U.S., at 458, 49 S.Ct., at 416. The understanding of these cases is that the Framers expected that Congress would be free to commit such matters completely to nonjudicial executive determination, and that as a result there can be no constitutional objection to Congress' employing the less drastic expedient of committing their determination to a legislative court or an administrative agency. *Crowell v. Benson, supra*, 285 U.S., at 50, 52 S.Ct., at 292.[19]

The public-rights doctrine is grounded in a historically recognized distinction between matters that could be conclusively determined by the Executive and Legislative Branches and matters that are "inherently . . . judicial." *Ex parte Bakelite Corp., supra*, 279 U.S., at 458, 49 S.Ct., at 416. See *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How., at 280-282. For example, the Court in *Murray's Lessee* looked to the law of England and the States at the time the Constitution was adopted, in order to determine whether the issue presented was customarily

cognizable in the courts. *Ibid.* Concluding that the matter had not traditionally been one for judicial determination, the Court perceived no bar to Congress' establishment of summary procedures, outside of Art. III courts, to collect a debt due to the Government from one of its customs agents.[20] On the same premise, the Court in *Ex*

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parte Bakelite Corp., supra, held that the Court of Customs Appeals had been properly constituted by Congress as a legislative court:

"The *full* province of the court under the act creating it is that of determining matters arising between the Government and others in the executive administration and application of the customs laws. . . . The appeals include nothing which inherently or necessarily requires judicial determination, but only matters the determination of *which may be, and at times has been, committed exclusively to executive officers.*" 279 U.S., at 458, 49 S.Ct., at 416 (emphasis added).[21]

The distinction between public rights and private rights has not been definitively explained in our precedents.[22] Nor is it necessary to do so in the present cases, for it suffices to observe that a matter of public rights must at a minimum arise "between the government and others." *Ex parte Bakelite Corp., supra,* at 451, 49 S.Ct., at 413.[23] In contrast, "the liability of-

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one individual to another under the law as defined," *Crowell v. Benson, supra,* at 51, 52 S.Ct., at 292, is a matter of private rights. Our precedents clearly establish that *only* controversies in the former category may be removed from Art. III courts and delegated to legislative courts or administrative agencies for their determination. See *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 450, n. 7, 97 S.Ct. 1261, 1266, n. 7, 51 L.Ed.2d 464 (1977); *Crowell v. Benson, supra,* 285 U.S., at 50-51, 52 S.Ct., at 292. See also Katz, Federal Legislative Courts, 43 Harv.L.Rev. 894, 917-918 (1930).[24] Private-rights disputes, on the other hand, lie at the core of the historically recognized judicial power.

In sum, this Court has identified three situations in which Art. III does not bar the creation of legislative courts. In each of these situations, the Court has recognized certain exceptional powers bestowed upon Congress by the Constitution or by historical consensus. Only in the face of such an exceptional grant of power has the Court declined to hold the authority of Congress subject to the general prescriptions of Art. III.[25]

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We discern no such exceptional grant of power applicable in the cases before us. The courts created by the Bankruptcy Act of 1978 do not lie exclusively outside the States of the Federal Union, like those in the District of Columbia and the Territories. Nor do the bankruptcy courts bear any resemblance to courts-martial, which are founded upon the Constitution's grant of plenary authority over the Nation's military forces to the Legislative and Executive Branches. Finally, the substantive legal rights at issue in the present action cannot be deemed "public rights." Appellants argue that a discharge in bankruptcy is indeed a "public right," similar to such congressionally created benefits as "radio station licenses, pilot licenses, or certificates for common carriers" granted by administrative agencies. See Brief for United States 34. But the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case. The former may well be a "public right," but the latter obviously is not. Appellant Northern's right to recover contract damages to augment its estate is "one of private right, that is, of the liability of one

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individual to another under the law as defined." *Crowell v. Benson*, 285 U.S., at 51, 52 S.Ct., at 292.[26]

Recognizing that the present cases may not fall within the scope of any of our prior cases permitting the establishment of legislative courts, appellants argue that we should recognize an additional situation beyond the command of Art. III, sufficiently broad to sustain the Act. Appellants contend that Congress' constitutional authority to establish "uniform Laws on the subject of Bankruptcies throughout the United States," Art. I, § 8, cl. 4, carries with it an inherent power to establish legislative courts capable of adjudicating "bankruptcy-related controversies." Brief for United States 14. In support of this argument, appellants rely primarily upon a quotation from the opinion in *Palmore v. United States*, 411 U.S. 389, 93 S.Ct. 1670, 36 L.Ed.2d 342 (1973), in which we stated that

"both Congress and this Court have recognized that . . . the requirements of Art. III, which are applicable where laws of national applicability and affairs of national concern are at stake, must in proper circumstances give way to accommodate plenary grants of power to Congress to legislate with respect to specialized areas having particularized needs and warranting distinctive treatment." *Id.*, 407-408, 93 S.Ct., at 1681.

Appellants cite this language to support their proposition that a bankruptcy court created by Congress under its Art. I

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powers is constitutional, because the law of bankruptcy is a "specialized area," and Congress has found a "particularized need" that warrants "distinctive treatment." Brief for United States 20-33.

Appellants' contention, in essence, is that pursuant to any of its Art. I powers, Congress may create courts free of Art. III's requirements whenever it finds that course expedient. This contention has been rejected in previous cases. See, *e.g., Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S., at 450, n. 7, 97 S.Ct., at 1266, n. 7; *United States ex rel. Toth v. Quarles*, 350 U.S. 11, 76 S.Ct. 1, 100 L.Ed. 8 (1955). Although the cases relied upon by appellants demonstrate that independent courts are not required for *all* federal adjudications, those cases also make it clear that where Art. III does apply, all of the legislative powers specified in Art. I and elsewhere are subject to it. See, *e.g., Ex parte Bakelite Corp.*, 279 U.S., at 449, 49 S.Ct., at 412; *United States ex rel. Toth v. Quarles, supra; American Ins. Co. v. Canter*, 1 Pet., at 546; *Murray's Lessee*, 18 How., at 284. Cf. *Crowell v. Benson, supra*, 285 U.S., at 51, 52 S.Ct., at 292.

The flaw in appellants' analysis is that it provides no limiting principle. It thus threatens to supplant completely our system of adjudication in independent Art. III tribunals and replace it with a system of "specialized" legislative courts. True, appellants argue that under their analysis Congress could create legislative courts pursuant only to some "specific" Art. I power, and "only when there is a particularized need for distinctive treatment." Brief for United States 22-23. They therefore assert that their analysis would not permit Congress to replace the independent Art. III Judiciary through a "wholesale assignment of federal judicial business to legislative courts." *Ibid.* But these "limitations" are wholly illusory. For example, Art. I, § 8, empowers Congress to enact laws, *inter alia*, regulating interstate commerce and punishing certain crimes. Art. I, § 8, cls. 3, 6. On appellants' reasoning Congress could provide for the adjudication of these and "related" matters by judges and

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courts within Congress' exclusive control.[27] The potential for encroachment upon powers reserved to the Judicial Branch through the device of "specialized" legislative courts is dramatically evidenced in the jurisdiction granted to the courts created by the Act before us. The broad range of questions that can be brought into a bankruptcy court because they are "related to cases under title

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11," 28 U.S.C. § 1471(b) (1976 ed., Supp.IV), see *supra*, at 54, is the clearest proof that even when Congress acts through a "specialized" court, and pursuant to only one of its many Art. I powers, appellants' analysis fails to provide any real protection against the erosion of Art. III jurisdiction by the unilateral action of the political Branches. In short, to accept appellants' reasoning, would require that we replace the principles delineated in our precedents, rooted in history and the Constitution, with a rule of broad legislative discretion that could effectively eviscerate the constitutional guarantee of an independent Judicial Branch of the Federal Government.[28]

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Appellants' reliance upon *Palmore* for such broad legislative discretion is misplaced. In the context of the issue decided in that case, the language quoted from the *Palmore* opinion, *supra*, at 72, offers no substantial support for appellants' argument. *Palmore* was concerned with the courts of the District of Columbia, a unique federal enclave over which "Congress has . . . entire control . . . for every purpose of government." *Kendall v. United States*, 12 Pet., at 619.

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The "plenary authority" under the District of Columbia Clause, Art. I, § 8, cl. 17, was the subject of the quoted passage and the powers granted under that Clause are obviously different in kind from the other broad powers conferred on Congress: Congress' power over the District of Columbia encompasses the *full* authority of government, and thus, necessarily, the Executive and Judicial powers as well as the Legislative. This is a power that is clearly possessed by Congress only in limited geographic areas. *Palmore* itself makes this limitation clear. The quoted passage distinguishes the congressional powers at issue in *Palmore* from those in which the Art. III command of an independent Judiciary must be honored: where "laws of national applicability and affairs of national concern are at stake." 411 U.S., at 408, 93 S.Ct., at 1681. Laws respecting bankruptcy, like most laws enacted pursuant to the national powers cataloged in Art. I, § 8, are clearly laws of national applicability and affairs of national concern. Thus our reference in *Palmore* to "specialized areas having particularized needs" referred only to *geographic* areas, such as the District of Columbia or territories outside the States of the Federal Union. In light of the clear commands of Art. III, nothing held or said in *Palmore* can be taken to mean that in every area in which Congress may legislate, it may also create non-Art. III courts with Art. III powers.

In sum, Art. III bars Congress from establishing legislative courts to exercise jurisdiction over all matters related to those arising under the bankruptcy laws. The establishment of such courts does not fall within any of the historically recognized situations in which the general principle of independent adjudication commanded by Art. III does not apply. Nor can we discern any persuasive reason, in logic, history, or the Constitution, why the bankruptcy courts here established lie beyond the reach of Art. III.

IV

Appellants advance a second argument for upholding the constitutionality of the Act: that "viewed within the entire ju-

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dicial framework set up by Congress," the bankruptcy court is merely an "adjunct" to the district court, and that the delegation of certain adjudicative functions to the bankruptcy court is accordingly consistent with the principle that the judicial power of the United States must be vested in Art. III courts. See Brief for United States 11-13, 37-45. As support for their argument, appellants rely principally upon *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932), and *United States v. Raddatz*, 447 U.S. 667, 100 S.Ct. 2406, 65 L.Ed.2d 424 (1980), cases in which we approved the use of administrative agencies and

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magistrates as adjuncts to Art. III courts. Brief for United States 40-42. The question to which we turn, therefore, is whether the Act has retained "the essential attributes of the judicial power," *Crowell v. Benson, supra,* 285 U.S., at 51, 52 S.Ct., at 292, in Art. III tribunals.[29]

The essential premise underlying appellants' argument is that even where the Constitution denies Congress the power to establish legislative courts, Congress possesses the authority to assign certain factfinding functions to adjunct tribunals. It is, of course, true that while the power to adjudicate "private rights" must be vested in an Art. III court, see Part III, *supra,*

"this Court has accepted factfinding by an administrative agency, . . . as an adjunct to the Art. III court, analogizing the agency to a jury or a special master and permitting it in admiralty cases to perform the function of the special master. *Crowell v. Benson,* 285 U.S. 22, 51-

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65 [52 S.Ct. 285, 292-298, 76 L.Ed. 598] (1932)." *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S., at 450, n. 7, 97 S.Ct., at 1266, n. 7.

The use of administrative agencies as adjuncts was first upheld in *Crowell v. Benson, supra.* The congressional scheme challenged in *Crowell* empowered an administrative agency, the United States Employees' Compensation Commission, to make initial factual determinations pursuant to a federal statute requiring employers to compensate their employees for work-related injuries occurring upon the navigable waters of the United States. The Court began its analysis by noting that the federal statute administered by the Compensation Commission provided for compensation of injured employees "irrespective of fault," and that the statute also prescribed a fixed and mandatory schedule of compensation. *Id.,* 285 U.S., at 38, 52 S.Ct., at 287. The agency was thus left with the limited role of determining "questions of fact as to the circumstances, nature, extent and consequences of the injuries sustained by the employee for which compensation is to be made." *Id.,* at 54, 52 S.Ct., at 293. The agency did not possess the power to enforce any of its compensation orders: On the contrary, every compensation order was appealable to the appropriate federal district court, which had the sole power to enforce it or set it aside, depending upon whether the court determined it to be "in accordance with law" and supported by evidence in the record. *Id.,* at 44-45, 48, 52 S.Ct., at 289-290, 291. The Court found that in view of these limitations upon the Compensation Commission's functions and powers, its determinations were "closely analogous to findings of the amount of damages that are made, according to familiar practice, by commissioners or assessors." *Id.,* at 54, 52 S.Ct., at 293. Observing that "there is no requirement that, in order to maintain the essential attributes of the judicial power, all determinations of fact in constitutional courts shall be made by judges," *id.,* at 51, 52 S.Ct., at 292, the Court held that Art. III imposed no bar to the scheme enacted by Congress, *id.,* at 54, 52 S.Ct., at 293.

Crowell involved the adjudication of congressionally created rights. But this Court has sustained the use of adjunct factfinders even in the adjudication of constitutional rights—

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so long as those adjuncts were subject to sufficient control by an Art. III district court. In *United States v. Raddatz, supra,* the Court upheld the 1978 Federal Magistrates Act, which permitted district court judges to refer certain pretrial motions, including suppression motions based on alleged violations of constitutional rights, to a magistrate for initial determination. The Court observed that the magistrate's proposed findings and recommendations were subject to *de novo* review by the district court, which was free to rehear the evidence or to call for additional evidence. *Id.,* 447 U.S., at 676-677, 681-683, 100 S.Ct., at 2412-2413, 2415-2416. Moreover, it was noted that the magistrate considered motions only upon reference from the

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district court, and that the magistrates were appointed, and subject to removal, by the district court. *Id.*, at 685, 100 S.Ct., at 2417 (BLACKMUN, J., concurring).[30] In short, the ultimate decisionmaking authority respecting all pretrial motions clearly remained with the district court. *Id.*, at 682, 100 S.Ct., at 2415. Under these circumstances, the Court held that the Act did not violate the constraints of Art. III. *Id.*, at 683-684, 100 S.Ct., at 2416.[31]

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Together these cases establish two principles that aid us in determining the extent to which Congress may constitutionally vest traditionally judicial functions in non-Art. III officers. First, it is clear that when Congress creates a substantive federal right, it possesses substantial discretion to prescribe the manner in which that right may be adjudicated—including the assignment to an adjunct of some functions historically performed by judges.[32] Thus *Crowell* rec-

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ognized that Art. III does not require "all determinations of fact [to] be made by judges," 285 U.S., at 51, 52 S.Ct., at 292; with respect to congressionally created rights, some factual determinations may be made by a specialized factfinding tribunal designed by Congress, without constitutional bar, *id.*, at 54, 52 S.Ct., at 293. Second, the functions of the adjunct must be limited in such a way that "the essential attributes" of judicial power are retained in the Art. III court. Thus in upholding the adjunct scheme challenged in *Crowell*, the Court emphasized that "the reservation of full authority to the court to deal with matters of law provides for the appropriate exercise of the judicial function in this class of cases." *Ibid.* And in refusing to invalidate the Magistrates Act at issue in *Raddatz*, the Court stressed that under the congressional scheme " '[t]he authority and the responsibility—to make an informed, final determination . . . remains with the judge,' " 447 U.S., at 682, 100 S.Ct., at 2415, quoting *Mathews v. Weber*, 423 U.S. 261, 271, 96 S.Ct. 549, 554, 46 L.Ed.2d 483 (1976); the statute's delegation of power was therefore permissible, since "the ultimate decision is made by the district court," 447 U.S., at 683, 100 S.Ct., at 2416.

These two principles assist us in evaluating the "adjunct" scheme presented in these cases. Appellants assume that Congress' power to create "adjuncts" to consider all cases related to those arising under Title 11 is as great as it was in the circumstances of *Crowell*. But while *Crowell* certainly endorsed the proposition that Congress possesses broad discretion to assign factfinding functions to an adjunct created to aid in the adjudication of congressionally created statutory rights, *Crowell* does not support the further proposition necessary to appellants' argument—that Congress possesses the same degree of discretion in assigning traditionally judicial power to adjuncts engaged in the adjudication of rights *not*

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created by Congress. Indeed, the validity of this proposition was expressly denied in *Crowell*, when the Court rejected "the untenable assumption that the constitutional courts may be deprived in all cases of the determination of facts upon evidence even though a *constitutional* right may be involved," 285 U.S., at 60-61, 52 S.Ct., at 296 (emphasis added),[33] and stated that

"the essential independence of the exercise of the judicial power of the United States in the enforcement of *constitutional* rights requires that the Federal court should determine . . . an issue [of agency jurisdiction] upon its own record and the facts elicited before it." *Id.*, at 64, 52 S.Ct., at 297 (emphasis added).[34]

Appellants' proposition was also implicitly rejected in *Raddatz*. Congress' assignment of adjunct functions under the Federal Magistrates Act was substantially narrower than under the statute challenged in *Crowell*. Yet the Court's scrutiny of the adjunct scheme in *Raddatz* — which played a

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role in the adjudication of *constitutional* rights—was far stricter than it had been in *Crowell.* Critical to the Court's decision to uphold the Magistrates Act was the fact that the ultimate decision was made by the district court. 447 U.S., at 683, 100 S.Ct., at 2416.

Although *Crowell* and *Raddatz* do not explicitly distinguish between rights created by Congress and other rights, such a distinction underlies in part *Crowell's* and *Raddatz'* recognition of a critical difference between rights created by federal statute and rights recognized by the Constitution. Moreover, such a distinction seems to us to be necessary in light of the delicate accommodations required by the principle of separation of powers reflected in Art. III. The constitutional system of checks and balances is designed to guard against "encroachment or aggrandizement" by Congress at the expense of the other branches of government. *Buckley v. Valeo*, 424 U.S., at 122, 96 S.Ct., at 683. But when Congress creates a statutory right, it clearly has the discretion, in defining that right, to create presumptions, or assign burdens of proof, or prescribe remedies; it may also provide that persons seeking to vindicate that right must do so before particularized tribunals created to perform the specialized adjudicative tasks related to that right.[35] Such provisions do, in a sense, affect the exercise of judicial power, but they are also incidental to Congress' power to define the right that it has created. No

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comparable justification exists, however, when the right being adjudicated is not of congressional creation. In such a situation, substantial inroads into functions that have traditionally been performed by the Judiciary cannot be characterized merely as incidental extensions of Congress' power to define rights that it has created. Rather, such inroads suggest unwarranted encroachments upon the judicial power of the United States, which our Constitution reserves for Art. III courts.

We hold that the Bankruptcy Act of 1978 carries the possibility of such an unwarranted encroachment. Many of the rights subject to adjudication by the Act's bankruptcy courts, like the rights implicated in *Raddatz*, are not of Congress' creation. Indeed, the cases before us, which center upon appellant Northern's claim for damages for breach of contract and misrepresentation, involve a right created by *state* law, a right independent of and antecedent to the reorganization petition that conferred jurisdiction upon the Bankruptcy Court.[36] Accordingly, Congress' authority to control the manner in which that right is adjudicated, through assignment of historically judicial functions to a non-Art. III "adjunct," plainly must be deemed at a minimum. Yet it is equally plain that Congress has vested the "adjunct" bankruptcy judges with powers over Northern's state-created right that far exceed the powers that it has vested in administrative agencies that adjudicate only rights of Congress' own creation.

Unlike the administrative scheme that we reviewed in *Crowell*, the Act vests all "essential attributes" of the judicial

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power of the United States in the "adjunct" bankruptcy court. First, the agency in *Crowell* made only specialized, narrowly confined factual determinations regarding a particularized area of law. In contrast, the subject-matter jurisdiction of the bankruptcy courts encompasses not only traditional matters of bankruptcy, but also "all civil proceedings arising under title 11 or arising in or *related to* cases under title 11." 28 U.S.C. § 1471(c) (1976 ed., Supp.IV) (emphasis added). Second, while the agency in *Crowell* engaged in statutorily channeled factfinding functions, the bankruptcy courts exercise "*all* of the jurisdiction" conferred by the Act on the district courts, § 1471(c) (emphasis added). Third, the agency in *Crowell* possessed only a limited power to issue compensation orders pursuant to specialized procedures, and its orders could be enforced only by order of the district court. By contrast, the bankruptcy courts exercise all ordinary powers of

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district courts, including the power to preside over jury trials, 28 U.S.C. § 1480 (1976 ed., Supp.IV), the power to issue declaratory judgments, § 2201, the power to issue writs of habeas corpus, § 2256, and the power to issue any order, process, or judgment appropriate for the enforcement of the provisions of Title 11, 11 U.S.C. § 105(a) (1976 ed., Supp.IV).[37] Fourth, while orders issued by the agency in *Crowell* were to be set aside if "not supported by the evidence," the judgments of the bankruptcy courts are apparently subject to review only under the more deferential "clearly erroneous" standard. See n. 5, *supra*. Finally, the agency in *Crowell* was required by law to seek enforcement of its compensation orders in the district court. In contrast, the bankruptcy courts issue final judgments, which are bind-

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ing and enforceable even in the absence of an appeal.[38] In short, the "adjunct" bankruptcy courts created by the Act exercise jurisdiction behind the facade of a grant to the district courts, and are exercising powers far greater than those lodged in the adjuncts approved in either *Crowell* or *Raddatz*.[39]

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We conclude that 28 U.S.C. § 1471 (1976 ed., Supp.IV), as added by § 241(a) of the Bankruptcy Act of 1978, has impermissibly removed most, if not all, of "the essential attributes of the judicial power" from the Art. III district court, and has vested those attributes in a non-Art. III adjunct. Such a grant of jurisdiction cannot be sustained as an exercise of Congress' power to create adjuncts to Art. III courts.

V

Having concluded that the broad grant of jurisdiction to the bankruptcy courts contained in 28 U.S.C. § 1471 (1976 ed., Supp.IV) is unconstitutional, we must now determine whether our holding should be applied retroactively to the effective date of the Act.[40] Our decision in *Chevron*

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Oil Co. v. Huson, 404 U.S. 97, 92 S.Ct. 349, 30 L.Ed.2d 296 (1971), sets forth the three considerations recognized by our precedents as properly bearing upon the issue of retroactivity. They are, first, whether the holding in question "decid[ed] an issue of first impression whose resolution was not clearly foreshadowed" by earlier cases, *id.*, at 106, 92 S.Ct., at 355; second, "whether retrospective operation will further or retard [the] operation" of the holding in question, *id.*, at 107, 92 S.Ct., at 355; and third, whether retroactive application "could produce substantial inequitable results" in individual cases, *ibid.* In the present cases, all of these considerations militate against the retroactive application of our holding today. It is plain that Congress' broad grant of judicial power to non-Art. III bankruptcy judges presents an unprecedented question of interpretation of Art. III. It is equally plain that retroactive application would not further the operation of our holding, and would surely visit substantial injustice and hardship upon those litigants who relied upon the Act's vesting of jurisdiction in the bankruptcy courts. We hold, therefore, that our decision today shall apply only prospectively.[41]

The judgment of the District Court is affirmed. However, we stay our judgment until October 4, 1982. This limited stay will afford Congress an opportunity to reconstitute the bankruptcy courts or to adopt other valid means of adjudication, without impairing the interim administration of the bankruptcy laws. See *Buckley v. Valeo*, 424 U.S., at 143, 96 S.Ct., at 693;

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cf. *Georgia v. United States*, 411 U.S. 526, 541, 93 S.Ct. 1702, 1711, 36 L.Ed.2d 472 (1973); *Fortson v. Morris*, 385 U.S. 231, 235, 87 S.Ct. 446, 449, 17 L.Ed.2d 330 (1966); *Maryland Committee for Fair Representation v. Tawes*, 377 U.S. 656, 675-

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676, 84 S.Ct. 1429, 1439-1440, 12 L.Ed.2d 595 (1964).

It is so ordered.

Justice REHNQUIST, with whom Justice O'CONNOR joins, concurring in the judgment.

Were I to agree with the plurality that the question presented by these cases is "whether the assignment by Congress to bankruptcy judges of the jurisdiction granted in 28 U.S.C. § 1471 (1976 ed., Supp.IV) by § 241(a) of the Bankruptcy Act of 1978 violates Art. III of the Constitution," *ante*, at 52, I would with considerable reluctance embark on the duty of deciding this broad question. But appellee Marathon Pipe Line Co. has not been subjected to the full range of authority granted bankruptcy courts by § 1471. It was named as a defendant in a suit brought by appellant Northern Pipeline Construction Co. in a United States Bankruptcy Court. The suit sought damages for, *inter alia*, breaches of contract and warranty. Marathon moved to dismiss the action on the grounds that the Bankruptcy Act of 1978, which authorized the suit, violated Art. III of the Constitution insofar as it established bankruptcy judges whose tenure and salary protection do not conform to the requirements of Art. III.

With the cases in this posture, Marathon has simply been named defendant in a lawsuit about a contract, a lawsuit initiated by appellant Northern after having previously filed a petition for reorganization under the Bankruptcy Act. Marathon may object to proceeding further with this lawsuit on the grounds that if it is to be resolved by an agency of the United States, it may be resolved only by an agency which exercises "[t]he judicial power of the United States" described by Art. III of the Constitution. But resolution of

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any objections it may make on this ground to the exercise of a different authority conferred on bankruptcy courts by the 1978 Act, see *ante*, at 54-55, should await the exercise of such authority.

"This Court, as is the case with all federal courts, 'has no jurisdiction to pronounce any statute, either of a State or of the United States, void, because irreconcilable with the Constitution, except as it is called upon to adjudge the legal rights of litigants in actual controversies. In the exercise of that jurisdiction, it is bound by two rules, to which it has rigidly adhered, one, never to anticipate a question of constitutional law in advance of the necessity of deciding it; the other never to formulate a rule of constitutional law broader than is required by the precise facts to which it is to be applied.' *Liverpool, New York & Philadelphia S.S. Co. v. Commissioners of Emigration*, 113 U.S. 33, 39 [5 S.Ct. 352, 355, 28 L.Ed. 899]." *United States v. Raines*, 362 U.S. 17, 21, 80 S.Ct. 519, 522, 4 L.Ed.2d 524 (1960).

Particularly in an area of constitutional law such as that of "Art. III Courts," with its frequently arcane distinctions and confusing precedents, rigorous adherence to the principle that this Court should decide no more of a constitutional question than is absolutely necessary accords with both our decided cases and with sound judicial policy.

From the record before us, the lawsuit in which Marathon was named defendant seeks damages for breach of contract, misrepresentation, and other counts which are the stuff of the traditional actions at common law tried by the courts at Westminster in 1789. There is apparently no federal rule of decision provided for any of the issues in the lawsuit; the claims of Northern arise entirely under state law. No method of adjudication is hinted, other than the traditional common-law mode of judge and jury. The lawsuit is before the Bankruptcy Court only because the plaintiff has previously filed a petition for reorganization in that court.

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The cases dealing with the authority of Congress to create courts other than by use of its power under Art. III do not admit of easy synthesis. In the interval of nearly 150 years between *American Insurance Co. v. Canter*, 1 Pet.

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511, 7 L.Ed. 242 (1828), and *Palmore v. United States*, 411 U.S. 389, 93 S.Ct. 1670, 36 L.Ed.2d 342 (1973), the Court addressed the question infrequently. I need not decide whether these cases in fact support a general proposition and three tidy exceptions, as the plurality believes, or whether instead they are but landmarks on a judicial "darkling plain" where ignorant armies have clashed by night, as JUSTICE WHITE apparently believes them to be. None of the cases has gone so far as to sanction the type of adjudication to which Marathon will be subjected against its will under the provisions of the 1978 Act. To whatever extent different powers granted under that Act might be sustained under the "public rights" doctrine of *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 15 L.Ed. 372 (1856), and succeeding cases, I am satisfied that the adjudication of Northern's lawsuit cannot be so sustained.

I am likewise of the opinion that the extent of review by Art. III courts provided on appeal from a decision of the bankruptcy court in a case such as Northern's does not save the grant of authority to the latter under the rule espoused in *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932). All matters of fact and law in whatever domains of the law to which the parties' dispute may lead are to be resolved by the bankruptcy court in the first instance, with only traditional appellate review by Art. III courts apparently contemplated. Acting in this manner the bankruptcy court is not an "adjunct" of either the district court or the court of appeals.

I would, therefore, hold so much of the Bankruptcy Act of 1978 as enables a Bankruptcy Court to entertain and decide Northern's lawsuit over Marathon's objection to be violative of Art. III of the United States Constitution. Because I agree with the plurality that this grant of authority is not readily severable from the remaining grant of authority to

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bankruptcy courts under § 1471, see *ante*, at 87-88, n. 40, I concur in the judgment. I also agree with the discussion in Part V of the plurality opinion respecting retroactivity and the staying of the judgment of this Court.

Chief Justice BURGER, dissenting.

I join Justice WHITE's dissenting opinion, but I write separately to emphasize that, notwithstanding the plurality opinion, the Court does *not* hold today that Congress' broad grant of jurisdiction to the new bankruptcy courts is generally inconsistent with Art. III of the Constitution. Rather, the Court's holding is limited to the proposition stated by Justice REHNQUIST in his concurrence in the judgment—that a "traditional" state common-law action, not made subject to a federal rule of decision, and related only peripherally to an adjudication of bankruptcy under federal law, must, absent the consent of the litigants, be heard by an "Art. III court" if it is to be heard by any court or agency of the United States. This limited holding, of course, does not suggest that there is something inherently unconstitutional about the new bankruptcy courts; nor does it preclude such courts from adjudicating all but a relatively narrow category of claims "arising under" or "arising in or related to cases under" the Bankruptcy Act.

It will not be necessary for Congress, in order to meet the requirements of the Court's holding, to undertake a radical restructuring of the present system of bankruptcy adjudication. The problems arising from today's judgment can be resolved simply by providing that ancillary common-law actions, such as the one involved in these cases, be routed to the United States district court of which the bankruptcy court is an adjunct.

Justice WHITE, with whom THE CHIEF JUSTICE and Justice POWELL join, dissenting.

Article III, § 1, of the Constitution is straightforward and uncomplicated on its face:

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"The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish. The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office."

Any reader could easily take this provision to mean that although Congress was free to establish such lower courts as it saw fit, any court that it did establish would be an "inferior" court exercising "judicial Power of the United States" and so must be manned by judges possessing both life tenure and a guaranteed minimal income. This would be an eminently sensible reading and one that, as the plurality shows, is well founded in both the documentary sources and the political doctrine of separation of powers that stands behind much of our constitutional structure. *Ante*, at 57-60.

If this simple reading were correct and we were free to disregard 150 years of history, these would be easy cases and the plurality opinion could end with its observation that "[i]t is undisputed that the bankruptcy judges whose offices were created by the Bankruptcy Act of 1978 do not enjoy the protections constitutionally afforded to Art. III judges." *Ante*, at 60. The fact that the plurality must go on to deal with what has been characterized as one of the most confusing and controversial areas of constitutional law [1] itself indicates the gross oversimplification implicit in the plurality's claim that "our Constitution unambiguously enunciates a fundamental principle—that the 'judicial Power of the United States' must be reposed in an independent Judiciary [and] provides clear institutional protections for that independence." *Ibid*. While this is fine rhetoric, analytically it serves only to put a distracting and superficial gloss on a difficult question.

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That question is what limits Art. III places on Congress' ability to create adjudicative institutions designed to carry out federal policy established pursuant to the substantive authority given Congress elsewhere in the Constitution. Whether fortunate or unfortunate, at this point in the history of constitutional law that question can no longer be answered by looking only to the constitutional text. This Court's cases construing that text must also be considered. In its attempt to pigeonhole these cases, the plurality does violence to their meaning and creates an artificial structure that itself lacks coherence.

I

There are, I believe, two separate grounds for today's decision. First, non-Art. III judges, regardless of whether they are labeled "adjuncts" to Art. III courts or "Art. I judges," may consider only controversies arising out of federal law. Because the immediate controversy in these cases—Northern Pipeline's claim against Marathon—arises out of state law, it may only be adjudicated, within the federal system, by an Art. III court.[2] Second, regardless of the source of law that governs the controversy, Congress is prohibited by Art. III from establishing Art. I courts, with three narrow exceptions. Adjudication of bankruptcy proceedings does not fall within any of these exceptions. I shall deal with the first of these contentions in this section.

The plurality concedes that Congress may provide for initial adjudications by Art. I courts or administrative judges of all rights and duties arising under otherwise valid federal laws. *Ante*, at 80. There is no apparent reason why this principle should not extend to matters arising in federal bankruptcy proceedings. The plurality attempts to escape the reach of prior decisions by contending that the bankrupt's claim against Marathon arose under state law. Non-Article III

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judges, in its view, cannot be vested with authority to adjudicate such issues. It then proceeds to strike down 28 U.S.C. § 1471 (1976

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ed., Supp.IV) on this ground. For several reasons, the Court's judgment is unsupportable.

First, clearly this ground alone cannot support the Court's invalidation of § 1471 on its face. The plurality concedes that in adjudications and discharges in bankruptcy, "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power," *ante*, at 71, and "the manner in which the rights of debtors and creditors are adjusted," *ante*, at 84, n. 36, are matters of federal law. Under the plurality's own interpretation of the cases, therefore, these matters could be heard and decided by Art. I judges. But because the bankruptcy judge is also given authority to hear a case like that of appellant Northern against Marathon, which the Court says is founded on state law, the Court holds that the section must be stricken down on its face. This is a grossly unwarranted emasculation of the scheme Congress has adopted. Even if the Court is correct that such a state-law claim cannot be heard by a bankruptcy judge, there is no basis for doing more than declaring the section unconstitutional as applied to the claim against Marathon, leaving the section otherwise intact. In that event, cases such as these would have to be heard by Art. III judges or by state courts—unless the defendant consents to suit before the bankruptcy judge—just as they were before the 1978 Act was adopted. But this would remove from the jurisdiction of the bankruptcy judge only a tiny fraction of the cases he is now empowered to adjudicate and would not otherwise limit his jurisdiction.[3]

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Second, the distinction between claims based on state law and those based on federal law disregards the real character of bankruptcy proceedings. The routine in ordinary bankruptcy cases now, as it was before 1978, is to stay actions against the bankrupt, collect the bankrupt's assets, require creditors to file claims or be forever barred, allow or disallow claims that are filed, adjudicate preferences and fraudulent transfers, and make pro rata distributions to creditors, who will be barred by the discharge from taking further actions against the bankrupt. The crucial point to be made is that in the ordinary bankruptcy proceeding the great bulk of creditor claims are claims that have accrued under state law prior to bankruptcy—claims for goods sold, wages, rent, utilities, and the like. "[T]he word debt as used by the Act is not confined to its technical common law meaning but . . . extends to liabilities arising out of breach of contract . . . to torts . . . and to taxes owing to the United States or state or local governments." 1 W. Collier, Bankruptcy ¶ 1.14, p. 88 (14th ed. 1976). Every such claim must be filed and its validity is sub-

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ject to adjudication by the bankruptcy court. The existence and validity of such claims recurringly depend on state law. Hence, the bankruptcy judge is constantly enmeshed in state-law issues.

The new aspect of the Bankruptcy Act of 1978, in this regard, therefore, is not the extension of federal jurisdiction to state law claims, but its extension to particular kinds of state-law claims, such as contract cases against third parties or disputes involving property in the possession of a third person.[4] Prior to 1978, a claim of a bankrupt against a third party, such as the claim against Marathon in this case, was not within the jurisdiction of the bankruptcy judge. The old limits were based, of course, on the restrictions implicit within the concept of *in rem* jurisdiction; the new extension is based on the concept of *in personam* jurisdiction. "The bankruptcy court is given in personam jurisdiction as well as in rem jurisdiction to handle everything that arises in a bankruptcy case." H.R.Rep.No. 95-595, p. 445 (1977), U.S.Code Cong. & Admin.News 1978, p. 6400. The difference between the new and old Acts, therefore, is not to be found in a distinction between state-law and federal-law matters; rather, it is in a distinction between *in rem* and *in personam* jurisdiction. The majority at no place explains why this distinction should have constitutional implications.

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Third, all that can be left of the majority's argument in this regard is that state-law claims adjudicated within the federal system must be heard in the first instance by Art. III judges. I shall argue below that any such attempt to distinguish Art. I from Art. III courts by the character of the controversies they may adjudicate fundamentally misunderstands the his-

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torical and constitutional significance of Art. I courts. Initially, however, the majority's proposal seems to turn the separation-of-powers doctrine, upon which the majority relies, on its head: Since state-law claims would ordinarily not be heard by Art. III judges—*i.e.*, they would be heard by state judges—one would think that there is little danger of a diminution of, or intrusion upon, the power of Art. III courts, when such claims are assigned to a non-Art. III court. The plurality misses this obvious point because it concentrates on explaining how it is that federally created rights can ever be adjudicated in Art. I courts a far more difficult problem under the separation-of-powers doctrine. The plurality fumbles when it assumes that the rationale it develops to deal with the latter problem must also govern the former problem. In fact, the two are simply unrelated and the majority never really explains the separation-of-powers problem that would be created by assigning state law questions to legislative courts or to adjuncts of Art. III courts.

One need not contemplate the intricacies of the separation-of-powers doctrine, however, to realize that the majority's position on adjudication of state-law claims is based on an abstract theory that has little to do with the reality of bankruptcy proceedings. Even prior to the present Act, bankruptcy cases were generally referred to bankruptcy judges, previously called referees. Bkrtcy.Rule 102(a). Title 11 U.S.C. § 66 described the jurisdiction of the referees. Their powers included the authority to

"consider all petitions referred to them and make the adjudications or dismiss the petitions . . . grant, deny or revoke discharges, determine the dischargeability of debts, and render judgments thereon [and] perform such of the duties as are by this title conferred on courts of bankruptcy, including those incidental to ancillary jurisdiction, and as shall be prescribed by rules or orders of the courts of bankruptcy of their respective districts, except as herein otherwise provided."

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The bankruptcy judge possessed "complete jurisdiction of the proceedings." 1 W. Collier, Bankruptcy ¶ 1.09, p. 65 (14th ed. 1976). The referee would initially hear and decide practically all matters arising in the proceedings, including the allowance and disallowance of the claims of creditors.[5] If a claim was disallowed by the bankruptcy judge and the decision was not reversed on appeal, the creditor was forever barred from further action against the bankrupt. As pointed out above, all of these matters could and usually did involve state-law issues. Initial adjudication of state-law issues by non-Art. III judges is, then, hardly a new aspect of the 1978 Act.

Furthermore, I take it that the Court does not condemn as inconsistent with Art. III the assignment of these functions—*i.e.*, those within the summary jurisdiction of the old bankruptcy courts to a non-Art. III judge, since, as the plurality says, they lie at the core of the federal bankruptcy power. *Ante*, at 71. They also happen to be functions that have been performed by referees or bankruptcy judges for a very long time and without constitutional objection. Indeed, we approved the authority of the referee to allow or disallow claims in *Katchen v. Landy*, 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966). There, the referee held that a creditor had received a preference and that his claim could therefore not be allowed. We agreed that the referee had the authority not only to adjudicate the existence of the preference, but also to order that the preference be disgorged. We also recognized that the referee could adjudicate counterclaims against a creditor who files his claim against the estate.

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The 1973 Bankruptcy Rules make similar provision. See Rule 306(c), Rule 701, and Advisory Committee Note to Rule 701, 11 U.S.C., p. 1340. Hence, if Marathon had filed a claim against the bankrupt in this case, the trustee could have filed and the bankruptcy judge

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could have adjudicated a counterclaim seeking the relief that is involved in these cases.

Of course, all such adjudications by a bankruptcy judge or referee were subject to review in the district court, on the record. See 11 U.S.C. § 67(c). Bankruptcy Rule 810, transmitted to Congress by this Court, provided that the district court "shall accept the referee's findings of fact unless they are clearly-erroneous." As the plurality recognizes, *ante*, at 55, the 1978 Act provides for appellate review in Art. III courts and presumably under the same "clearly erroneous standard." In other words, under both the old and new Acts, initial determinations of state-law questions were to be made by non-Art. III judges, subject to review by Art. III judges. Why the differences in the provisions for appeal in the two Acts are of unconstitutional dimension remains entirely unclear.

In theory and fact, therefore, I can find no basis for that part of the majority's argument that rests on the state-law character of the claim involved here. Even if, prior to 1978, the referee could not generally participate in cases aimed at collecting the assets of a bankrupt estate, he nevertheless repeatedly adjudicated issues controlled by state law. There is very little reason to strike down § 1471 on its face on the ground that it extends, in a comparatively minimal way, the referees' authority to deal with state-law questions. To do so is to lose all sense of proportion.

II

The plurality unpersuasively attempts to bolster its case for facial invalidity by asserting that the bankruptcy courts are now "exercising powers far greater than those lodged in the adjuncts approved in either *Crowell* or *Raddatz*." *Ante*, at 86. In support of this proposition it makes five arguments in addition to the "state-law" issue. Preliminarily, I see no basis for according standing to Marathon to raise any of these additional points. The state-law objection applies to

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the Marathon case. Only that objection should now be adjudicated.[6]

I also believe that the major premise of the plurality's argument is wholly unsupported: There is no explanation of why *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932), and *United States v. Raddatz*, 447 U.S. 667, 100 S.Ct. 2406, 65 L.Ed.2d 424 (1980), define the outer limits of constitutional authority. Much more relevant to today's decision are, first, the practice in bankruptcy prior to 1978, which neither the majority nor any authoritative case has questioned, and, second, the practice of today's administrative agencies. Considered from this perspective, all of the plurality's arguments are unsupportable abstractions, divorced from the realities of modern practice.

The first three arguments offered by the plurality, *ante*, at 85, focus on the narrowly defined task and authority of the agency considered in *Crowell*: The agency made only "specialized, narrowly confined factual determinations" and could issue only a narrow class of orders. Regardless of whether this was true of the Compensation Board at issue in *Crowell*, it certainly was not true of the old bankruptcy courts, nor does it even vaguely resemble current administrative practice. As I have already said, general references to bankruptcy judges, which was the usual practice prior to 1978, permitted bankruptcy judges to perform almost all of the functions of a bankruptcy court. Referees or bankruptcy judges not only exercised summary jurisdiction but could also conduct adversary proceedings to

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"(1) recover money or property . . . . (2) determine the validity, priority, or extent of a lien or other interest in property, (3) sell property free of a lien or other interest for which the holder can be compelled to make a money satisfaction, (4) object to or revoke a discharge, (5) obtain an injunction, (6) obtain relief from a stay . . . (7) determine the dischargeability of a debt." Bkrtcy.Rule 701.

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Although there were some exceptions to the referees' authority, which have been removed by the 1978 Act, the additions to the jurisdiction of the bankruptcy judges were of marginal significance when examined in the light of the overall functions of those judges before and after 1978. In my view, those changes are not sufficient to work a qualitative change in the character of the bankruptcy judge.

The plurality's fourth argument fails to point to any difference between the new and old Bankruptcy Acts. While the administrative orders in *Crowell* may have been set aside by a court if "not supported by the evidence," under both the new and old Acts at issue here, orders of the bankruptcy judge are reviewed under the "clearly-erroneous standard." See Bkrtcy.Rule 810. Indeed, judicial review of the orders of bankruptcy judges is more stringent than that of many modern administrative agencies. Generally courts are not free to set aside the findings of administrative agencies, if supported by substantial evidence. But more importantly, courts are also admonished to give substantial deference to the agency's interpretation of the statute it is enforcing. No such deference is required with respect to decisions on the law made by bankruptcy judges.

Finally, the plurality suggests that, unlike the agency considered in *Crowell*, the orders of a post-1978 bankruptcy judge are final and binding even though not appealed. *Ante*, at 85-86. To attribute any constitutional significance to this, unless the plurality intends to throw into question a large body of administrative law, is strange. More directly, this simply does not represent any change in bankruptcy practice. It was hornbook law prior to 1978 that the authorized judgments and orders of referees, including turnover orders, were final and binding and res judicata unless appealed and overturned:

"The practice before the referee should not differ from that before the judge of the court of bankruptcy and, apart from direct review within the limitation of § 39(c),

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the orders of the referee are entitled to the same presumption of validity, conclusiveness and recognition in the court of bankruptcy or other courts." 1 W. Collier, Bankruptcy ¶ 1.09, pp. 65-66 (14th ed. 1976).

Even if there are specific powers now vested in bankruptcy judges that should be performed by Art. III judges, the great bulk of their functions are unexceptionable and should be left intact. Whatever is invalid should be declared to be such; the rest of the 1978 Act should be left alone. I can account for the majority's inexplicably heavy hand in this case only by assuming that the Court has once again lost its conceptual bearings when confronted with the difficult problem of the nature and role of Art. I courts. To that question I now turn.

III

A.

The plurality contends that the precedents upholding Art. I courts can be reduced to three categories. First, there are territorial courts, which need not satisfy Art. III constraints because "the Framers intended that as to certain geographical areas . . . Congress was to exercise the general powers of government." [7] *Ante*, at 64. Second, there are courts martial, which are exempt from Art. III limits because of a constitutional grant of power that has been "historically understood as giving the political Branches of Government extraordinary control over the precise subject matter at issue." *Ante*, at

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66. Finally, there are those legislative courts and administrative agencies that adjudicate cases involving public rights—controversies between the Government and private parties—which are not covered by Art. III because the controversy could have been resolved by the ex-

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ecutive alone without judicial review. See *ante*, at 68. Despite the plurality's attempt to cabin the domain of Art. I courts, it is quite unrealistic to consider these to be only three "narrow," *ante*, at 64, limitations on or exceptions to the reach of Art. III. In fact, the plurality itself breaks the mold in its discussion of "adjuncts" in Part IV, when it announces that "when Congress creates a substantive federal right, it possesses substantial discretion to prescribe the manner in which that right may be adjudicated." *Ante*, at 80. Ajudications of federal rights may, according to the plurality, be committed to administrative agencies, as long as provision is made for judicial review.

The first principle introduced by the plurality is geographical: Art. I courts presumably are not permitted within the States.[8] The problem, of course, is that both of the other exceptions recognize that Art. I courts can indeed operate within the States. The second category relies upon a new principle: Art. I courts are permissible in areas in which the Constitution grants Congress "extraordinary control over the precise subject matter." *Ante*, at 66. Preliminarily, I do not know how we are to distinguish those areas in which Congress' control is "extraordinary" from those in which it is not. Congress' power over the Armed Forces is established in Art. I, § 8, cls. 13, 14. There is nothing in those Clauses that creates congressional authority different in kind from the authority granted to legislate with respect to bankruptcy. But more importantly, in its third category, and in its treatment of "adjuncts," the plurality itself recognizes that Congress can create Art. I courts in virtually all the areas in which Congress is authorized to act, regardless of the quality of the constitutional grant of authority. At the same time,

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territorial courts or the courts of the District of Columbia, which are Art. I courts, adjudicate private, just as much as public or federal, rights.

Instead of telling us what it is Art. I courts can and cannot do, the plurality presents us with a list of Art. I courts. When we try to distinguish those courts from their Art. III counterparts, we find—apart from the obvious lack of Art. III judges—a series of nondistinctions. By the plurality's own admission, Art. I courts can operate throughout the country, they can adjudicate both private and public rights, and they can adjudicate matters arising from congressional actions in those areas in which congressional control is "extraordinary." I cannot distinguish this last category from the general "arising under" jurisdiction of Art. III courts.

The plurality opinion has the appearance of limiting Art. I courts only because it fails to add together the sum of its parts. Rather than limiting each other, the principles relied upon complement each other; together they cover virtually the whole domain of possible areas of adjudication. Without a unifying principle, the plurality's argument reduces to the proposition that because bankruptcy courts are not sufficiently like any of these three exceptions, they may not be either Art. I courts or adjuncts to Art. III courts. But we need to know why bankruptcy courts cannot qualify as Art. I courts in their own right.

B

The plurality opinion is not the first unsuccessful attempt to articulate a principled ground by which to distinguish Article I from Article III courts. The concept of a legislative, or Article I, court was introduced by an opinion authored by Chief Justice Marshall. Not only did he create the concept, but at the same time he

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started the theoretical controversy that has ever since surrounded the concept:

"The Judges of the Superior Courts of Florida hold their offices for four years. These Courts, then, are not constitutional Courts, in which the judicial power conferred

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by the Constitution on the general government, can be deposited. They are incapable of receiving it. They are legislative Courts, created in virtue of the general right of sovereignty which exists in the government, or in virtue of that clause which enables Congress to make all needful rules and regulations, respecting the territory belonging to the United States. The jurisdiction with which they are invested, is not a part of that judicial power which is defined in the 3d article of the Constitution, but is conferred by Congress, in the execution of those general powers which that body possesses over the territories of the United States." *American Insurance Co. v. Canter*, 1 Pet. 511, 546, 7 L.Ed. 242 (1828).

The proposition was simple enough: Constitutional courts exercise the judicial power described in Art. III of the Constitution; legislative courts do not and cannot.

There were only two problems with this proposition. First, *Canter* itself involved a case in admiralty jurisdiction, which is specifically included within the "judicial power of the United States" delineated in Art. III. How, then, could the territorial court not be exercising Art. III judicial power? Second, and no less troubling, if the territorial courts could not exercise Art. III power, how could their decisions be subject to appellate review in Art. III courts, including this one, that can exercise only Art. III "judicial" power? Yet from early on this Court has exercised such appellate jurisdiction. *Benner v. Porter*, 9 How. 235, 243, 13 L.Ed. 119 (1850); *Clinton v. Englebrecht*, 13 Wall. 434, 20 L.Ed. 659 (1872); *Reynolds v. United States*, 98 U.S. 145, 154, 25 L.Ed. 244 (1879); *United States v. Coe*, 155 U.S. 76, 86, 15 S.Ct. 16, 19, 39 L.Ed. 76 (1894); *Balzac v. Porto Rico*, 258 U.S. 298, 312-313, 42 S.Ct. 343, 348-49, 66 L.Ed. 627 (1922). The attempt to understand the seemingly unexplainable was bound to generate "confusion and controversy." This analytic framework, however—the search for a principled distinction—has continued to burden the Court.

The first major elaboration on the *Canter* principle was in *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18

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How. 272, 15 L.Ed. 372 (1856). The plaintiff in that case argued that a proceeding against a customs collector for the collection of moneys claimed to be due to the United States was an exercise of "judicial power" and therefore had to be carried out by Art. III judges. The Court accepted this premise: "It must be admitted that, if the auditing of this account, and the ascertainment of its balance, and the issuing of this process, was an exercise of the judicial power of the United States, the proceeding was void; for the officers who performed these acts could exercise no part of that judicial power." *Id.*, at 275. Having accepted this premise, the Court went on to delineate those matters which could be determined only by an Art. III court, *i.e.*, those matters that fall within the nondelegable "judicial power" of the United States. The Court's response to this was twofold. First, it suggested that there are certain matters which are inherently "judicial": "[W]e do not consider congress can either withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Id.*, at 284. Second, it suggested that there is another class of issues that, depending upon the form in which Congress structures the decisionmaking process, may or may not fall within "the cognizance of the courts of the United States." *Ibid.* This latter category consisted of the so-called "public rights." Apparently, the idea was that Congress was free to structure the adjudication of "public rights" without regard to Art. III.

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Having accepted the plaintiff's premise, it is hard to see how the Court could have taken too seriously its first contention. The Court presented no examples of such issues that are judicial "by nature" and simply failed to acknowledge that Art. I courts already sanctioned by the Court—*e.g.*, territorial courts—were deciding such issues all the time. The second point, however, contains implicitly a critical insight; one that if openly acknowledged would have undermined the entire structure. That insight follows from the Court's earlier

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recognition that the term "judicial act" is broad enough to encompass all administrative action involving inquiry into facts and the application of law to those facts. *Id.*, at 280. If administrative action can be characterized as "judicial" in nature, then obviously the Court's subsequent attempt to distinguish administrative from judicial action on the basis of the manner in which Congress structures the decision cannot succeed. There need be no Art. III court involvement in any adjudication of a "public right," which the majority now interprets as any civil matter arising between the Federal Government and a citizen. In that area, whether an issue is to be decided by an Art. III court depends, finally, on congressional intent.

Although *Murray's Lessee* implicitly undermined Chief Justice Marshall's suggestion that there is a difference in kind between the work of Art. I and that of Art. III courts, it did not contend that the Court must always defer to congressional desire in this regard. The Court considered the plaintiff's contention that removal of the issue from an Art. III court must be justified by "necessity." Although not entirely clear, the Court seems to have accepted this proposition: "[I]t seems to us that the just inference from the entire law is, that there was such a necessity for the warrant." *Id.*, at 285.[9]

The Court in *Murray's Lessee* was precisely right: Whether an issue can be decided by a non-Art. III court does not depend upon the judicial or nonjudicial character of the issue, but on the will of Congress and the reasons Congress offers for not using an Art. III court. This insight, however, was completely disavowed in the next major case to consider

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the distinction between Art. I and Art. III courts, *Ex parte Bakelite Corp.*, 279 U.S. 438, 49 S.Ct. 411, 73 L.Ed. 789 (1929), in which the Court concluded that the Court of Customs Appeals was a legislative court. The Court there directly embraced the principle also articulated in *Murray's Lessee* that Art. I courts may not consider any matter "which inherently or necessarily requires judicial determination," but only such matters as are "susceptible of legislative or executive determination." 279 U.S., at 453, 49 S.Ct., at 414. It then went on effectively to bury the critical insight of *Murray's Lessee*, labeling as "fallacious" any argument that "assumes that whether a court is of one class or the other depends on the intention of Congress, whereas the true test lies in the power under which the court was created and in the jurisdiction conferred." 279 U.S., at 459, 49 S.Ct., at 416.[10]

The distinction between public and private rights as the principle delineating the proper domains of legislative and constitutional courts respectively received its death blow, I had believed, in *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932). In that case, the Court approved an administrative scheme for the determination, in the first instance, of maritime employee compensation claims. Although acknowledging the framework set out in *Murray's Lessee* and *Ex parte Bakelite Corp.*, the Court specifically distinguished the case before it: "The present case does not fall within the categories just described but is one of private right, that is, of the liability of one individual to another under the law as defined." [11] 285 U.S., at 51, 52 S.Ct., at 292. Nevertheless, the Court approved of the use of an Art. I adjudication mechanism on the new theory that "there is no requirement that, in order to maintain the essen-

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tial attributes of the judicial power, all determinations of fact in constitutional courts shall be made by judges." *Ibid.* Article I courts could deal not only with public rights, but also, to an extent, with private rights. The Court now established a distinction between questions of fact and law: "[T]he reservation of full authority to the court to deal with matters of law provides for the appropriate exercise of the judicial function in this class of cases." [12] *Id.*, at 54, 52 S.Ct., at 293.

Whatever sense *Crowell* may have seemed to give to this subject was exceedingly short-lived. One year later, the Court returned to this subject, abandoning both the public/private and the fact/law distinction and replacing both with a simple literalism. In *O'Donoghue v. United States*, 289 U.S. 516, 53 S.Ct. 740, 77 L.Ed. 1356 (1933), considering the courts of the District of Columbia, and in *Williams v. United States*, 289 U.S. 553, 53 S.Ct. 751, 77 L.Ed. 1372 (1933), considering the Court of Claims, the Court adopted the principle that if a federal court exercises jurisdiction over cases of the type listed in Art. III, § 2, as falling within the "judicial power of the United States," then that court must be an Art. III court:

"The provision of this section of the article is that the 'judicial power shall extend' to the cases enumerated, and it logically follows that where jurisdiction over these cases is conferred upon the courts of the District, the judicial power, since they are capable of receiving it, is *ipso facto*, vested in such courts as inferior courts of the United States." *O'Donoghue, supra*, 289 U.S., at 545, 53 S.Ct., at 748.[13]

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In order to apply this same principle and yet hold the Court of Claims to be a legislative court, the Court found it necessary in *Williams, supra*, to conclude that the phrase "Controversies to which the United States shall be a party" in Art. III must be read as if it said "controversies to which the United States shall be a party plaintiff or petitioner." [14]

By the time of the *Williams* decision, this area of the law was mystifying to say the least. What followed helped very little, if at all. In the next two major cases the Court could not agree internally on a majority position. In *National Insurance Co. v. Tidewater Co.*, 337 U.S. 582, 69 S.Ct. 1173, 93 L.Ed. 1556 (1949), the Court upheld a statute giving federal district courts jurisdiction over suits between citizens of the District of Columbia and citizens of a State. A majority of the Court, however, rejected the plurality position that Congress had the authority to assign Art. I powers to Art. III courts, at least outside of the District of Columbia. Only Chief Justice Vinson in dissent reflected on the other side of this problem: whether Art. I courts could be assigned Art. III powers. He entirely disagreed with the conceptual basis for *Williams* and *O'Donoghue*, noting that to the extent that Art. I courts consider non-Art. III matters, appellate review by an Art. III court would be precluded. Or conversely, since appellate review is exercised by this Court over Art. I courts, Art. I courts must "exercise federal question jurisdiction." 337 U.S., at 643, 69 S.Ct., at 1208. Having gone this far, the Chief Justice was confronted with the obvious question of whether in fact "the distinction between constitutional and legislative courts is meaningless." *Id.*, at 644, 69 S.Ct., at 1208-09. Although suggesting that out-

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side of the Territories or the District of Columbia there may be some limits on assignment to Art. I courts of matters that fall within Art. III jurisdiction—apart from federal-question jurisdiction—for the most part the Chief Justice ended up relying on the good will of Congress: "[W]e cannot impute to Congress an intent now or in the future to transfer jurisdiction from constitutional to legislative courts for the purpose of emasculating the former." *Ibid.*

Another chapter in this somewhat dense history of a constitutional quandary was provided

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by Justice Harlan's plurality opinion in *Glidden Co. v. Zdanok*, 370 U.S. 530, 82 S.Ct. 1459, 8 L.Ed.2d 671 (1962), in which the Court, despite *Bakelite* and *Williams* —and relying on an Act of Congress enacted since those decisions—held the Court of Claims and the Court of Customs and Patent Appeals to be Art. III courts. Justice Harlan continued the process of intellectual repudiation begun by Chief Justice Vinson in *Tidewater*. First, it was clear to him that Chief Justice Marshall could not have meant what he said in *Canter* on the inability of Art. I courts to consider issues within the jurisdiction of Art. III courts: "Far from being 'incapable of receiving' federal-question jurisdiction, the territorial courts have long exercised a jurisdiction commensurate in this regard with that of the regular federal courts and have been subjected to the appellate jurisdiction of this Court precisely because they do so." 370 U.S., at 545, n. 13, 82 S.Ct., at 1470, n. 13. Second, exceptions to the requirements of Art. III, he thought, have not been founded on any principled distinction between Art. I issues and Art. III issues; rather, a "confluence of practical considerations," *id.*, at 547, 82 S.Ct., at 1471, accounts for this Court's sanctioning of Art. I courts:

"The touchstone of decision in all these cases has been the need to exercise the jurisdiction then and there and for a transitory period. Whether constitutional limitations on the exercise of judicial power have been held inapplicable has depended on the particular local setting, the practical necessities, and the possible alternatives." *Id.*, at 547-548, 82 S.Ct., at 1471-72.

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Finally, recognizing that there is frequently no way to distinguish Art. I and Art. III courts on the basis of the work they do, Justice Harlan suggested that the only way to tell them apart is to examine the "establishing legislation" to see if it complies with the requirements of Art. III. This, however, comes dangerously close to saying that Art. III courts are those with Art. III judges; Art. I courts are those without such judges. One hundred and fifty years of constitutional history, in other words, had led to a simple tautology.

IV

The complicated and contradictory history of the issue before us leads me to conclude that Chief Justice Vinson and Justice Harlan reached the correct conclusion: There is no difference in principle between the work that Congress may assign to an Art. I court and that which the Constitution assigns to Art. III courts. Unless we want to overrule a large number of our precedents upholding a variety of Art. I courts—not to speak of those Art. I courts that go by the contemporary name of "administrative agencies"—this conclusion is inevitable. It is too late to go back that far; too late to return to the simplicity of the principle pronounced in Art. III and defended so vigorously and persuasively by Hamilton in The Federalist Nos. 78-82.

To say that the Court has failed to articulate a principle by which we can test the constitutionality of a putative Art. I court, or that there is no such abstract principle, is not to say that this Court must always defer to the legislative decision to create Art. I, rather than Art. III, courts. Article III is not to be read out of the Constitution; rather, it should be read as expressing one value that must be balanced against competing constitutional values and legislative responsibilities. This Court retains the final word on how that balance is to be struck.

Despite the principled, although largely mistaken, rhetoric expanded by the Court in this area over the years, such a balancing approach stands behind many of the decisions

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holding Art. I courts. Justice Harlan suggested as much in *Glidden*, although he needlessly limited his consideration to the "temporary" courts that Congress has had to set up on a variety of occasions. In each of these instances, this Court has implicitly concluded that the legislative interest in creating an adjudicative institution of

temporary duration outweighed the values furthered by a strict adherence to Art. III. Besides the territorial courts approved in *American Insurance Co. v. Canter*, 1 Pet. 511, 7 L.Ed. 242 (1828), these courts have included the Court of Private Land Claims, *United States v. Coe*, 155 U.S. 76, 15 S.Ct. 16, 39 L.Ed. 76 (1894), the Choctaw and Chickasaw Citizenship Court, *Stephens v. Cherokee Nation*, 174 U.S. 445, 19 S.Ct. 722, 43 L.Ed. 1041 (1899), and consular courts established in foreign countries, *In re Ross*, 140 U.S. 453, 11 S.Ct. 897, 35 L.Ed. 581 (1891). This same sort of "practical" judgment was voiced, even if not relied upon, in *Crowell* with respect to the Employees' Compensation Claims Commission, which was not meant to be of limited duration: "[W]e are unable to find any constitutional obstacle to the action of the Congress in availing itself of a method shown by experience to be essential in order to apply its standards to the thousands of cases involved." 285 U.S., at 54, 52 S.Ct., at 293. And even in *Murray's Lessee*, there was a discussion of the "necessity" of Congress' adopting an approach that avoided adjudication in an Art. III court. 18 How., at 285.

This was precisely the approach taken to this problem in *Palmore v. United States*, 411 U.S. 389, 93 S.Ct. 1670, 36 L.Ed.2d 342 (1973), which, contrary to the suggestion of the plurality, did not rest on any theory of territorial or geographical control. *Ante*, at 75-76. Rather, it rested on an evaluation of the strength of the legislative interest in pursuing in this manner one of its constitutionally assigned responsibilities—a responsibility not different in kind from numerous other legislative responsibilities. Thus, *Palmore* referred to the wide variety of Art. I courts, not just territorial courts. It is in this light that the critical statement of the case must be understood:

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"[T]he requirements of Art.. III, which are applicable where laws of national applicability and affairs of national concern are at stake, must in proper circumstances give way to accommodate plenary grants of power to Congress to legislate with respect to specialized areas having particularized needs and warranting distinctive treatment." 411 U.S., at 407-408, 93 S.Ct., at 1681-1682.

I do not suggest that the Court should simply look to the strength of the legislative interest and ask itself if that interest is more compelling than the values furthered by Art. III. The inquiry should, rather, focus equally on those Art. III values and ask whether and to what extent the legislative scheme accommodates them or, conversely, substantially undermines them. The burden on Art. III values should then be measured against the values Congress hopes to serve through the use of Art. I courts.

To be more concrete: *Crowell, supra*, suggests that the presence of appellate review by an Art. III court will go a long way toward insuring a proper separation of powers. Appellate review of the decisions of legislative courts, like appellate review of state-court decisions, provides a firm check on the ability of the political institutions of government to ignore or transgress constitutional limits on their own authority. Obviously, therefore, a scheme of Art. I courts that provides for appellate review by Art. III courts should be substantially less controversial than a legislative attempt entirely to avoid judicial review in a constitutional court.

Similarly, as long as the proposed Art. I courts are designed to deal with issues likely to be of little interest to the political branches, there is less reason to fear that such courts represent a dangerous accumulation of power in one of the political branches of government. Chief Justice Vinson suggested as much when he stated that the Court should guard against any congressional attempt "to transfer jurisdiction

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. . . for the purpose of emasculating" constitutional courts. *National Insurance Co. v. Tidewater Co.*, 337 U.S., at 644, 69 S.Ct., at 1208-1209.

V

I believe that the new bankruptcy courts established by the Bankruptcy Act of 1978, 28 U.S.C. § 1471 (1976 ed., Supp.IV), satisfy this standard.

First, ample provision is made for appellate review by Art. III courts. Appeals may in some circumstances be brought directly to the district courts. 28 U.S.C. § 1334 (1976 ed., Supp.IV). Decisions of the district courts are further appealable to the court of appeals. § 1293. In other circumstances, appeals go first to a panel of bankruptcy judges, § 1482, and then to the court of appeals. § 1293. In still other circumstances—when the parties agree—appeals may go directly to the court of appeals. In sum, there is in every instance a right of appeal to at least one Art. III court. Had Congress decided to assign all bankruptcy matters to the state courts, a power it clearly possesses, no greater review in an Art. III court would exist. Although I do not suggest that this analogy means that Congress may establish an Art. I court wherever it could have chosen to rely upon the state courts, it does suggest that the critical function of judicial review is being met in a manner that the Constitution suggests is sufficient.

Second, no one seriously argues that the Bankruptcy Act of 1978 represents an attempt by the political branches of government to aggrandize themselves at the expense of the third branch or an attempt to undermine the authority of constitutional courts in general. Indeed, the congressional perception of a lack of judicial interest in bankruptcy matters was one of the factors that led to the establishment of the bankruptcy courts: Congress feared that this lack of interest would lead to a failure by federal district courts to deal with bankruptcy matters in an expeditious manner. H.R.Rep.No. 95-595, p. 14 (1977). Bankruptcy matters are, for the most part, private adjudications of little political significance.

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Although some bankruptcies may indeed present politically controversial circumstances or issues, Congress has far more direct ways to involve itself in such matters than through some sort of subtle, or not so subtle, influence on bankruptcy judges. Furthermore, were such circumstances to arise, the Due Process Clause might very well require that the matter be considered by an Art. III judge: Bankruptcy proceedings remain, after all, subject to all of the strictures of that constitutional provision.[15]

Finally, I have no doubt that the ends that Congress sought to accomplish by creating a system of non-Art. III bankruptcy courts were at least as compelling as the ends found to be satisfactory in *Palmore v. United States*, 411 U.S. 389, 83 S.Ct. 1670, 36 L.Ed.2d 342 (1973), or the ends that have traditionally justified the creation of legislative courts. The stresses placed upon the old bankruptcy system by the tremendous increase in bankruptcy cases were well documented and were clearly a matter to which Congress could respond.[16] I do not believe it is possible to challenge Congress' further determination that it was necessary to create a specialized court to deal with bankruptcy matters. This was the nearly uniform conclusion of all those that testified before Congress on the question of reform of the bankruptcy system, as well as the conclusion of the Commission on Bankruptcy Laws established by Congress in 1970 to explore possible improvements in the system.[17]

The real question is not whether Congress was justified

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in establishing a specialized bankruptcy court, but rather whether it was justified in failing to create a specialized, Art. III bankruptcy court. My own view is that the very fact of extreme specialization may be enough, and certainly has been enough in the past,[18] to justify the creation of a legislative court. Congress may legitimately consider the effect on the federal judiciary of the addition of several hundred specialized judges: We are, on the whole, a body of generalists.[19] The addition of

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several hundred specialists may substantially change, whether for good or bad, the character of the federal bench. Moreover, Congress may have desired to maintain some flexibility in its possible future responses to the general problem of bankruptcy. There is no question that the existence of several hundred bankruptcy judges with life tenure would have severely limited Congress' future options. Furthermore, the number of bankruptcies may fluctuate, producing a substantially reduced need for bankruptcy judges. Congress may have thought that, in that event, a bankruptcy specialist should not as a general matter serve as a judge in the countless nonspecialized cases that come before the federal district courts. It would then face the prospect of large numbers of idle federal judges. Finally, Congress may have believed that the change from bankruptcy referees to Art. I judges was far less dramatic, and so less disruptive of the existing bankruptcy and constitutional court systems, than would be a change to Art. III judges.

For all of these reasons, I would defer to the congressional judgment. Accordingly, I dissent.

1. Pub.L. 95-598, 92 Stat. 2549, U.S.Code Cong. & Admin.News 1978, p. 5787. The Act became effective October 1, 1979.

2. Bankruptcy referees were redesignated as "judges" in 1973. Bkrtcy.Rule 901(7). For purposes of clarity, however, we refer to all judges under the old Act as "referees."

3. Although the Act initially vests this jurisdiction in district courts, 28 U.S.C. § 1471(a) (1976 ed., Supp.IV), it subsequently provides that "[t]he bankruptcy court for the district in which a case under title 11 is commenced shall exercise *all* of the jurisdiction conferred by this section on the district courts," § 1471(c) (1976 ed., Supp.IV) (emphasis added). Thus the ultimate repository of the Act's broad jurisdictional grant is the bankruptcy courts. See 1 W. Collier, Bankruptcy ¶ 3.01, pp. 3-37, 3-44 to 3-49 (15th ed. 1982).

4. With respect to both personal jurisdiction and venue, the scope of the Act is also expansive. Although the Act does not in terms indicate the extent to which bankruptcy judges may exercise personal jurisdiction, it has been construed to allow the constitutional maximum. See, *e.g., In re Whippany Paper Board Co.*, 15 B.R. 312, 314-315 (Bkrtcy. NJ 1981). With two exceptions not relevant here, the venue of "a proceeding arising in or related to a case under title 11 [is] in the bankruptcy court in which such case is pending." 28 U.S.C. § 1473(a) (1976 ed., Supp.IV). Furthermore, the Act permits parties to remove many kinds of actions to the bankruptcy court. Parties "may remove any claim or cause of action in a civil action, other than a proceeding before the United States Tax Court or a civil action by a Government unit to enforce such governmental unit's police or regulatory power." § 1478(a) (1976 ed., Supp.IV). The bankruptcy court may, however, remand such actions "on any equitable ground"; the decision to remand or retain an action is unreviewable. § 1478(b).

5. Although no particular standard of review is specified in the Act, the parties in the present cases seem to agree that the appropriate one is the clearly-erroneous standard, employed in old Bankruptcy Rule 810 for review of findings of fact made by a referee. See Brief for United States 41; Tr. of Oral Arg. 27. See also *In re Rivers*, 19 B.R. 438 (Bkrtcy. ED Tenn.1982); 1 Collier, *supra* n. 3, ¶ 3.03, p. 3-315.

6. Under the old Bankruptcy Act, referees could be removed by the district court for "incompetency, misconduct, or neglect of duty," 11 U.S.C. § 62(b) (repealed); the same grounds for removal apply during the transition period, see § 404(d), 92 Stat. 2684.

7. It appears, however, that during the transition period an appeal of a bankruptcy judge's decision may be taken to the district court even if an appellate panel of bankruptcy judges has been established.

8. After Northern docketed an appeal in this Court, the District Court supplemented its order with an opinion. 12 B.R. 946, 947 (1981).

9. Two other Bankruptcy Courts have considered the constitutionality of § 1471: The Bankruptcy Court for the District of Puerto Rico determined it to be constitutional, *In re Segarra*, 14 B.R. 870 (1981), while the Bankruptcy Court for the Eastern District of Tennessee reached the opposite conclusion, *In re Rivers, supra.*

10. These provisions serve other institutional values as well. The independence from political forces that they guarantee helps to promote public confidence in judicial determinations. See The Federalist No. 78 (A. Hamilton). The security that they provide to members of the Judicial Branch helps to attract well-qualified persons to the federal bench. *Ibid.* The guarantee of life tenure insulates the individual judge from improper influences not only by other branches but by colleagues as well, and thus promotes judicial individualism. See Kaufman, Chilling Judicial Independence, 88 Yale L.J. 681, 713 (1979). See generally Note, Article III Limits on Article I Courts: The Constitutionality of the Bankruptcy Court and the 1979 Magistrate Act, 80 Colum.L.Rev. 560, 583-585 (1980).

11. Further evidence of the Framers' concern for assuring the independence of the Judicial Branch may be found in the fact that the Constitutional Convention soundly defeated a proposal to allow the removal of judges by the Executive and Legislative Branches. See 2 M. Farrand, Records of the Federal Convention of 1787, pp. 428-429 (1911); P. Bator, P. Mishkin, D. Shapiro, & H. Wechsler, Hart and Wechsler's The Federal Courts and the Federal System 7 (2d ed. 1973). Mr. Wilson, of Pennsylvania, commented that "[t]he Judges would be in a bad situation if made to depend on every gust of faction which might prevail in the two branches of our Govt." 2 Farrand, *supra*, at 429.

12. It should be noted, however, that the House of Representatives expressed substantial doubts respecting the constitutionality of the provisions eventually included in the Act. The House Judiciary Committee and its Subcommittee on Civil and Constitutional Rights gave lengthy consideration to the constitutional issues surrounding the conferral of broad powers upon the new bankruptcy courts. The Committee, the Subcommittee, and the House as a whole initially concluded that Art. III courts were constitutionally required for bankruptcy adjudications. See H.R. 8200, 95th Cong., 1st Sess. (1977); Hearings on H.R. 31 and H.R. 32 before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94th Cong., 2d Sess., 2081-2084 (1976); *id.*, at 2682-2706; H.R.Rep.No. 95-595, p. 39 (1977), U.S.Code Cong. & Admin.News 1978, p. 5787, 6000 ("Article III is the constitutional norm, and the limited circumstances in which the courts have permitted departure from the requirements of Article III are not present in the bankruptcy context"); *id.*, at 21-38; Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, Constitutional Bankruptcy Courts, 95th Cong., 1st Sess., 33 (Comm.Print No. 3, 1977) (concluding that the proposed bankruptcy courts should be established "under Article III, with all of the protection that the Framers intended for an independent judiciary"); Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, Report on Hearings on the Court Administrative Structure for Bankruptcy Cases, 95th Cong., 2d Sess., 5 (Comm.Print No. 13, 1978) (same); see generally Klee, Legislative History of the New Bankruptcy Law, 28 De Paul L.Rev. 941, 945-949, 951 (1979). The Senate bankruptcy bill did not provide for life tenure or a guaranteed salary, instead adopting the concept of a bankruptcy court with similarly broad powers but as an "adjunct" to an Art. III court. S. 2266, 95th Cong., 2d Sess. (1978). The bill that was finally enacted, denying bankruptcy judges the tenure and compensation protections of Art. III, was the result of a series of last-minute conferences and compromises between the managers of both Houses. See Klee, *supra*, at 952-956.

13. The Act designates the bankruptcy court in each district as an "adjunct" to the district court. 28 U.S.C. § 151(a) (1976 ed., Supp.IV). Neither House of Congress concluded that the bankruptcy courts should be established as independent legislative courts. See n. 12, *supra*.

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14. At one time, this Court suggested a rigid distinction between those subjects that could be considered only in Art. III courts and those that could be considered only in legislative courts. See *Williams v. United States*, 289 U.S. 553, 53 S.Ct. 751, 77 L.Ed. 1372 (1933). But this suggested dichotomy has not withstood analysis. See C. Wright, Law of the Federal Courts 33-35 (3d ed. 1976). Our more recent cases clearly recognize that legislative courts may be granted jurisdiction over some cases and controversies to which the Art. III judicial power might also be extended. *E.g., Palmore v. United States*, 411 U.S. 389, 93 S.Ct. 1670, 36 L.Ed.2d 342 (1973). See *Glidden Co. v. Zdanok*, 370 U.S. 530, 549-551, 82 S.Ct. 1459, 1472-1473, 8 L.Ed.2d 671 (1962) (opinion of Harlan, J.).

15. Justice WHITE's dissent finds particular significance in the fact that Congress could have assigned all bankruptcy matters to the state courts. *Post*, at 116. But, of course, virtually all matters that might be heard in Art. III courts could also be left by Congress to state courts. This fact is simply irrelevant to the question before us. Congress has no control over state-court judges; accordingly the principle of separation of powers is not threatened by leaving the adjudication of federal disputes to such judges. See Krattenmaker, Article III and Judicial Independence: Why the New Bankruptcy Courts are Unconstitutional, 70 Geo.L.J. 297, 304-305 (1981). The Framers chose to leave to Congress the precise role to be played by the lower federal courts in the administration of justice. See Hart and Wechsler's The Federal Courts and the Federal System, *supra*, n. 11, at 11. But the Framers did not leave it to Congress to define the character of those courts—they were to be independent of the political branches and presided over by judges with guaranteed salary and life tenure.

16. We recently reaffirmed the principle, expressed in these early cases, that Art. I, § 8, cl. 17, provides that Congress shall have power "[t]o exercise exclusive Legislation in all Cases whatsoever, over" the District of Columbia. *Palmore v. United States*, 411 U.S., at 397, 93 S.Ct., at 1676. See also *Wallace v. Adams*, 204 U.S. 415, 423, 27 S.Ct. 363, 365, 51 L.Ed. 547 (1907) (recognizing Congress' authority to establish legislative courts to determine questions of tribal membership relevant to property claims within Indian territory); *In re Ross*, 140 U.S. 453, 11 S.Ct. 897, 35 L.Ed. 581 (1891) (same, respecting consular courts established by concession from foreign countries). See generally 1 J. Moore, J. Lucas, H. Fink, D. Weckstein, & J. Wicker, Moore's Federal Practice 46-49, 53-54 (1982). But see *Reid v. Covert*, 354 U.S. 1, 77 S.Ct. 1222, 1 L.Ed.2d 1148 (1957).

17. See also *Burns v. Wilson*, 346 U.S. 137, 139-140, 73 S.Ct. 1045, 1047, 97 L.Ed. 1508 (1953). But this Court has been alert to ensure that Congress does not exceed the constitutional bounds and bring within the jurisdiction of the military courts matters beyond that jurisdiction, and properly within the realm of "judicial power." See, *e.g., Reid v. Covert, supra*; *United States ex rel. Toth v. Quarles*, 350 U.S. 11, 76 S.Ct. 1, 100 L.Ed. 8 (1955).

18. Congress' power to create legislative courts to adjudicate public rights carries with it the lesser power to create administrative agencies for the same purpose, and to provide for review of those agency decisions in Art. III courts. See, *e.g., Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S. 442, 450, 97 S.Ct. 1261, 1266, 51 L.Ed.2d 464 (1977).

19. See *Oceanic Steam Navigation Co. v. Stranahan*, 214 U.S. 320, 339, 29 S.Ct. 671, 676, 53 L.Ed. 1013 (1909); Katz, Federal Legislative Courts, 43 Harv.L.Rev. 894, 915 (1930).

20. Doubtless it could be argued that the need for independent judicial determination is greatest in cases arising between the Government and an individual. But the rationale for the public-rights line of cases lies not in political theory, but rather in Congress' and this Court's understanding of what power was reserved to the Judiciary by the Constitution as a matter of historical fact.

21. See also *Williams v. United States*, 289 U.S. 553, 53 S.Ct. 751, 77 L.Ed. 1372 (1933) (holding

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that Court of Claims was a legislative court and that salary of a judge of that court could therefore be reduced by Congress).

[22] *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932), attempted to catalog some of the matters that fall within the public-rights doctrine:

"Familiar illustrations of administrative agencies created for the determination of such matters are found in connection with the exercise of the congressional power as to interstate and foreign commerce, taxation, immigration, the public lands, public health, the facilities of the post office, pensions and payments to veterans." *Id.*, at 51, 52 S.Ct., at 292 (footnote omitted).

[23] Congress cannot "withdraw from [Art. III] judicial cognizance *any* matter which, *from its nature*, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 284 (1856) (emphasis added). It is thus clear that the presence of the United States as a proper party to the proceeding is a necessary but not sufficient means of distinguishing "private rights" from "public rights." And it is also clear that even with respect to matters that arguably fall within the scope of the "public rights" doctrine, the presumption is in favor of Art. III courts. See *Glidden Co. v. Zdanok*, 370 U.S., at 548-549, and n. 21, 82 S.Ct., at 1471-1472, and n. 21 (opinion of Harlan, J.). See also Currie, The Federal Courts and the American Law Institute, Part 1, 36 U.Chi.L.Rev. 1, 13-14, n. 67 (1968). Moreover, when Congress assigns these matters to administrative agencies, or to legislative courts, it has generally provided, and we have suggested that it may be required to provide, for Art. III judicial review. See *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S., at 455, n. 13, 97 S.Ct., at 1269, n. 13.

[24] Of course, the public-rights doctrine does not extend to any criminal matters, although the Government is a proper party. See, *e.g., United States ex rel. Toth v. Quarles*, 350 U.S. 11, 76 S.Ct. 1, 100 L.Ed. 8 (1955).

[25] The "unifying principle" that Justice WHITE's dissent finds lacking in all of these cases, see *post*, at 105, is to be found in the exceptional constitutional grants of power to Congress with respect to certain matters. Although the dissent is correct that these grants are not explicit in the language of the Constitution, they are nonetheless firmly established in our historical understanding of the constitutional structure. When these three exceptional grants are properly constrained, they do not threaten the Framers' vision of an independent Federal Judiciary. What clearly remains subject to Art. III are all private adjudications in federal courts within the States—matters from their nature subject to "a suit at common law or in equity or admiralty"—and all criminal matters, with the narrow exception of military crimes. There is no doubt that when the Framers assigned the "judicial Power" to an independent Art. III Branch, these matters lay at what they perceived to be the protected core of that power.

Although the dissent recognizes that the Framers had something important in mind when they assigned the judicial power of the United States to Art. III courts, it concludes that our cases and subsequent practice have eroded this conception. Unable to find a satisfactory theme in our precedents for analyzing these cases, the dissent rejects all of them, as well as the historical understanding upon which they were based, in favor of an ad hoc balancing approach in which Congress can essentially determine for itself whether Art. III courts are required. See *post*, at 105-116. But even the dissent recognizes that the notion that Congress rather than the Constitution should determine whether there is a need for independent federal courts cannot be what the Framers had in mind. See *post*, at 113.

[26] This claim may be adjudicated in federal court on the basis of its relationship to the petition for reorganization. See *Williams v. Austrian*, 331 U.S. 642, 67 S.Ct. 1443, 91 L.Ed. 1718 (1947); *Schumacher v. Beeler*, 293 U.S. 367, 55 S.Ct. 230, 79 L.Ed. 433 (1934). See also *National Ins. Co. v. Tidewater Co.*, 337 U.S. 582, 611-613, 69 S.Ct. 1173, 1187-1188, 93 L.Ed. 1556 (1949) (Rutledge,

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J., concurring); *Textile Workers v. Lincoln Mills*, 353 U.S. 448, 472, 77 S.Ct. 912, 929, 1 L.Ed.2d 972 (1957) (Frankfurter, J., dissenting). Cf. *Osborn v. Bank of the United States*, 9 Wheat. 738, 6 L.Ed. 204 (1824). But this relationship does not transform the state-created right into a matter between the Government and the petitioner for reorganization. Even in the absence of the federal scheme, the plaintiff would be able to proceed against the defendant on the state-law contractual claims.

27. Nor can appellants' analysis logically be limited to Congress' Art. I powers. For example, appellants' reasoning relies in part upon analogy to our approval of territorial courts in *American Ins. Co. v. Canter*, 1 Pet. 511, 7 L.Ed. 242 (1828), and of the use of an administrative agency in *Crowell v. Benson*, 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932). Brief for United States 15; Brief for Northern Pipeline Construction Co. 10. In those cases the Court recognized the right of Congress to create territorial courts pursuant to the authority granted under Art. IV, § 3, cl. 2, and to create administrative tribunals to adjudicate rights in admiralty pursuant to the federal authority in Art. III, § 2, over admiralty jurisdiction. See *American Ins. Co. v. Canter, supra*, at 546; *Crowell v. Benson, supra*, 285 U.S., at 39, 52 S.Ct., at 287. This reliance underscores the fact that appellants offer no principled means of distinguishing between Congress' Art. I powers and any of Congress' other powers including, for example, those conferred by the various amendments to the Constitution, *e.g.*, U.S.Const., Amdts. 13-16, 19, 23, 24, 26.

28. Justice WHITE's suggested "limitations" on Congress' power to create Art. I courts are even more transparent. Justice WHITE's dissent suggests that Art. III "should be read as expressing one value that must be balanced against competing constitutional values and legislative responsibilities," and that the Court retains the final word on how the balance is

to be struck. *Post*, at 113-114. The dissent would find the Art. III "value" accommodated where appellate review by Art. III courts is provided and where the Art. I courts are "designed to deal with issues likely to be of little interest to the political branches." *Post*, at 115. But the dissent's view that appellate review is sufficient to satisfy either the command or the purpose of Art. III is incorrect. See n. 39, *infra*. And the suggestion that we should consider whether the Art. I courts are designed to deal with issues likely to be of interest to the political Branches would undermine the validity of the adjudications performed by most of the administrative agencies, on which validity the dissent so heavily relies.

In applying its ad hoc balancing approach to the facts of this case, the dissent rests on the justification that these courts differ from standard Art. III courts because of their "extreme specialization." As noted above, "extreme specialization" is hardly an accurate description of bankruptcy courts designed to adjudicate the entire range of federal and state controversies. See *infra*, at 84-85. Moreover, the special nature of bankruptcy adjudications is in no sense incompatible with performance of such functions in a tribunal afforded the protection of Art. III. As one witness pointed out to Congress:

"Relevant to that question of need, it seems worth noting that Article III itself permits much flexibility; so long as tenure during good behavior is granted, much room exists as regards other conditions. Thus it would certainly be possible to create a special bankruptcy court under Article III and there is no reason why the judges of that court would have to be paid the same salary as district judges or any other existing judges. It would also be permissible to provide that when a judge of that court retired pursuant to statute, a vacancy for a new appointment would not automatically be created. And it would be entirely valid to specify that the judges of that court could not be assigned to sit, even temporarily, on the general district courts or courts of appeals." Hearings on H.R. 31 and H.R. 32 before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94th Cong., 2d Sess., 2697 (1976) (letter of Paul Mishkin).

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29. Justice WHITE's dissent fails to distinguish between Congress' power to create adjuncts to Art. III courts, and Congress' power to create Art. I courts in limited circumstances. See *post*, at 103-104. Congress' power to create adjuncts and assign them limited adjudicatory functions is in no sense an "exception" to Art. III. Rather, such an assignment is consistent with Art. III, so long as "the essential attributes of the judicial power" are retained in the Art. III court, *Crowell v. Benson*, 285 U.S., at 51, 52 S.Ct., at 292, and so long as Congress' adjustment of the traditional manner of adjudication can be sufficiently linked to its legislative power to define substantive rights, see *infra*, at 83-84. Cf. *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S., at 450, n. 7, 97 S.Ct., at 1266, n. 7.

30. Thus in *Raddatz* there was no serious threat that the exercise of the judicial power would be subject to incursion by other branches. "[T]he only conceivable danger of a 'threat' to the 'independence' of the magistrate comes from within, rather than without the judicial department." 447 U.S., at 685, 100 S.Ct., at 2417 (BLACKMUN, J., concurring).

31. Appellants and Justice WHITE's dissent also rely on the broad powers exercised by the bankruptcy referees immediately before the Bankruptcy Act of 1978. See *post*, at 98-103. But those particular adjunct functions, which represent the culmination of years of gradual expansion of the power and authority of the bankruptcy referee, see 1 Collier, *supra* n. 3, ¶ 1.02, have never been explicitly endorsed by this Court. In *Katchen v. Landy*, 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), on which the dissent relies, there was no discussion of the Art. III issue. Moreover, when *Katchen* was decided the 1973 Bankruptcy Rules had not yet been adopted, and the district judge, after hearing the report of magistrate, was free to "modify it or . . . reject it in whole or in part or . . . receive further evidence or . . . recommit it with instructions." General Order in Bankruptcy No. 47, 305 U.S. 702 (1939).

We note, moreover, that the 1978 Act made at least three significant changes from the bankruptcy practice that immediately preceded it. First, of course, the jurisdiction of the bankruptcy courts was "substantially expanded" by the Act. H.R.Rep.No. 95-595, p. 13 (1977). Before the Act the referee had no jurisdiction, except with consent, over controversies beyond those involving property in the actual or constructive possession of the court. 11 U.S.C. § 46(b) (repealed). See *MacDonald v. Plymouth Trust Co.*, 286 U.S. 263, 266, 52 S.Ct. 505, 506, 76 L.Ed. 1093 (1932). It cannot be doubted that the new bankruptcy judges, unlike the referees, have jurisdiction far beyond that which can be even arguably characterized as merely incidental to the discharge in bankruptcy or a plan for reorganization. Second, the bankruptcy judges have broader powers than those exercised by the referees. See *infra* at 84-86;

H.R.Rep. No. 95-595, *supra*, at 12, and nn. 63-68. Finally, and perhaps most significantly, the relationship between the district court and the bankruptcy court was changed under the 1978 Act. Before the Act, bankruptcy referees were "subordinate adjuncts of the district courts." *Id.*, at 7, U.S.Code Cong. & Admin.News 1978, p. 5968. In contrast, the new bankruptcy courts are "independent of the United States district courts." *Ibid.*; 1 Collier, *supra* n. 3, ¶ 1.03, p. 1-9. Before the Act, bankruptcy referees were appointed and removable only by the district court. 11 U.S.C. § 62 (repealed). And the district court retained control over the reference by his power to withdraw the case from the referee. Bkrptcy.Rule 102. Thus even at the trial stage, the parties had access to an independent judicial officer. Although Congress could still lower the salary of referees, they were not dependent on the political Branches of Government for their appointment. To paraphrase Justice BLACKMUN's observation in *Raddatz, supra*, the primary "danger of a 'threat' to the 'independence' of the [adjunct came] from within, rather than without, the judicial department." 447 U.S., at 685, 100 S.Ct., at 2417 (concurring opinion).

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[32] Contrary to Justice WHITE's suggestion, we do not concede that "Congress may provide for initial adjudications by Art. I courts or administrative judges of all rights and duties arising under otherwise valid federal laws." See *post*, at 94. Rather we simply reaffirm the holding of *Crowell*—that Congress may assign to non-Art. III bodies some adjudicatory functions. *Crowell* itself spoke of "specialized" functions. These cases do not require us to specify further any limitations that may exist with respect to Congress' power to create adjuncts to assist in the adjudication of federal statutory rights.

[33] The Court in *Crowell* found that the requirement of *de novo* review as to certain facts was not "simply the question of due process in relation to notice and hearing," but was "rather a question of the appropriate maintenance of the Federal judicial power." 285 U.S., at 56, 52 S.Ct., at 294. The dissent agreed that some factual findings cannot be made by adjuncts, on the ground that "under certain circumstances, the constitutional requirement of due process is a requirement of [Art. III] judicial process." *Id.*, at 87, 52 S.Ct., at 306 (Brandeis, J., dissenting).

[34] *Crowell* § precise holding, with respect to the review of "jurisdictional" and "constitutional" facts that arise within ordinary administrative proceedings, has been undermined by later cases. See *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 53, 56 S.Ct. 720, 726, 80 L.Ed. 1033 (1936). See generally 4 K. Davis, Administrative Law Treatise §§ 29.08, 29.09 (1st ed. 1958). But the general principle of *Crowell*—distinguishing between congressionally created rights and constitutionally recognized rights—remains valid, as evidenced by the Court's recent approval of *Ng Fung Ho v. White*, 259 U.S. 276, 42 S.Ct. 492, 66 L.Ed. 938 (1922), on which *Crowell* relied. See *Agosto v. INS*, 436 U.S. 748, 753, 98 S.Ct. 2081, 2085, 56 L.Ed.2d 677 (1978) (*de novo* judicial determination required for claims of American citizenship in deportation proceedings). See also *United States v. Raddatz*, 447 U.S., at 682-684, 100 S.Ct., at 2415-2416; *id.*, at 707-712, 100 S.Ct., at 2426-2431 (MARSHALL, J., dissenting).

[35] Drawing the line between permissible extensions of legislative power and impermissible incursions into judicial power is a delicate undertaking, for the powers of the Judicial and Legislative Branches are often overlapping. As Justice Frankfurter noted in a similar context: "To be sure the content of the three authorities of government is not to be derived from an abstract analysis. The areas are partly interacting, not wholly disjointed." *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579, 610, 72 S.Ct. 863, 897, 96 L.Ed. 1153 (1952) (concurring opinion). The interaction between the Legislative and Judicial Branches is at its height where courts are adjudicating rights wholly of Congress' creation. Thus where Congress creates a substantive right, pursuant to one of its broad powers to make laws, Congress may have something to say about the proper manner of adjudicating that right.

[36] Of course, bankruptcy adjudications themselves, as well as the manner in which the rights of debtors and creditors are adjusted, are matters of federal law. Appellant Northern's state-law contract claim is now in federal court because of its relationship to Northern's reorganization petition. See n. 26, *supra*. But Congress has not purported to prescribe a rule of decision for the resolution of Northern's contractual claims.

[37] The limitations that the judges "may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment," 28 U.S.C. § 1481 (1976 ed., Supp.IV), are also denied to Art. III judges under certain circumstances. See 18 U.S.C. §§ 401, 402, 3691; 28 U.S.C. § 2283.

[38] Although the entry of an enforcement order is in some respects merely formal, it has long been recognized that

" '[t]he award of execution . . . is a part, and an essential part of every judgment passed by a court exercising judicial power. It is no judgment in the legal sense of the term, without it.' " *ICC v. Brimson*, 154 U.S. 447, 484, 14 S.Ct. 1125, 1136, 38 L.Ed. 1047 (1894), quoting Chief Justice

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Taney's memorandum in *Gordon v. United States*, 117 U.S. 697, 702 (1864).

39. Appellants suggest that *Crowell* and *Raddatz* stand for the proposition that Art. III is satisfied so long as some degree of appellate review is provided. But that suggestion is directly contrary to the text of our Constitution: "The Judges, *both* of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall . . . receive [undiminished] Compensation." Art. III, § 1 (emphasis added). Our precedents make it clear that the constitutional requirements for the exercise of the judicial power must be met at all stages of adjudication, and not only on appeal, where the court is restricted to considerations of law, as well as the nature of the case as it has been shaped at the trial level. The Court responded to a similar suggestion in *Crowell* by stating that to accept such a regime,

"would be to sap the judicial power as it exists under the Federal Constitution, and to establish a government of bureaucratic character alien to our system, wherever fundamental rights depend, as not infrequently they do depend, upon the facts, and finality as to facts becomes in effect finality in law." 285 U.S., at 57, 52 S.Ct., at 295.

Cf. *Ward v. Village of Monroeville*, 409 U.S. 57, 61-62, 93 S.Ct. 80, 83-84, 34 L.Ed.2d 267 (1972); *Osborn v. Bank of the United States*, 9 Wheat. 738, 883, 6 L.Ed. 204 (1824).

Justice WHITE's dissent views the function of the Third Branch as interpreting the Constitution in order to keep the other two Branches in check, and would accordingly find the purpose, if not the language, of Art. III satisfied where there is an appeal to an Art. III court. See *post*, at 115. But in the Framers' view, Art. III courts would do a great deal more than, in an abstract way, announce guidelines for the other two Branches. While "expounding" the Constitution was surely one vital function of the Art. III courts in the Framers' view, the tasks of those courts, for which independence was an important safeguard, included the mundane as well as the glamorous, matters of common law and statute as well as constitutional law, issues of fact as well as issues of law. As Hamilton noted, "it is not with a view to infractions of the Constitution only, that the independence of the judges may be an essential safeguard against the effects of occasional ill humors in the society." The Federalist No. 78, p. 488 (H. Lodge ed. 1888). In order to promote the independence and improve the quality of federal judicial decisionmaking in all of these areas, the Framers created a system of independent federal courts. See The Federalist Nos. 78-82.

40. It is clear that, at the least, the new bankruptcy judges cannot constitutionally be vested with jurisdiction to decide this state-law contract claim against Marathon. As part of a comprehensive restructuring of the bankruptcy laws, Congress has vested jurisdiction over this and all matters related to cases under Title 11 in a single non-Art. III court, and has done so pursuant to a single statutory grant of jurisdiction. In these circumstances we cannot conclude that if Congress were aware that the grant of jurisdiction could not constitutionally encompass this and similar claims, it would simply remove the jurisdiction of the bankruptcy court over these matters, leaving the jurisdictional provision and adjudicatory structure intact with respect to other types of claims, and thus subject to Art. III constitutional challenge on a claim-by-claim basis. Indeed, we note that one of the express purposes of the Act was to ensure adjudication of all claims in a single forum and to avoid the delay and expense of jurisdictional disputes. See H.R.Rep.No. 95-595, pp. 43-48 (1977); S.Rep.No. 95-989, p. 17 (1978). Nor can we assume, as THE CHIEF JUSTICE suggests, *post*, at 92, that Congress' choice would be to have these cases "routed to the United States district court of which the bankruptcy court is an adjunct." We think that it is for Congress to determine the proper manner of restructuring the Bankruptcy Act of 1978 to conform to the requirements of Art. III in the way that will best effectuate the legislative purpose.

41. See also *Buckley v. Valeo*, 424 U.S., 1, 142, 96 S.Ct. 612, 692, 46 L.Ed.2d 659 (1976); *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371, 376-377, 60 S.Ct. 317, 319-320, 84 L.Ed.

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329 (1940); *Insurance Corp. of Ireland v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 702, n. 9, 102 S.Ct. 2099, 2104, n.9, 72 L.Ed.2d 492 (1982).

1. *Glidden Co. v. Zdanok*, 370 U.S. 530, 534, 82 S.Ct. 1459, 1464, 8 L.Ed.2d 671 (1962) (plurality opinion of Harlan, J.).

2. Because this is the sole ground relied upon by the Justices concurring in the judgment, this is the effective basis for today's decision.

3. The plurality attempts to justify its sweeping invalidation of § 1471, because of its inclusion of state-law claims, by suggesting that this statutory provision is nonseverable. *Ante*, at 87-88, n. 40. The Justices concurring in the judgment specifically adopt this argument as the reason for their decision to join the judgment of the Court. The basis for the conclusion of nonseverability, however, is nothing more than a presumption: "Congress has vested jurisdiction over this and all matters related to cases under Title 11 in a single non-Art. III court, and has done so pursuant to a single statutory grant of jurisdiction. In these circumstances, we cannot conclude that if Congress were aware that the grant of jurisdiction could not constitutionally encompass this and similar claims, it would simply remove the jurisdiction of the bankruptcy court over these matters." *Ante*, at 87, n. 40. Although it is possible, as a historical matter, to find cases of this Court supporting this presumption, see, *e.g.*, *Williams v. Standard Oil Co.*, 278 U.S. 235, 242, 49 S.Ct. 115, 117, 73 L.Ed. 287 (1929), I had not thought this to be the contemporary approach to the problem of severability, particularly when dealing with federal statutes. I would follow the approach taken by the Court in *Buckley v. Valeo*, 424 U.S. 1, 108, 96 S.Ct. 612, 677, 46 L.Ed.2d 659 (1976):

" 'Unless it is evident that the Legislature would not have enacted those provisions which are within its power, independently of that which is not, the invalid part may be dropped if what is left is fully operative as a law.' " Quoting *Champlin Refining Co. v. Corporation Comm'n*, 286 U.S. 210, 234, 52 S.Ct. 559, 565, 76 L.Ed. 1062 (1932).

This presumption seems particularly strong when Congress has already "enacted those provisions which are within its power, independently of that which is not"—*i.e.*, in the old Bankruptcy Act.

4. Even this is not entirely new. Under the old Act, in certain circumstances, the referee could actually adjudicate and order the payment of a claim of the bankrupt estate against another. In *Katchen v. Landy*, 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), for example, we recognized that when a creditor files a claim, the referee is empowered to hear and decide a counterclaim against that creditor arising out of the same transaction. A similar situation could arise in adjudicating setoffs under former § 68 of the Bankruptcy Act.

5. "The judicial act of allowance or disallowance is one, of course, that is performed by the referee where the proceedings have been generally referred." 3 W. Collier, Bankruptcy ¶ 57.14, p. 229, n.3 (14th ed. 1977).

6. On this point I am in agreement with the Justices concurring in the judgment.

7. The majority does not explain why the constitutional grant of power over the Territories to Congress is sufficient to overcome the strictures of Art. III, but presumably not sufficient to overcome the strictures of the Presentment Clause or other executive limits on congressional authority.

8. Had the plurality cited only the territorial courts, the principle relied on perhaps could have been the fact that power over the Territories is provided Congress in Art. IV. However, Congress' power over the District of Columbia is an Art. I power. As such, it does not seem to have any greater status than any of the other powers enumerated in Art. I, § 8.

9. By stating that "of this necessity congress alone is the judge," 18 How., at 285, the Court added some serious ambiguity to the standard it applied. Because this statement ends the Court's analysis of the merits of the claim, it does not seem to mean that the Court will simply defer to

congressional judgment. Rather, it appears to mean that the Court will review the legislative record to determine whether there appeared to Congress to be compelling reasons for not establishing an Art. III court.

[10] The Court did not, however, entirely follow this principle, for it stated elsewhere that "there is propriety in mentioning the fact that Congress always has treated [the Court of Claims as an Art. I court]." 279 U.S., at 454, 49 S.Ct., at 414.

[11] The plurality is clearly wrong in citing *Crowell* in support of the proposition that matters involving private, as opposed to public, rights may not be considered in a non-Art. III court. *Ante*, at 70.

[12] *Crowell* also suggests that certain facts—constitutional or jurisdictional—must also be subject to *de novo* review in an Art. III court. I agree with the plurality that this aspect of *Crowell* has been "undermined by later cases," *ante*, at 82, n.34. As a matter of historical interest, however, I would contend that *Crowell's* holding with respect to these "facts" turned more on the questions of law that were inseparably tied to them, than on some notion of the inadequacy of a non-Art. III factfinder.

[13] *O'Donoghue* does not apply this principle wholly consistently: It still recognizes a territorial court exception to Art. III's requirements. It now bases this exception, however, not on any theoretical difference in principle, but simply on the "transitory character of the territorial governments." 289 U.S., at 536, 53 S.Ct., at 745.

[14] See P. Bator, P. Mishkin, D. Shapiro, & H. Wechsler, Hart and Wechsler's The Federal Courts and The Federal System 399 (2d ed. 1973) (reviewing the problems of the *Williams* case and characterizing it as an "intellectual disaster").

[15] See *Crowell v. Benson*, 285 U.S. 22, 87, 52 S.Ct. 285, 306, 76 L.Ed. 598 (1932) (Brandeis, J., dissenting) ("If there be any controversy to which the judicial power extends that may not be subjected to the conclusive determination of administrative bodies or federal legislative courts, it is not because of any prohibition against the diminution of the jurisdiction of the federal district courts as such, but because, under the circumstances, the constitutional requirement of due process is a requirement of judicial process").

[16] "During the past 30 years, the number of bankruptcy cases filed annually has increased steadily from 10,000 to over 254,000." H.R.Rep.No. 95-595, p. 21 (1977); U.S.Code Cong. & Admin.News 1978, p. 5982.

[17] See H.R.Doc.No. 93-137, pt. 1, pp. 85-96 (1973).

[18] Consider, for example, the Court of Customs Appeals involved in *Ex parte Bakelite Corp.*, 279 U.S. 438, 49 S.Ct. 411, 73 L.Ed. 789 (1929), or the variety of specialized administrative agencies that engage in some form of adjudication.

[19] In 1977, there were approximately 190 full-time and 30 part-time bankruptcy judges throughout the country. H.R.Rep.No. 95-595, at 9.

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Guam Society of CPAs
August 20, 2024
Law of Bankruptcy (including tax ramifications)

1. History and Development of Tax Treatment in Bankruptcy
2. Committee on Finance—Bankruptcy Tax Act of 1980
3. I.R.C. Sec. 108 Income from discharge of indebtedness
4. Treas. Reg. Sec. 1.108-1 Stock-for-debt exception not to apply in de minimis cases
5. Treas, Reg, Sec. 1.108-2 Acquisition of indebtedness by a person related to the debtor
6. Treas. Reg. Sec. 1.108-3 Intercompany losses and deductions
7. Treas. Reg. Sec. 1.108-4 Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code
8. Treas. Reg. Sec. 1.108-5 Time and manner for making election under Omnibus Budget Reconciliation Act of 1993
9. Treas. Reg. Sec. 1.108-6 Limitations on the exclusion of income from the discharge of qualified real property business indebtedness
10. Treas. Reg. Sec. 1.108-7 Reduction of attributes
11. Treas. Reg. Sec. 1-108-8 Indebtedness satisfied by partnership interest
12. Treas, Reg, Sec. 1-108-9 Application of the bankruptcy and the insolvency provisions of section 108 to grantor trusts and disregarded entities
13. I.R.C. Sec. 1398 Rules relating to individuals' title 11 cases
14. Treas. Reg. Sec. 1.1398-1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases
15. Treas. Reg. Sec. 1.1398-2 Treatment of section 465 losses in individuals' title 11 cases
16. Treas. Reg. Sec. 1.1398-3 Treatment of section 121 exclusion in individuals' title 11 cases
17. Bankruptcy estate of an individual as a separate taxable entity
18. Tax attribute reduction with respect to bankruptcy estates of individual debtors
19. Selecting bankruptcy estate's tax year
20. Tax rates for bankruptcy estates
21. Computation of the taxable income of the bankruptcy estate
22. Abandonment of property by bankruptcy estate
23. Introduction—Income taxation of individual debtors in bankruptcy
24. Election by individual debtor in a bankruptcy case to close tax year
25. Due date for making the election to close the debtor's tax year
26. Election by debtor's spouse to close tax year
27. Bankruptcy of debtor's spouse after debtor's election
28. Status in bankruptcy of earned income credits and child tax credits
29. Gitlitz v. Commissioner of Internal Revenue, 531 U.S. 206 (2001)—S corporation loss deductions—discharge of indebtedness income-insolvency exception—"items of income"

[File: H:\WS\LETTERS\9965-624 GUAM LAW OF BANKRUPTCY.DOCX]

30. Ball for Ball III by Appointment v. Commissioner of Internal Revenue, 742 F.3d 552 (2014; 3rd Cir.)—S corporations—electing small business trusts—shareholder liability—items of income—basis adjustments—QSub elections – unrecognized gain; gross income; liquidations
31. Clark v. Rameker, 573 U.S. 122 (2014—Inherited IRA as "retirement funds" within the meaning of bankruptcy exemption
32. Northern Pipeline Construction Co. v. Marathon Pipe Line Company, 458 U.S. 50 (1982)—A jaundiced view of bankruptcy
33. Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989)—Retrenchment extended from Article III to the 7th Amendment
34. Stern v. Marshall, 564 U.S. 462 (2011)—Marathon Consolidated
35. National Labor Relations Board v. Bildisco, 465 U.S. 465 (1984)—Bankruptcy versus Labor Law
36. Midlantic National Bank v. New Jersey Department of Environmental Protection, 474 U.S/ 494 (1986)—Bankruptcy versus Environmental Law
37. Kelly v. Robinson, 479 U.S. 36 (1986)—Bankruptcy versus Criminal Law
38. United States v. Ron Pair Enterprises—Setting Text Against Tradition
39. BFP v. Resolution Trust Corporation, 511 U.S. 531 (1994)—Bankruptcy and State Sovereignty
40. United States Association of Texas v. Timbers if Inwood Forest Associates, 484 U.S. 365 (1988)—Denial of post petition interest to unsecured creditors on their claims
41. Office of the United States Trustee v. John Q. Hammons Fall 2006, 602 U.S. ___, (2024) Meaning of Uniformity
42. Overview of Judicial Collection Law
43. Nature, Source, and Policies of Bankruptcy Law
44. The Automatic Stay
45. Property of the Estate
46. Chapter 13
47. Debtor Eligibility and the Different Forms of Bankruptcy Relief
48. Exemptions, Redemption, and Reaffirmation
49. Jurisdiction and Procedure
50. The Discharge
51. Reorganization Under Chapter 11

492 U.S. 33
109 S.Ct. 2782
106 L.Ed.2d 26
GRANFINANCIERA, S.A., et al., Petitioners

v.

Paul C. NORDBERG, Creditor Trustee for the Estate of Chase & Sanborn Corporation, etc.

No. 87-1716.

Argued Jan. 9, 1989.
Decided June 23, 1989.
Syllabus

Respondent, the bankruptcy trustee for a corporation undergoing Chapter 11 reorganization, filed suit in the District Court against petitioners, seeking to avoid allegedly fraudulent monetary transfers to them by the bankrupt corporation's predecessor and to recover damages, costs, expenses, and interest. The court referred the proceedings to the Bankruptcy Court. Shortly after the Colombian Government nationalized petitioner Granfinanciera, S.A., petitioners requested a jury trial. The Bankruptcy Judge denied the request, deeming a suit to recover a fraudulent transfer a "core action" which, under his understanding of English common law, "was a non-jury issue." The District Court affirmed the Bankruptcy Court's judgment for respondent, without discussing petitioners' jury trial request. The Court of Appeals also affirmed, ruling, *inter alia,* that the Seventh Amendment supplied no right to a jury trial, because fraudulent conveyance actions are equitable in nature, even when a plaintiff seeks only monetary relief; because bankruptcy proceedings themselves are inherently equitable in nature; and because Congress has displaced any right to a jury trial by designating, in 28 U.S.C. § 157(b)(2)(H), fraudulent conveyance actions as "core proceedings" triable by bankruptcy judges sitting without juries.

Held:

1. This Court will not address respondent's contention that the judgment below should be affirmed as to petitioner Granfinanciera because it was a commercial instrumentality of the Colombian Government when it made its request for a jury trial and was therefore not entitled to such a trial under the Seventh Amendment or applicable statutory provisions. This difficult question was neither raised below nor adequately briefed and argued here, and this is not an "exceptional case" as to which the Court will consider arguments not raised below. Moreover, petitioners' claim is uncontradicted that an affirmance on the ground respondent now urges would enlarge respondent's rights under the judgment below and decrease those of Granfinanciera. Pp. 38-40.

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2. Provided that Congress has not permissibly assigned resolution of the claim to a non-Article III adjudicative body that does not use a jury as factfinder, the Seventh Amendment entitles a person who has not submitted a claim against a bankruptcy estate to a jury trial when sued by the bankruptcy trustee to recover an allegedly fraudulent monetary transfer. Pp. 40-49.

(a) Since this Court's decisions, early English cases, and scholarly authority all demonstrate that respondent would have had to bring his action at law in 18th-century England, and that a court of equity would not have adjudicated it, it must be concluded preliminarily that the action is a "Sui[t] at common law" for which a jury trial is required by the Seventh Amendment. Pp. 43-47.

(b) More importantly, the nature of the relief respondent seeks—the recovery of money payments of ascertained and definite amounts—conclusively demonstrates that his cause of action should be characterized as legal rather than equitable, such that petit oners are prima facie entitled to a jury trial under the Amendment. *Schoenthal v. Irving Trust Co.,* 287 U.S. 92, 53 S.Ct. 50, 77 L.Ed. 185. Pp. 47-49.

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3. The Seventh Amendment entitles petitioners to their requested jury trial notwithstanding § 157(b)(2)(H)'s designation of fraudulent conveyance actions as "core proceedings" which non-Article III bankruptcy judges may adjudicate. Pp. 49-65.

(a) Although the Seventh Amendment does not prohibit Congress from assigning resolution of a statutory claim that is legal in nature to a non-Article III tribunal that does not use a jury as a factfinder so long as the claim asserts a "public right," Congress lacks the power to strip parties who are contesting matters of private right of their constitutional right to a jury trial. See, *e.g., Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 97 S.Ct. 1261, 51 L.Ed.2d 464; *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598. For these purposes, a "public right" is not limited to a matter arising between the Government and others, but extends to a seemingly "private" right that is closely intertwined with a federal regulatory program that Congress has power to enact. *Thomas v. Union Carbide Agricultural Products Co.,* 473 U.S. 568, 586, 593-594, 105 S.Ct. 3325, 3335, 3339-3340, 87 L.Ed.2d 409. Pp. 51-55.

(b) A bankruptcy trustee's right to recover a fraudulent conveyance is more accurately characterized as a private rather than a public right. Although the plurality in *Northern Pipeline Construction Co., supra,* 458 U.S., at 71, 102 S.Ct., at 2871, noted that the restructuring of debtor-creditor relations in bankruptcy may well be a "public right," it also emphasized that state-law causes of action for breach of contract are paradigmatic private rights, even when asserted by an insolvent corporation in the midst of Chapter 11 reorganization proceedings. Trustees' fraudulent conveyance actions

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are quintessentially common-law suits that more nearly resemble state-law contract claims by a bankrupt corporation to augment the bankruptcy estate than they do creditors' claims to a pro rata share of the bankruptcy res. This analysis is confirmed by *Katchen v. Landy,* 382 U.S. 323, 327-328, 86 S.Ct. 467, 471-472, 15 L.Ed.2d 391, which must be read to hold that a creditor's Seventh Amendment right to a jury trial on a bankruptcy trustee's preference claim depends upon whether the creditor submitted a claim against the estate. Since petitioners here have not filed such claims, respondent's suit is neither part of the claims adjudication process nor integral to the restructuring of debtor-creditor relations. Congress therefore cannot divest petitioners of their Seventh Amendment right merely by relabeling a pre-existing, common-law cause of action to which that right attaches and assigning it to a specialized court of equity, particularly where there is no evidence that Congress considered the constitutional implications of its designation of all fraudulent conveyance actions as core proceedings. Pp. 55-61.

(c) Permitting jury trials in fraudulent conveyance actions will not significantly impair the functioning of the legislative scheme. It cannot seriously be argued that allowing such actions in a trustee's suit against a person who has not entered a claim against the estate would "go far to dismantle the statutory scheme," as that phrase was used in *Atlas Roofing, supra,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268, n. 11, since *Atlas* plainly assumed that such claims carried with them a right to a jury trial. In addition, it cannot easily be said that a jury would be incompatible with bankruptcy proceedings, since Congress has expressly provided for jury trials in certain other actions arising out of bankruptcy litigation. The claim that juries may serve usefully as checks only on life-tenured judges' decisions overlooks the potential for juries to exercise beneficial restraint on the decisions of fixed-term judges, who may be beholden to Congress or the Executive. Moreover, although providing jury trials in some fraudulent conveyance actions might impede swift resolution of bankruptcy proceedings and increase the expense of Chapter 11 reorganizations, these considerations are insufficient to overcome the Seventh Amendment's clear command. Pp. 61-63.

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835 F.2d 1341 (CA11 1988), reversed and remanded.

BRENNAN, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and MARSHALL, STEVENS, and KENNEDY, JJ., joined, and in Parts I, II, III, and V, of which SCALIA, J., joined. SCALIA, J., filed an opinion concurring in part and concurring in the judgment, *post*, p. 65, WHITE, J., filed a dissenting opinion, *post*, p. 71. BLACKMUN, J., filed a dissenting opinion, in which O'CONNOR, J., joined, *post*, p. 91.

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Adam Lawrence, Miami, Fla., for petitioners.

Laurence Tribe, Cambridge, Mass., for respondent.

Justice BRENNAN delivered the opinion of the Court.

The question presented is whether a person who has not submitted a claim against a bankruptcy estate has a right to a jury trial when sued by the trustee in bankruptcy to recover an allegedly fraudulent monetary transfer. We hold that the Seventh Amendment entitles such a person to a trial by jury, notwithstanding Congress' designation of fraudulent conveyance actions as "core proceedings" in 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V).

I

The Chase & Sanborn Corporation filed a petition for reorganization under Chapter 11 of the Bankruptcy Code in 1983. A plan of reorganization approved by the United States Bankruptcy Court for the Southern District of Florida vested in respondent Nordberg, the trustee in bankruptcy, causes of action for fraudulent conveyances. App. to Pet. for Cert. 37. In 1985, respondent filed suit against petitioners Granfinanciera, S.A., and Medex, Ltda., in the United States District Court for the Southern District of Florida. The complaint alleged that petitioners had received $1.7 million from Chase & Sanborn's corporate predecessor within one year of the date its bankruptcy petition was filed, without receiving consideration or reasonably equivalent value in return. *Id.*, at 39-40. Respondent sought to avoid what he alleged were constructively and actually fraudulent transfers and to recover damages, costs, expenses, and interest under 11 U.S.C. §§ 548(a)(1) and (a)(2), 550(a)(1) (1982 ed. and Supp. V). App. to Pet. for Cert. 41.

The District Court referred the proceedings to the Bankruptcy Court. Over five months later, and shortly before the Colombian Government nationalized Granfinanciera, respond-

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ent served a summons on petitioners in Bogota, Colombia. In their answer to the complaint following Granfinanciera's nationalization, both petitioners requested a "trial by jury on all issues so triable." App. 7. The Bankruptcy Judge denied petitioners' request for a jury trial, deeming a suit to recover a fraudulent transfer "a core action that originally, under the English common law, as I understand it, was a non-jury issue." App. to Pet. for Cert. 34. Following a bench trial, the court dismissed with prejudice respondent's actual fraud claim but entered judgment for respondent on the constructive fraud claim in the amount of $1,500,000 against Granfinanciera and $180,000 against Medex. *Id.*, at 24-30. The District Court affirmed without discussing petitioners' claim that they were entitled to a jury trial. *Id.*, at 18-23.

The Court of Appeals for the Eleventh Circuit also affirmed. 835 F.2d 1341 (1988). The court found that petitioners lacked a statutory right to a jury trial, because the constructive fraud provision under which suit was brought—11 U.S.C. § 548(a)(2) (1982 ed., Supp. V)—contains no mention of a right to a jury trial, and 28 U.S.C. § 1411 (1982 ed., Supp. V) "affords jury trials only in personal injury or wrongful death sui s." 835 F.2d, at 1348. The Court of Appeals further ruled that the Seventh Amendment supplied no right to

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a jury trial, because actions to recover fraudulent conveyances are equitable in nature, even when a plaintiff seeks only monetary relief, *id.*, at 1348-1349, and because "bankruptcy itself is equitable in nature and thus bankruptcy proceedings are inherently equitable." *Id.*, at 1349. The court read our opinion in *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), to say that "Congress may convert a creditor's legal right into an equitable claim and displace any seventh amendment right to trial by jury," and held that Congress had done so by designating fraudulent conveyance actions "core proceedings" triable by bankruptcy judges sitting without juries. 835 F.2d, at 1349.

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We granted certiorari to decide whether petitioners were entitled to a jury trial, 486 U.S. 1054, 108 S.Ct. 2818, 100 L.Ed.2d 920 (1988), and now reverse.

II

Before considering petitioners' claim to a jury trial, we must confront a preliminary argument. Respondent contends that the judgment below should be affirmed with respect to Granfinanciera—though not Medex—because Granfinanciera was a commercial instrumentality of the Colombian Government when it made its request for a jury trial. Respondent argues that the Seventh Amendment preserves only those jury trial rights recognized in England at common law in the late 18th century, and that foreign sovereigns and their instrumentalities were immune from suit at common law. Suits against foreign sovereigns are only possible, respondent asserts, in accordance with the Foreign Sovereign Immunities Act of 1976 (FSIA), 28 U.S.C. §§ 1330, 1602-1611, and respondent reads § 1330(a) [1] to prohibit trial by jury of a case against a foreign state. Respondent concludes that Granfinanciera has no right to a jury trial, regardless of the merits of Medex's Seventh Amendment claim.

We decline to address this argument because respondent failed to raise it below and because the question it poses has not been adequately briefed and argued. Without cross-petitioning for certiorari, a prevailing party may, of course, "defend its judgment on any ground properly raised below whether or not that ground was relied upon, rejected, or even considered by the District Court or the Court of Appeals," *Washington v. Yakima Indian Nation,* 439 U.S. 463,

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476, n. 20, 99 S.Ct. 740, 749, n. 20, 58 L.Ed.2d 740 (1979), provided that an affirmance on the alternative ground would neither expand nor contract the rights of either party established by the judgment below. See, *e.g., Blum v. Bacon,* 457 U.S. 132, 137, n. 5, 102 S.Ct. 2355, 2359, n. 5, 72 L.Ed.2d 728 (1982); *United States v. New York Telephone Co.,* 434 U.S. 159, 166, n. 8, 98 S.Ct. 364, 369, n. 8, 54 L.Ed.2d 376 (1977). Respondent's present defense of the judgment, however, is not one he advanced below.[2] Although "we could consider grounds supporting [the] judgment different from those on which the Court of Appeals rested its decision," "where the ground presented here has not been raised below we exercise this authority 'only in exceptional cases.' " *Heckler v. Campbell,* 461 U.S. 458, 468-469, n. 12, 103 S.Ct. 1952, 1958, n. 12, 76 L.Ed.2d 66 (1983), quoting *McGoldrick v. Compagnie Generale Transatlantique,* 309 U.S. 430, 434, 60 S.Ct. 670, 672, 84 L.Ed. 849 (1940).

This is not such an exceptional case. Not only do we lack guidance from the District Court or the Court of Appeals on this issue, but difficult questions remain whether a jury trial is available to a foreign state upon request under 28 U.S.C. § 1330 and, if not, under what circumstances a business enterprise that has since become an arm of a foreign state may be entitled to a jury trial. Compare *Gould, Inc. v. Pechiney*

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Ugine Kuhlmann, 853 F.2d 445, 450 (CA6 1988) (jurisdiction under 28 U.S.C. § 1330 determined by party's status when act complained of

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occurred); *Morgan Guaranty Trust Co. of N.Y. v. Republic of Palau,* 639 F.Supp. 706, 712-716 (S.D.N.Y.1986) (status at time complaint was filed is decisive for § 1330 jurisdiction), with *Callejo v. Bancomer, S.A.,* 764 F.2d 1101, 1106-1107 (CA5 1985) (FSIA applies even though bank was nationalized after suit was filed); *Wolf v. Banco National de Mexico, S.A.,* 739 F.2d 1458, 1460 (CA9 1984) (same), cert. denied, 469 U.S. 1108, 105 S.Ct. 784, 83 L.Ed.2d 778 (1985). Moreover, petitioners alleged in their reply brief, without contradiction by respondent at oral argument, that affirmance on the ground that respondent now urges would "unquestionably enlarge the respondent's rights under the circuit court's decision and concomitantly decrease those of the petitioner" by "open[ing] up new areas of discovery in aid of execution" and by allowing respondent, for the first time, to recover any judgment he wins against Granfinanciera from Colombia's central banking institutions and possibly those of other Colombian governmental instrumentalities. Reply Brief for Petitioners 19. Whatever the merits of these claims, their plausibility, coupled with respondent's failure to offer rebuttal, furnishes an additional reason not to consider respondent's novel argument in support of the judgment at this late stage in the litigation. We therefore leave for another day the questions respondent's argument raises under the FSIA.

III

Petitioners rest their claim to a jury trial on the Seventh Amendment alone.[3] The Seventh Amendment provides: "In

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Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved. . . ." We have consistently interpreted the phrase "Suits at common law" to refer to "suits in which *legal* rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered." *Parsons v. Bedford,* 3 Pet. 433, 447, 7 L.Ed. 732 (1830). Although "the thrust of the

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Amendment was to preserve the right to jury trial as it existed in 1791," the Seventh Amendment also applies to actions brought to enforce statutory rights that are analogous to common-law causes of action ordinarily decided in English law courts in the late 18th century, as opposed to hose customarily heard by courts of equity or admiralty. *Curtis v. Loether,* 415 U.S. 189, 193, 94 S.Ct. 1005, 1007, 39 L.Ed.2d 260 (1974).

The form of our analysis is familiar. "First, we compare the statutory action to 18th-century actions brought in the courts of England prior to the merger of the courts of law and equity. Second, we examine the remedy sought and determine whether it is legal or equitable in nature." *Tull v. United States,* 481 U.S. 412, 417-418, 107 S.Ct. 1831, 1835, 95 L.Ed.2d 365 (1987) (citations omitted). The second stage of this analysis is more important than the first. *Id.,* at 421, 107 S.Ct., at 1837. If, on balance, these two factors indicate that a party is entitled to a jury trial under the Seventh Amendment, we must decide whether Congress may assign and has assigned resolution of the relevant claim to a non-Article III adjudicative body that does not use a jury as factfinder.[4]

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A

There is no dispute that actions to recover preferential or fraudulent transfers were often brought at law in late 18th-century England. As we noted in *Schoenthal v. Irving Trust Co.,* 287 U.S. 92, 94, 53 S.Ct. 50, 51, 77 L.Ed. 185 (1932) (footnote omitted): "In England, long prior to the enactment of our first Judiciary Act, common law actions of trover and money had and received were resorted to for the recovery of preferential payments by bankrupts." See, *e.g., Smith v. Payne,* 6 T.R. 152, 101 Eng.Rep. 484 (K.B.1795) (trover); *Barnes v. Freeland,* 6 T.R. 80, 101

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Eng.Rep. 447 (K.B.1794) (trover); *Smith v. Hodson,* 4 T.R. 211, 100 Eng.Rep. 979 (K.B.1791) (assumpsit; goods sold and delivered); *Vernon v. Hanson,* 2 T.R. 287, 100 Eng.Rep. 156 (K.B.1788) (assumpsit; money had and received); *Thompson v. Freeman,* 1 T.R. 155, 99 Eng.Rep. 1026 (K.B.1786) (trover); *Rust v. Cooper,* 2 Cowp. 629, 98 Eng.Rep. 1277 (K.B.1777) (trover); *Harman v. Fishar,* 1 Cowp. 117, 98 Eng.Rep. 998 (K.B.1774) (trover); *Martin v. Pewtress,* 4 Burr. 2477, 98 Eng.Rep. 299 (K.B.1769) (trover); *Alderson v. Temple,* 4 Burr. 2235, 98 Eng.Rep. 165 (K.B.1768) (trover). These actions, like all suits at law, were conducted before juries.

Respondent does not challenge this proposition or even contend that actions to recover fraudulent conveyances or preferential transfers were more than occasionally tried in courts of equity. He asserts only that courts of equity had concurrent jurisdiction with courts of law over fraudulent conveyance actions. Brief for Respondent 37-38. While respondent's assertion that courts of equity sometimes provided relief in fraudulent conveyance actions is true, however, it hardly suffices to undermine petitioners' submission that the present action for *monetary* relief would not have sounded in equity 200 years ago in England. In *Parsons v. Bedford, supra,* 3 Pet., at 447 (emphasis added), we contrasted suits at law with "those where equitable rights *alone* were recognized" in holding that the Seventh Amendment right to a jury

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trial applies to all but the latter actions. Respondent adduces no authority to buttress the claim that suits to recover an allegedly fraudulent transfer of money, of the sort that he has brought, were typically or indeed ever entertained by English courts of equity when the Seventh Amendment was adopted. In fact, prior decisions of this Court, see, *e.g., Buzard v. Houston,* 119 U.S. 347, 352-353, 7 S.Ct. 249, 252-253, 30 L.Ed. 451 (1886), and scholarly authority compel the contrary conclusion:

"[W]hether the trustee's suit should be at law or in equity is to be judged by the same standards that are applied to any other owner of property which is wrongfully withheld. If the subject matter is a chatte , and is still in the grantee's possession, an action in trover or replevin would be the trustee's remedy; and if the fraudulent transfer was of cash, the trustee's action would be for money had and received. Such actions at law are as available to the trustee to-day as they were in the English courts of long ago. If, on the other hand, the subject matter is land or an intangible, or the trustee needs equitable aid for an accounting or the like, he may invoke the equitable process, and that also is beyond dispute." 1 G. Glenn, Fraudulent Conveyances and Preferences § 98, pp. 183-184 (rev. ed. 1940) (footnotes omitted).

The two cases respondent discusses confirm this account of English practice. *Ex parte Scudamore,* 3 Ves.jun. 85, 30 Eng.Rep. 907 (Ch. 1796), involved the debtor's assignment of his share of a law partnership's receivables to repay a debt shortly before the debtor was declared bankrupt. Other creditors petitioned chancery for an order directing the debtor's law partner to hand over for general distribution among creditors the debtor's current and future shares of the partnership's receivables, which he held in trust for the assignee. The Chancellor refused to do so, finding the proposal inequitable. Instead, he directed the creditors to bring an action at law against the assignee if they thought themselves enti-

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tled to relief. Although this case demonstrates that fraudulent conveyance actions could be brought in equity, it does not show that suits to recover a definite sum of money would be decided by a court of equity when a petitioner did not seek distinctively equitable remedies. The creditors in *Ex parte Scudamore* asked the Chancellor to provide injunctive relief by ordering the debtor's former law partner to convey to them the debtor's share of the partnership's receivables that came into his possession in the future, along with

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receivables he then held in trust for the debtor. To the extent that they asked the court to order relinquishment of a specific preferential transfer rather than ongoing equitable relief, the Chancellor dismissed their suit and noted that the proper means of recovery would be an action at law against the transferee. Respondent's own cause of action is of precisely that sort.

Hobbs v. Hull, 1 Cox 445, 29 Eng.Rep. 1242 (Ch. 1788), also fails to advance respondent's case. The assignees in bankruptcy there sued to set aside an alleged fraudulent conveyance of real estate in trust by a husband to his wife, in return for her relinquishment of a cause of action in divorce upon discovering his adultery. The court dismissed the suit, finding that the transfer was not fraudulent, and allowed the assignees to bring an ejectment or other legal action in the law courts. The salient point is that the bankruptcy assignees sought the traditional equitable remedy of setting aside a conveyance of land in trust, rather than the recovery of money or goods, and that the court refused to decide their legal claim to ejectment once it had ruled that no equitable remedy would lie. The court's sweeping statement that "Courts of Equity have most certainly been in the habit of exercising a concurrent jurisdiction with the Courts of Law on the statutes of *Elizabeth* respecting fraudulent conveyances," *id.,* at 445-446, 30 Eng.Rep., at 1242, is not supported by reference to any cases that sought the recovery of a fixed sum of money without the need for an accounting or

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other equitable relief. Nor has respondent repaired this deficit.[5] We therefore conclude that respondent would have had to bring his action to recover an alleged fraudulent con-

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veyance of a determinate sum of money at law in 18th-century England, and that a court of equity would not have adjudicated it.[6]

B

The nature of the relief respondent seeks strongly supports our preliminary finding that the right he invokes should be denominated legal rather than equitable. Our decisions establish beyond peradventure that "[i]n cases of fraud or mistake, as under any other head of chancery jurisdiction, a court of the United States will not sustain a bill in equity to obtain only a decree for the payment of money by way of

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damages, when the like amount can be recovered at law in an action sounding in tort or for money had and received." *Buzard v. Houston,* 119 U.S., at 352, 7 S.Ct., at 252, citing *Parkersburg v. Brown,* 106 U.S. 487, 500, 1 S.Ct. 442, 452, 27 L.Ed. 238 (1883); *Ambler v. Choteau,* 107 U.S. 586, 1 S.Ct. 556, 27 L.Ed. 322 (1883); *Litchfield v. Ballou,* 114 U.S. 190, 5 S.Ct. 820, 29 L.Ed. 132 (1885). See also *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 454, n. 11, 97 S.Ct. 1261, 1268, n. 11, 51 L.Ed.2d 464 (1977) ("the otherwise legal issues of voidable preferences"); *Pernell v. Southall Realty,* 416 U.S. 363, 370, 94 S.Ct. 1723, 1727, 40 L.Ed.2d 198 (1974) (" '[W]here an action is simply for the recovery . . . of a money judgment, the action is one at law' "), quoting *Whitehead v. Shattuck,* 138 U.S. 146, 151, 11 S.Ct. 276, 277, 34 L.Ed. 873 (1891); *Dairy Queen, Inc. v. Wood,* 369 U.S. 469, 476, 82 S.Ct. 894, 899, 8 L.Ed.2d 44 (1962) ("Petitioner's contention . . . is that insofar as the complaint requests a money judgment it presents a claim which is unquestionably legal. We agree with that contention"); *Gaines v. Miller,* 111 U.S. 395, 397-398, 4 S.Ct. 426, 427, 28 L.Ed. 466 (1884) ("Whenever one person has in his hands money equitably belonging to another, that other person may recover it by assumpsit for money had and received. The remedy at law is adequate and complete") (citations omitted).

Indeed, in our view *Schoenthal v. Irving Trust Co.,* 287 U.S. 92, 53 S.Ct. 50, 77 L.Ed. 185 (1932), removes all doubt that respondent's cause of action should be characterized as legal rather than as equitable. In *Schoenthal,* the trustee in bankruptcy sued in equity to recover alleged

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preferential payments, claiming that he had no adequate remedy at law. As in this case, the recipients of the payments apparently did not file claims against the bankruptcy estate. The Court held that the suit had to proceed at law instead, because the long-settled rule that suits in equity will not be sustained where a complete remedy exists at law, then codified at 28 U.S.C. § 384, "serves to guard the right of trial by jury preserved by the Seventh Amendment and to that end it should be liberally construed." 287 U.S., at 94, 53 S.Ct., at 51. The Court found that the trustee's suit indistinguishable from respondent's suit in all relevant respects could not go forward in equity because an adequate remedy

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was available at law. There, as here, "[t]he preferences sued for were money payments of ascertained and definite amounts," and "[t]he bill discloses no facts that call for an accounting or other equitable relief." *Id.*, at 95, 53 S.Ct., at 51. Respondent's fraudulent conveyance action plainly seeks relief traditionally provided by law courts or on the law side of courts having both legal and equitable dockets.[7] Unless Congress may and has permissibly withdrawn juri diction over that action by courts of law and assigned it exclusively to non-Article III tribunals sitting without juries, the Seventh Amendment guarantees petitioners a jury trial upon request.

IV

Prior to passage of the Bankruptcy Reform Act of 1978, Pub.L. 95-598, 92 Stat. 2549 (1978 Act), "[s]uits to recover preferences constitute[d] no part of the proceedings in bank-

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ruptcy." *Schoenthal v. Irving Trust Co., supra*, at 94-95, 53 S.Ct., at 51. Although related to bankruptcy proceedings, fraudulent conveyance and preference actions brought by a trustee in bankruptcy were deemed separate, plenary suits to which the Seventh Amendment applied. While the 1978 Act brought those actions within the jurisdiction of the bankruptcy courts, it preserved parties' rights to trial by jury as they existed prior to the effective date of the 1978 Act. 28 U.S.C. § 1480(a) (repealed). The 1984 Amendments, however, designated fraudulent conveyance actions "core proceedings," 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V), which bankruptcy judges may adjudicate and in which they may issue final judgments, § 157(b)(1), if a district court has referred the matter to them, § 157(a). We are not obliged to decide today whether bankruptcy courts may conduct jury trials in fraudulent conveyance suits brought by a trustee against a person who has not entered a claim against the estate, either in the rare procedural posture of this case, see *supra*, at 41, n. 3, or under the current statutory scheme, see 28 U.S.C. § 1411 (1982 ed., Supp. V). Nor need we decide whether, if Congress has authorized bankruptcy courts to hold jury trials in such actions, that authorization comports with Article III when non-Article III judges preside over the actions subject to review in, or withdrawal by, the district courts. We also need not consider whether jury trials conducted by a bankruptcy court would satisfy the Seventh Amendment's command that "no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law," given that district courts may presently set aside clearly erroneous factual findings by bankruptcy courts. Bkrtcy. Rule 8013. The sole issue before us is whether the Seventh Ame dment confers on petitioners a right to a jury trial in the face of Congress' decision to allow a non-Article III tribunal to adjudicate the claims against them.

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A

In *Atlas Roofing*, we noted that "when Congress creates new statutory 'public rights,' it may assign their adjudication to an administrative agency with which a jury trial would be incompatible, without violating the Seventh Amendment's injunction that jury trial is to be 'preserved' in 'suits at common law.' " 430 U.S., at 455, 97 S.Ct., at 1269 (footnote omitted).

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We emphasized, however, that Congress' power to block application of the Seventh Amendment to a cause of action has limits. Congress may only deny trials by jury in actions at law, we said, in cases where "public rights" are litigated: "Our prior cases support administrative factfinding in only those situations involving 'public rights,' *e.g.*, where the Government is involved in its sovereign capacity under an otherwise valid statute creating enforceable public rights. Wholly private tort, contract, and property cases, as well as a vast range of other cases, are not at all implicated." *Id.*, at 458, 97 S.Ct., at 1270.[8]

We adhere to that general teaching. As we said in *Atlas Roofing:* " 'On the common law side of the federal courts, the aid of juries is not only deemed appropriate but is required by the Constitution itself.' " *Id.*, 430 U.S., at 450, n. 7, 97 S.Ct., at 1266, n. 7, quoting *Crowell v. Benson*, 285 U.S. 22, 51, 52 S.Ct. 285, 292, 76 L.Ed. 598 (1932). Congress may devise novel causes of action involving public rights free from the strictures of the Seventh Amendment if it assigns their adjudication to tribunals without statutory authority to employ juries as factfinders.[9] But it lacks the power to strip parties

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contesting matters of private right of their constitutional right to a trial by jury. As we recognized in *Atlas Roofing*, to hold otherwise would be to permit Congress to eviscerate the Seventh Amendment's guarantee by assigning to administrative agencies or courts of equity all causes of action not grounded in state law, whether they originate in a newly fashioned regulatory scheme or possess a long line of common-law forebears. 430 U.S., at 457-458, 97 S.Ct., at 1270-1271. The Constitution nowhere grants Congress such puissant authority. "[L]egal claims are not magically converted into equitable issues by their presentation to a court of equity," *Ross v. Bernhard*, 396 U.S. 531, 538, 90 S.Ct. 733, 738, 24 L.Ed.2d 729 (1970), nor can Congress conjure away the Seventh Amendment by mandating that traditional legal claims be brought there or taken to an administrative tribunal.

In certain situations, of course, Congress may fashion causes of action that are closely *analogous* to common-law claims and place them beyond the ambit of the Seventh Amendment by assigning their resolution to a forum in which jury trials are unavailable. See, *e.g.*, *Atlas Roofing, supra*, 430 U.S., at 450-461, 97 S.Ct., at 1266-1272 (workplace safety regulations); *Block v. Hirsh*, 256 U.S. 135, 158, 41 S.Ct. 458, 460, 65 L.Ed. 865 (1921) (temporary emergency regulation of rental real estate). See also *Pernell v. Southall Realty*, 416 U.S., at 382-383, 94 S.Ct., at 1733 (discussing cases); *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 284, 15 L.Ed. 372 (1856) (Congress "may or may not bring within the cognizance of the courts of the United States, as it may deem proper," matters involving public rights). Congress' power to do so is limited, however, just as its power to place adjudicative authority in non-Article III tribunals is circumscribed. See *Thomas v.*

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Union Carbide Agricultural Products Co., 473 U.S. 568, 589, 593-594, 105 S.Ct. 3325, 3337, 3339-3340, 87 L.Ed.2d 409 (1985); *id.*, at 598-600, 105 S.Ct., at 3342-3343 (BRENNAN, J., concurring in judgment); *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 73-76, 102 S.Ct. 2858, 2872-2874, 73 L.Ed.2d 598 (1982) (opinion of BRENNAN, J.); *id.*, at 91, 102 S.Ct., at 2881 (REHNQUIST, J., concurring in judgment). Unless a legal cause of action involves "public rights," Congress may not deprive parties litigating over such a right of the Seventh Amendment's guarantee to a jury trial.

In *Atlas Roofing, supra*, 430 U.S., at 458, 97 S.Ct., at 1270, we noted that Congress may effectively supplant a common-law cause of action carrying with it a right to a jury trial with a statutory cause of action shorn of a jury trial right if that statutory cause of action inheres in, or lies against, the Federal Government in its sovereign capacity. Our case law makes plain, however, that

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the class of "public rights" whose adjudication Congress may assign to administrative agencies or courts of equity sitting without juries is more expansive than *Atlas Roofing* 's discussion suggests. Indeed, our decisions point to the conclusion that, if a statutory cause of action is legal in nature, the question whether the Seventh Amendment permits Congress to assign its adjudication to a tribunal that does not employ juries as factfinders requires the same answer as the question whether Article III allows Congress to assign adjudication of that cause of action to a non-Article III tribunal. For if a statutory cause of action, such as respondent's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2), is not a "public right" for Article III purposes, then Congress may not assign its adjudication to a specialized non-Article III court lacking "the essential attributes of the judicial power." *Crowell v. Benson, supra,* 285 U.S., at 51, 52 S.Ct., at 292. And if the action must be tried under the auspices of an Article III court, then the Seventh Amendment affords the parties a right to a jury trial whenever the cause of action is legal in nature. Conversely, if Congress may assign the adjudication of a statutory cause of action to a non-Article III tribunal, then the

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Seventh Amendment poses no independent bar to the adjudication of that action by a nonjury factfinder. See, *e.g., Atlas Roofing, supra,* 430 U.S., at 453-455, 460, 97 S.Ct., at 1268-1269, 1271; *Pernell v. Southall Realty, supra,* 416 U.S., at 383, 94 S.Ct., at 1733; *Block v. Hirsh, supra,* 256 U.S., at 158, 41 S.Ct., at 460. In addition to our Seventh Amendment precedents, we therefore rely on our decisions exploring the restrictions Article III places on Congress' choice of adjudicative bodies to resolve disputes over statutory rights to determine whether petitioners are entitled to a jury trial.

In our most recent discussion of the "public rights" doctrine as it bears on Congress' power to commit adjudication of a statutory cause of action to a non-Article III tribunal, we rejected the view that "a matter of public rights must at a minimum arise 'between the government and others.' " *Northern Pipeline Construction Co., supra,* 458 U.S., at 69, 102 S.Ct., at 2870 (opinion of BRENNAN, J.), quoting *Ex parte Bakelite Corp.,* 279 U.S. 438, 451, 49 S.Ct. 411, 413, 73 L.Ed. 789 (1929). We held, instead, that the Federal Government need not be a party for a case to revolve around "public rights." *Thomas v. Union Carbide Agricultural Products Co.,* 473 U.S., at 586, 105 S.Ct., at 3335; *id.,* at 596-599, 105 S.Ct., at 3341-3343 (BRENNAN, J., concurring in judgment). The crucial question, in cases not involving the Federal Government, is whether "Congress, acting for a valid legislative purpose pursuant to its constitutional powers under Article I, [has] create[d] a seemingly 'private' right that is so closely integrated into a public regulatory scheme as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary." *Id.,* at 593-594, 105 S.Ct., at 3339-3340. See *id.,* at 600, 105 S.Ct., at 3343 (BRENNAN, J., concurring in judgment) (challenged provision involves public rights because "the dispute arises in the context of a federal regulatory scheme that virtually occupies the field"). If a statutory right is not closely intertwined with a federal regulatory program Congress has power to enact, and if that right neither belongs to nor exists against the Federal Government,

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then it must be adjudicated by an Article III court.[10] If the right is legal in nature, then it carries with it the Seventh Amendment's guarantee of a jury trial.

B

Although the issue admits of some debate, a bankruptcy trustee's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2) seems to us more accurately characterized as a private rather than a public right as we have used these terms in our Article III decisions. In *Northern Pipeline Construction Co.,* 458 U.S., at 71, 102 S.Ct., at 2871, the plurality noted

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that the restructuring of debtor-creditor relations in bankruptcy "may well be a 'public right.' " [11] But the plurality also emphasized that state-law causes of action for breach of contract or warranty are paradigmatic private rights, even when asserted by an insolvent corporation in the midst of Chapter 11 reorganization proceedings. The plurality further said that "matters from their nature subject to 'a suit at common law or in equity or admiralty' " lie at the "protected core" of Article III judicial power, *id.*, at 71, n. 25, 102 S.Ct., at 2871, n. 25; see *id.*, at 90, 102 S.Ct., at 2881 (REHNQUIST, J., concurring in judgment)—a point we reaffirmed in *Thomas, supra,* 473 U.S., at 587, 105 S.Ct., at 3336. There can be little doubt that fraudulent conveyance actions by bankruptcy trustees—suits which, we said in *Schoenthal v. Irving Trust Co.*, 287 U.S., at 94-95, 53 S.Ct., at 51 (citation omitted), "constitute no part of the proceedings in bankruptcy but concern controversies arising out of it"—are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res. See Gibson 1022-1025. They therefore appear matters of private rather than public right.[12]

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Our decision in *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), under the Seventh Amendment rather than Article III, confirms this analysis. Petitioner, an officer of a bankrupt corporation, made payments from corporate funds within four months of bankruptcy on corporate notes on which he was an accommodation maker. When petitioner later filed claims against the bankruptcy estate, the trustee counterclaimed, arguing that the payments petitioner made constituted voidable preferences because they reduced his potential personal liability on the notes. We held that the bankruptcy court had jurisdiction to order petitioner to surrender the preferences and that it could rule on the trustee's claim without according petitioner a jury trial. Our holding did not depend, however, on the fact that "[bankruptcy] courts are essentially courts of equity" because "they characteristically proceed in summary fashion to deal with the assets of the bankrupt they are administering." *Id.*, at 327, 86 S.Ct., at 471. Notwithstanding the fact that bankruptcy courts "characteristically" supervised summary proceedings, they were statutorily invested with jurisdiction at law as well, and could also oversee plenary proceedings. See *Atlas Roofing,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268, n. 11 (*Katchen* rested "on the ground that a bankruptcy court, *exercising its summary jurisdi tion,* was a specialized court of equity") (emphasis added); *Pepper v. Litton,* 308 U.S. 295, 304, 60 S.Ct. 238, 244, 84 L.Ed. 281 (1939) ("*[F]or many purposes* 'courts of bankruptcy are essentially courts of equity' ") (emphasis added). Our decision turned, rather, on the bankruptcy court's having "actual or constructive possession" of the bankruptcy estate, 382 U.S., at 327, 86 S.Ct., at 471, and its power and obligation to consider objections by the trustee in deciding whether to allow claims against the estate. *Id.*, at 329-331, 86 S.Ct., at 472-474. Citing *Schoenthal v. Irving Trust Co., supra,* approvingly, we expressly stated that, if petitioner had not submitted a claim to the bankruptcy court, the trustee could have recovered the preference only by a plenary action, and that petitioner would have

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been entitled to a jury trial if the trustee had brought a plenary action in federal court. See 382 U.S., at 327-328, 86 S.Ct., at 471-472. We could not have made plainer that our holding in *Schoenthal* retained its vitality: "[A]lthough petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee, *Schoenthal v. Irving Trust Co.*, 287 U.S. 92, 53 S.Ct. 50, when the same issue arises as part of the process of allowance and disallowance of claims, it is triable in equity." *Id.*, at 336, 86 S.Ct., at 476.[13]

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Unlike Justice WHITE, see *post,* at 72-75, 78, we do not view the Court's conclusion in *Katchen* as resting on an accident of statutory history. We read *Schoenthal* and *Katchen* as holding that, under the Seventh Amendment, a creditor's right to a jury trial on a bankruptcy trustee's preference claim depends upon whether the creditor has submitted a claim against the estate, not upon Congress' precise definition of the "bankruptcy estate" or upon whether Congress chanced to deny jury trials to creditors who have not filed claims and who are sued by a trustee to recover an alleged preference. Because petitioners here, like the petitioner in *Schoenthal,* have not filed claims against the estate, respondent's fraudulent conveyance action does not arise "as part of the process of allowance and disallowance of claims." Nor is that action integral to the restructuring of debtor-creditor relations. Congress therefore cannot divest petitioners of

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their Seventh Amendment right to a trial by jury. *Katchen* thus supports the result we reach today; it certainly does not compel its opposite.[14]

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The 1978 Act abolished the statutory distinction between plenary and summary bankruptcy proceedings, on which the Court relied in *Schoenthal* and *Katchen.* Although the 1978 Act preserved parties' rights to jury trials as they existed prior to the day it took effect, 28 U.S.C. § 1480(a) (repealed), in the 1984 Amendments Congress drew a new distinction between "core" and "non-core" proceedings and classified fraudulent conveyance actions as core proceedings triable by bankruptcy judges. 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V). Whether 28 U.S.C. § 1411 (1982 ed., Supp. V) purports to abolish jury trial rights in what were formerly plenary actions is unclear, and at any rate is not a question we need decide here. See *supra,* at 40-41, n. 3. The decisive point is that in neither the 1978 Act nor the 1984 Amendments did Congress "creat[e] a new cause of action, and remedies therefor, unknown to the common law," because traditional rights and remedies were inadequate to cope with a manifest public problem. *Atlas Roofing,* 430 U.S., at 461, 97 S.Ct., at 1272. Rather, Congress simply reclassified a pre-existing, common-law cause of action that was not integrally related to the reformation of debtor-creditor relations [15] and

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that apparently did not suffer from any grave deficiencies. This purely taxonomic change cannot alter our Seventh Amendment analysis. Congress cannot eliminate a party's Seventh Amendment right to a jury trial merely by relabeling the cause of action to which it attaches and placing exclusive jurisdiction in an administrative agency or a specialized court of equity. See Gibson 1022-1025.

Nor can Congress' assignment be justified on the ground that jury trials of fraudulent conveyance actions would "go far to dismantle the statutory scheme," *Atlas Roofing,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268, n. 11, or that bankruptcy proceedings have been placed in "an administrative forum with which the jury would be incompatible." *Id.,* at 450, 97 S.Ct., at 1266. To be sure, we owe some deference to Congress' judgment after it has given careful consideration to the constitutionality of a legislative provision. See *Northern Pipeline Construction Co.,* 458 U.S., at 61, 102 S.Ct., at 2866 (opinion of BRENNAN, J.). But respondent has adduced no evidence that Congress considered the constitutional implications of its designation of all fraudulent conveyance actions as core proceedings. Nor can it seriously be argued that permitting jury trials in fraudulent conveyance actions brought by a trustee against a person who has not entered a claim against the estate would "go far to dismantle the statutory scheme," as we used that phrase in *Atlas Roofing,* when our opinion in that case, following *Schoenthal,* plainly assumed that such claims carried with them a right to a jury trial.[16] In addition, one cannot easily say that "the

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jury would be incompatible" with bankruptcy proceedings, in view of Congress' express provision for jury trials in certain actions arising out of bankruptcy litigation. See 28 U.S.C. § 1411 (1982 ed., Supp. V); Gibson 1024-1025; Warner, *Katchen* Up in Bankruptcy: The New Jury Trial Right, 63 Am.Bankr.L.J. 1, 48 (1989) (hereinafter Warner). And Justice WHITE's claim that juries may serve usefully as checks only on the decisions of judges who enjoy life tenure, see

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post, at 82-83, overlooks the extent to which judges who are appointed for fixed terms may be beholden to Congress or Executive officials, and thus ignores the potential for juries to exercise beneficial restraint on their decisions.

It may be that providing jury trials in some fraudulent conveyance actions—if not in this particular case, because respondent's suit was commenced after the Bankruptcy Court approved the debtor's plan of reorganization—would impede swift resolution of bankruptcy proceedings and increase the expense of Chapter 11 reorganizations.[17] But "these considerations are insufficient to overcome the clear command of the Seventh Amendment." *Curtis v. Loether,* 415 U.S., at 198, 94 S.Ct., at 1010. See also *Bowsher v. Synar,* 478 U.S. 714, 736, 106 S.Ct. 3181, 3193, 92 L.Ed.2d 583 (1986) (" '[T]he fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution' "), quoting *INS v. Chadha,* 462 U.S. 919, 944, 103 S.Ct. 2764, 2780, 77 L.Ed.2d 317 (1983); *Pernell v. Southall Realty,* 416 U.S., at 383-384, 94 S.Ct., at 1733-1734 (discounting arguments that jury trials would be unduly burdensome and rejecting "the notion that there is some necessary

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inconsistency between the desire for speedy justice and the right to jury trial").[18]

V

We do not decide today whether the current jury trial provision—28 U.S.C. § 1411 (1982 ed., Supp. V)—permits bankruptcy courts to conduct jury trials in fraudulent conveyance actions like the one respondent initiated. Nor do we express any view as to whether the Seventh Amendment or Article III allows jury trials in such actions to be held before non-Article III bankruptcy judges subject to the oversight provided by the district courts pursuant to the 1984 Amendments. We leave those issues for future decisions.[19] We do hold, however, that whatever the answers to these questions, the Seventh Amendment entitles petitioners to the jury trial they requested. Accordingly, the judgment of

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the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Justice SCALIA, concurring in part and concurring in the judgment.

I join all but Part IV of the Court's opinion. I make that exception because I do not agree with the premise of its discussion: that "the Federal Government need not be a party for a case to revolve around 'public rights.' " *Ante,* at 54, quoting *Thomas v. Union Carbide Agricultural Products Co.,* 473 U.S. 568, 586, 105 S.Ct. 3325, 3335, 87 L.Ed.2d 409 (1985). In my view a matter of "public rights," whose adjudication Congress may assign to tribunals lacking the essential characteristics of Article III courts, "must at a minimum arise 'between the government and others.' " *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 69, 102 S.Ct. 2858, 2870, 73 L.Ed.2d 598 (1982) (plurality opinion), quoting *Ex parte Bakelite Corp.,* 279 U.S. 438, 451, 49 S.Ct. 411, 413, 73 L.Ed. 789 (1929). Until quite recently this has also been the consistent vi w of the Court. See 458 U.S., at 69, n. 23, 102 S.Ct., at 2870 ("[T]he presence of the United States as a proper party . . . is a necessary but not sufficient means of

distinguishing 'private rights' from 'public rights' "); *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 450, 97 S.Ct. 1261, 1266, 51 L.Ed.2d 464 (1977) (public rights cases are "cases in which the Government sues in its sovereign capacity to enforce public rights created by statutes"); *id.,* at 457, 97 S.Ct., at 1270 (noting "distinction between cases of private right and those which arise between the Government and persons subject to its authority"); *id.,* at 458, 97 S.Ct., at 1270 (situations involving "public rights" are those "where the Government is involved in its sovereign capacity under an otherwise valid statute creating enforceable public rights"); *Crowell v. Benson,* 285 U.S. 22, 50-51, 52 S.Ct. 285, 292, 76 L.Ed. 598 (1932) (public rights are "those which arise between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative depart-

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ments"); *Ex parte Bakelite Corp., supra,* at 451, 49 S.Ct., at 413 (public rights are those "arising between the government and others, which from their nature do not require judicial determination and yet are susceptible of it"); *Murray's Lessee v. Hoboken Land & Improvement Co.,* 18 How. 272, 283, 15 L.Ed. 372 (1856) (plaintiff's argument that a controversy susceptible of judicial determination must be a "judicial controversy" heard in an Article III court "leaves out of view the fact that the United States is a party").

The notion that the power to adjudicate a legal controversy between two private parties may be assigned to a non-Article III, yet federal, tribunal is entirely inconsistent with the origins of the public rights doctrine. The language of Article III itself, of course, admits of no exceptions; it directs unambiguously that the "judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." In *Murray's Lessee, supra,* however, we recognized a category of "public rights" whose adjudication, though a judicial act, Congress may assign to tribunals lacking the essential characteristics of Article III courts. That case involved the Act of May 15, 1820, 3 Stat. 592, which established a summary procedure for obtaining from collectors of federal revenue funds that they owed to the Treasury. Under that procedure, after a federal auditor made the determination that the funds were due, a "distress warrant" would be issued by the Solicitor of the Treasury, authorizing a United States marshal to seize and sell the personal property of the collector, and to convey his real property, in satisfaction of the debt. The United States' lien upon the real property would be effective upon the marshal's filing of the distress warrant in the district court of the district where the property was located. The debtor could, however, bring a challenge to the distress warrant in any United States district court, in which judicial challenge "every fact upon which the legality of the extra-judicial remedy depends may be drawn in[to] ques-

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tion," 18 How., at 284. *Murray's Lessee* involved a dispute over title to lands that had been owned by a former collector of customs whom the Treasury auditor had adjudged to be deficient in his remittances. The defendant had purchased the land in the marshal's sale pursuant to a duly issued distress warrant (which had apparently not been contested by the collector in any district court proceeding). The plaintiff, who had acquired the same land pursuant to the execution of a judgment against the collector, which execution occurred *before* the marshal's sale, but *after* the marshal's filing of the distress warrant to establish the lien, brought an action for ejectment to try tit e. He argued, *inter alia,* that the process by which the defendant had obtained title violated Article III because adjudication of the collector's indebtedness to the United States was inherently a judicial act, and could not lawfully have been performed by a Treasury auditor, but only by an Article III court. We rejected this contention by observing that although "the auditing of the accounts of a receiver of public moneys may be, in an enlarged sense, a judicial act," *id.,* at 280, the English and American traditions established that

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it did not, without consent of Congress, give rise to a judicial "controversy" within the meaning of Article III.

It was in the course of answering the plaintiff's rejoinder to this holding that we uttered the words giving birth to the public rights doctrine. The plaintiff argued that if we were correct that the matter was "not in its nature a judicial controversy, congress could not make it such, nor give jurisdiction over it to the district courts" in the bills permitted to be filed by collectors challenging distress warrants so that "the fact that congress has enabled the district court to pass upon it, is conclusive evidence that it is a judicial controversy." *Id.*, at 282. That argument, we said, "leaves out of view the fact that the United States is a party." *Id.*, at 283. Unlike a private party who acts extrajudicially to recapture his property, the marshal who executes a distress warrant "can-

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not be made responsible in a judicial tribunal for obeying the lawful command of the government; and the government itself, which gave the command, cannot be sued without its own consent," even though the issue in question is an appropriate matter for a judicial controversy. *Ibid.* Congress could, however, waive this immunity, so as to permit challenges to the factual bases of officers' actions in Article III courts; and this waiver did not have to place the proceeding in the courts unconditionally or *ab initio,* for the "United States may consent to be sued, and may yield this consent upon such terms and under such restrictions as it may think just." *Ibid.* Thus, we summed up, in the oft-quoted passage establishing the doctrine at issue here:

[T]here are matters, *involving public rights*, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination, but which Congress may or may not bring within the cognizance of the courts of the United States, as it may deem proper." *Id.*, at 284 (emphasis added).

It is clear that what we meant by public rights were not rights important to the public, or rights created by the public, but rights *of the public*—that is, rights pertaining to claims brought by or against the United States. For central to our reasoning was the device of waiver of sovereign immunity, as a means of converting a subject which, though its resolution involved a "judicial act," could not be brought before the courts, into the stuff of an Article III "judicial controversy." Waiver of sovereign immunity can only be implicated, of course, in suits where the Government is a party. We understood this from the time the doctrine of public rights was born, in 1856, until two Terms ago, saying as recently as 1982 that the suits to which it applies "must at a minimum arise 'between the government and others,' " *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S., at 69, 102 S.Ct., at 2870, quoting *Ex parte Bakelite Corp.,* 279

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U.S., at 451, 49 S.Ct., at 413. See also, in addition to the cases cited *supra,* at 65-66, *Williams v. United States,* 289 U.S. 553, 581, 53 S.Ct. 751, 760, 77 L.Ed. 1372 (1933) (noting sovereign immunity origins of legislative courts); *Ex parte Bakelite, supra,* 279 U.S., at 453-454, 49 S.Ct., at 414 (same). Cf. *McElrath v. United States,* 102 U.S. 426, 440, 26 L.Ed. 189 (1880).

In *Thomas v. Union Carbide Agricultura Products Co.,* 473 U.S. 568, 105 S.Ct. 3325, 87 L.Ed.2d 409 (1985), however, we decided to interpret the phrase "public rights" as though it had not been developed in the context just discussed and did not bear the meaning just described. We pronounced, as far as I can tell by sheer force of our office, that it applies to a right "so closely *integrated into a public regulatory scheme* as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary." *Id.*, at 593-594, 105 S.Ct., at 3339 (emphasis added). The doctrine reflects, we announced, "simply a pragmatic understanding that when Congress selects a quasi-judicial method of resolving matters that 'could be

conclusively determined by the Executive and Legislative Branches,' the danger of encroaching on the judicial powers is reduced," *id.*, at 589, 105 S.Ct., at 3337, quoting *Northern Pipeline, supra,* 458 U.S., at 68, 102 S.Ct., at 2869—without pointing out, as had *Murray's Lessee,* that the only adjudications of private rights that "could be conclusively determined by the Executive and Legislative Branches" were a select category of private rights vis-a-vis the Government itself. We thus held in *Thomas,* for the first time, that a purely private federally created action did not require Article III courts.

There was in my view no constitutional basis for that decision. It did not purport to be faithful to the origins of the public rights doctrine in *Murray's Lessee;* nor did it replace the careful analysis of that case with some other reasoning that identifies a discrete category of "judicial acts" which, at the time the Constitution was adopted, were not thought to implicate a "judicial controversy." The lines sought to be established by the Constitution did not matter. "Pragmatic understanding" was all that counted—in a case-by-case evaluation of whether the danger of "encroaching" on the "judi-

cial powers" (a phrase now drained of constant content) is too much. The Term after *Thomas,* in *Commodity Futures Trading Comm'n v. Schor,* 478 U.S. 833, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986), we reconfirmed our error, embracing the analysis of *Thomas* and describing at greater length the new Article III standard it established, which seems to me no standard at all:

"[I]n reviewing Article III challenges, we have weighed a number of factors, none of which has been deemed determinative, with an eye to the practical effect that the congressional action will have on the constitutionally assigned role of the federal judiciary. . . . Among the factors upon which we have focused are the extent to which the 'essential attributes of judicial power' are reserved to Article III courts, and, conversely, the extent to which the non-Article III forum exercises the range of jurisdiction and powers normally vested only in Article III courts, the origins and importance of the right to be adjudicated, and the concerns that drove Congress to depart from the requirements of Article III." 478 U.S., at 851, 106 S.Ct., at 3264 citing *Thomas, supra,* 473 U.S., at 587, 589-593, 105 S.Ct., at 3336, 3337-39.

I do not think one can preserve a system of separation of powers on the basis of such intuitive judgments regarding "practical effects," no more with regard to the assigned functions of the courts, see *Mistretta v. United States,* 488 U.S. 361, 426-427, 109 S.Ct. 647, 682-683, 102 L.Ed.2d 714 (1989) (SCALIA, J., dissenting), than with regard to the assigned functions of the Executive, see *Morrison v. Olson,* 487 U.S. 654, 708-712, 108 S.Ct. 2597, 2629, 101 L.Ed.2d 569 (1988) (SCALIA, J., dissenting). This central feature of the Constitution must be anchored in rules, not set adrift in some multifactored "balancing test"—and especially not in a test that contains as its last and most revealing factor "the concerns that drove Congress to depart from the requirements of Article III." *Schor, supra,* 478 U.S., at 851, 106 S.Ct., a 3257.

I would return to the longstanding principle that the public rights doctrine requires, at a minimum, that the United States be a party to the adjudication. On that basis, I concur in the Court's conclusion in Part IV of its opinion that

the Article III concomitant of a jury trial could not be eliminated here. Since I join the remainder of the Court's opinion, I concur in its judgment as well.

Justice WHITE, dissenting.

The Court's decision today calls into question several of our previous decisions,[1] strikes down at least one federal statute,[2] and potentially concludes for the first time that the Seventh Amendment [3] guarantees litigants in a specialized non-Article III forum the right to a jury trial.

Because I cannot accept these departures from established law, I respectfully dissent.

I

Before I explore the Court's approach to analyzing the issues presented in this case, I first take up the question of the

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precedent that the Court most directly disregards today, *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966). Though the Court professes not to overrule this decision, and curiously, to be acting in reliance on it, see *ante,* at 57-59, there is simply no way to reconcile our decision in *Katchen* with what the Court holds today.

In *Katchen,* the petitioner filed a claim in the bankruptcy proceeding to recover funds that he alleged were due to him from a bankrupt estate; respondent, the trustee, resisted paying the claims based on § 57(g) of the old Bankruptcy Act, which forbade payments to creditors holding "void or voidable" preferences. Petitioner claimed, much as petitioners here do, that the question whether prior payments to him were preferences was a matter that could not be adjudicated without the benefit of a jury trial. We rejected this claim, holding that "there is no Seventh Amendment right to a jury trial" on claims such as Katchen's. *Katchen,* 382 U.S., at 337, 86 S.Ct., at 476. Not only could the issue of preference be tried without a jury for the purpose of denying the filed claim pursuant to § 57(g), but a money judgment for the amount of the pre erence could be entered without a jury trial: "[I]t makes no difference, so far as petitioner's Seventh Amendment claim is concerned, whether the bankruptcy trustee urges only a § 57(g) objection or also seeks affirmative relief." *Id.,* at 337-338, 86 S.Ct., at 477. This holding dispositively settles the question before us today: like the petitioner in *Katchen,* petitioners in this case have no Seventh Amendment right to a jury trial when respondent trustee seeks to avoid the allegedly fraudulent transfers they received.

In order to escape the force of *Katchen* § holding, the Court exploits the circumstances under which that decision was made. Most notably, at the time *Katchen* was decided, the Bankruptcy Act then in force (the 1898 Act) did not include actions to set aside voidable preferences among those proceedings covered by the Act. Thus, the clause of our opinion in *Katchen, supra,* at 336, 86 S.Ct., at 476, on which the Court today puts so

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much weight—"petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee," see *ante,* at 58—simply stated the truism that, under the 1898 Act in force at that time, if petitioner had not presented his claim to the bankruptcy court, that court would have had no jurisdiction to perform a summary adjudication of the preference.

That entitlement, however, on which the Court so heavily relies, was solely the product of the statutory scheme in existence at the time. If it were not, the next phrase appearing in the *Katchen* decision would make little sense: "[W]hen the same issue [*i.e.,* validity of a preference] arises as part of the process of allowance and disallowance of claims, it is triable in equity." *Katchen, supra,* at 336, 86 S.Ct., at 476. *Katchen* makes it clear that when Congress does commit the issue and recovery of a preference to adjudication in a bankruptcy proceeding, the Seventh Amendment is inapplicable. Only the limits of the 1898 Act prevented this from being the case in *all* instances, and thereby, left Katchen with the possibility of a jury trial right.

Today's Bankruptcy Code is markedly different. Specifically, under the Bankruptcy Amendments and Federal Judgeship Act of 1984 (1984 Amendments), an action to recover fraudulently transferred property has been classified as a "core" bankruptcy proceeding. See 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V).

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While in Katchen's day, it was only in special circumstances that adjudicating a preference was committed to bankruptcy proceedings, today, Congress has expressly designated adjudication of a preference or a fraudulent transfer a "core" bankruptcy proceeding. The portion of *Katchen* on which the Court relies—" 'petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee,' " see *ante,* at 58—is therefore a relic of history. The same is true of the decision in *Schoen-*

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thal v. Irving Trust Co., 287 U.S. 92, 94-95, 53 S.Ct. 50, 51, 77 L.Ed. 185 (1932), which, in holding that "[s]uits to recover preferences constitute no part of the proceedings in bankruptcy," merely reflected the then-existing statutory scheme.

The Court recognizes the distinction between the earlier law and the present Code, but calls the change a "purely taxonomic" one that "cannot alter our Seventh Amendment analysis." *Ante,* at 61. I disagree for two reasons. First, the change is significant because it illustrates the state of the law at the time of *Katchen,* and explains why that case came out as it did. It is hypocritical for the Court to rely on *Katchen* § statement as to the existence of a jury trial entitlement for the petitioner's claim there, but then dismiss as "taxonomic" the change that wiped out that jury entitlement—or, at the very least, profoun ly shifted the basis for it.

More fundamentally, the inclusion of actions to recover fraudulently conveyed property among core bankruptcy proceedings has meaning beyond the taxonomic. As I explain in more detail below, see Part II-A, *infra,* we have long recognized that the forum in which a claim is to be heard plays a substantial role in determining the extent to which a Seventh Amendment jury trial right exists. As we put it in *Katchen:*

" '[I]n cases of bankruptcy, many incidental questions arise in the course of administering the bankrupt estate, which would ordinarily be pure cases at law, and in respect of their facts triable by jury, but, as belonging to bankruptcy proceedings, they become cases over which the bankruptcy court, which acts as a court of equity, exercises exclusive control. Thus a claim of debt or damages against the bankrupt is investigated by chancery methods.' " *Katchen, supra,* at 337, 86 S.Ct., at 477 (quoting *Barton v. Barbour,* 104 U.S. 126, 133-134, 26 L.Ed. 672 (1881)).

The same is true here, and it counsels affirmance under our holding in *Katchen.*

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In essence, the Court's rejection of *Katchen*—and its classification of the change effected by the 1984 Act as "taxonomic"—comes from its conclusion that the fraudulent conveyance action at issue here is not " 'part of the process of allowance and disallowance of claims.' " *Ante,* at 58 (quoting *Katchen,* 382 U.S., at 336, 86 S.Ct., at 476). The Court misses *Katchen* § point, however: it was the fact that *Congress* had committed the determination and recovery of preferences to bankruptcy proceedings that was determinative in that case, not just the bare fact that the action "happened" to take place in the process of adjudicating claims. And the same determinative element is present here, for under the 1984 Amendments, Congress unmistakably intended to have fraudulent conveyances adjudicated and recovered in the bankruptcy court in accordance with that court's usual procedures.

Perhaps in this respect the Court means something more akin to its later restatement of its position; namely, that the 1984 Amendments simply "reclassified a pre-existing, common-law cause of action that was not integrally related to the reformation of debtor-creditor relations." *Ante,* at 60. The Court further indicates that it will pay little heed to the congressional inclusion of avoidance and recovery proceedings in core bankruptcy jurisdiction since that choice was not made "because [Congress found that] traditional

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rights and remedies were inadequate to cope with a manifest public problem." [4] *Ibid.* This misguided view of the con-

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gressional enactment is the crux of the problem with the Court's approach.

How does the Court determine that an action to recover fraudulently conveyed property is not "integrally related" to the essence of bankruptcy proceedings? Certainly not by reference to a current statutory definition of the core of bank-

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ruptcy proceedings—enacted by Congress under its plenary constitutional power, see U.S. Const., Art. I, § 8, cl. 4, to establish bankruptcy laws. As discussed in the preceding paragraph, this vision of what is "integrally related" to the resolution of creditor-debtor conflicts includes the sort of action before us today. See 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V). Nor does the Court find support for its contrary understanding in petitioners' submission, which concedes that the action in question here is brought to "recover monies that are properly part of the debtor's estate and should be ratably distributed among creditors," and that fraudulent transfers put at risk "the basic policy of non-discriminatory distribution that underlies the bankruptcy law." Brief for Petitioners 12. This, too, seems to belie the Court's view that actions to set aside fraudulent conveyances are not "integrally related" to reforming creditor-debtor relations.

Nor is the Court's conclusion about the nature of actions to recover fraudulently transferred property supportable either by reference to the state of American bankruptcy law prior to adoption of the 1978 Code, or by reference to the pre-1791 practice in the English courts. If the Court draws its conclusions based on the fact that these actions were not considered to be part of bankruptcy proceedings under the 1800 or 1898 Bankruptcy Acts (or, more generally, under federal bankruptcy statutes predating the 1978 Code), it has treated the power given Congress in Article I, § 8, cl. 4, as if it were a disposable battery, good for a limited period only—once the power in it has been consumed by use, it is to be discarded and considered to have no future value. The power of Congress under this Clause is plainly not so limited: merely because Congress *once* had a scheme where actions such as this one were solely heard in p enary proceedings in Article III courts—where the Seventh Amendment attached—does not impugn the legality of every other possible arrangement. See also Part II-B, *infra.*

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Perhaps instead the Court rests its conclusion on the practice of the 18th-century English courts. I take issue with this view of the old English law, below. But even if this were correct, I do not see why the Article I, § 8, power should be so restricted. See *ibid.*

One final observation with respect to *Katchen*. The Court attempts to distinguish *Katchen* by saying that a jury trial was not needed there because the funds in dispute were part of the "bankruptcy estate." *Ante,* at 57. "Our decision [in *Katchen*] turned . . . on the bankruptcy court's having 'actual or constructive possession' of the bankruptcy estate," the Court writes. *Ibid.* (quoting 382 U.S., at 327, 86 S.Ct., at 471). But obviously in this case, the Bankruptcy Court similarly had " 'actual or constructive possession' of the bankruptcy estate"; certainly it had as much constructive possession of the property sought as it had of the preference recovered in *Katchen.* Thus, it is as true here as it was in *Katchen* that the funds in dispute are part of the "bankruptcy estate." The Bankruptcy Code defines that estate to be comprised of "all the following property, wherever located and by whomever held," including "[a]ny interest in property that the trustee recovers under" the provision authorizing actions to recover fraudulently transferred property. 11 U.S.C. §§ 541(a)(3), 550 (1982 ed., Supp. V). Consequently, even if the Court is accurate in pinpointing the dispositive fact in the

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Katchen decision, that fact equally points towards a ruling for the trustee here.

In sum, I find that our holding in *Katchen,* and its underlying logic, dictate affirmance. The Court's decision today amounts to nothing less than a *sub silentio* overruling of that precedent.

II

Even if the question before us were one of first impression, however, and we did not have the decision in *Katchen* to guide us, I would dissent from the Court's decision. Under our cases, the determination whether the Seventh Amendment guarantees a jury trial on petitioners' claims must turn

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on two questions: first, in what forum will those claims be heard; and second, what is the nature of those claims. A weighing of both of these factors must point toward application of the Seventh Amendment before that guarantee will attach.[5]

To read the Court's opinion, one might think that the Seventh Amendment is concerned only with the nature of a claim. If a laim is legal, the Court announces, then the Seventh Amendment guarantees a jury trial on that claim. *Ante,* at 42, n. 4. This is wrong. "[H]istory and our cases support the proposition that the right to a jury trial turns not solely on the nature of the issue to be resolved but also on the forum in which it is to be resolved," *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 460-461, 97 S.Ct. 1261, 1272, 51 L.Ed.2d 464 (1977). Perhaps like *Katchen, Atlas Roofing* is no longer good law after today's decision. A further examination of the issue before us reveals, though, that it is the

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Court's decision today, and not our prior rulings, that is in error.

In the most obvious case, it has been held that the Seventh Amendment does not apply when a "suit at common law" is heard in a state court. *Minneapolis & St. L.R. Co. v. Bombolis,* 241 U.S. 211, 217, 36 S.Ct. 595, 596, 60 L.Ed. 961 (1916); *Woods v. Holy Cross Hospital,* 591 F.2d 1164, 1171, n. 12 (CA5 1979). Even with its exclusive focus on the claim at issue here, the Court does not purport to hold that a fraudulent conveyance action brought in state court would be covered by the Seventh Amendment, because that action was one at "common law" in the Court's view.

Nor does the Seventh Amendment apply in all federal forums. "[T]he Seventh Amendment is not applicable to administrative proceedings," for example. *Tull v. United States,* 481 U.S. 412, 418, n. 4, 107 S.Ct. 1831, 1835, n. 4, 95 L.Ed.2d 365 (1987). In these forums " 'where jury trials would be incompatible with the whole concept of administrative adjudication,' " the Seventh Amendment has no application. *Atlas Roofing Co., supra,* 430 U.S., at 454, 97 S.Ct., at 1268 (emphasis deleted) (quoting *Pernell v. Southall Realty,* 416 U.S. 363, 383, 94 S.Ct. 1723, 1733, 40 L.Ed.2d 198 (1974)). Thus, we have often looked at the character of the federal forum in which the claim will be heard, asking if a jury has a place in that forum, when determining if the Seventh Amendment's guarantee of a jury trial will apply there.

Most specifically relevant for this case, we have indicated on several previous occasions that bankruptcy courts—by their very nature, courts of equity—are forums in which a jury would be out of place. "[A] bankruptcy court . . . [is] a specialized court of equity . . . a forum before which a jury would be out of place," *Atlas Roofing, supra,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268; consequently, the Seventh Amendment has no application to these courts. "[T]he Court [has] recognized that a bankruptcy court has been traditionally viewed as a court of equity, and that jury trials would 'dismember' the statutory scheme of the Bankruptcy Act." *Curtis v. Loether,*

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U.S. 189, 195, 94 S.Ct. 1005, 1009, 39 L.Ed.2d 260 (1974). *Atlas Roofing, Curtis,* and countless other cases have recognized that Congress has the power to "entrust enforcement of statutory rights to [a] . . . specialized court of equity free from the strictures of the Seventh Amendment." *Curtis, supra,* at 195, 94 S.Ct., at 1009. Prior cases emphatically hold that bankruptcy courts are such specialized courts of equity. Indeed, we have stated that "bankruptcy courts are inherently proceedings in equity." *Katchen v. Landy,* 382 U.S., at 336, 86 S.Ct., at 476; see also *Local Loan Co. v. Hunt,* 292 U.S. 234, 240, 54 S.Ct. 695, 697, 78 L.Ed. 1230 (1934).

Before today, this Court has never held that a party in a bankruptcy court has a Seventh Amendment right to a jury trial on its claims. Of course, the Court does not actually so hold today, preferring to be obtuse about just where petitioners are going to obtain the jury trial to which the Court deems them entitled. See *ante,* at 64. But in blithely ignoring the relevance of the forum Congress has designated to hear this action—focusing instead exclusively on the "legal" nature of petitioners' claim the Court turns its back on a long line of cases that have rested, in varying degrees, on that point. The Court's decision today ignores our statement in *Atlas Roofing* that "even if the Seventh Amendment would have required a jury where the adjudication of [some types of] rights is assigned to a federal court of law instead of an administrative agency," this constitutional provision does not apply when Congress assigns the adjudication of these rights to specialized tribunals where juries have no place. *Atlas Roofing,* 430 U.S., at 455, 97 S.Ct., at 1269. Indeed, we observed in *Atlas Roofing* that it was even true in "English or American legal systems at the time of the adoption of the Seventh Amendment [that] the question whether a fact would be found by a jury turned to a considerable degree on the nature of the forum in which a litigant found himself." *Id.,* at 458, 97 S.Ct., at 1270.

The Court's decision also substantially cuts back on Congress' power to assign selected causes of action to specialized forums and tribunals (such as bankruptcy courts), by holding

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that these forums will have to employ juries when hearing claims like the one before us today—a requirement that subverts in large part Congress' decision to create such forums in the first place. Past decisions have accorded Congress far more discretion in making these assignments. Thus, *Block v. Hirsh,* 256 U.S. 135, 158, 41 S.Ct. 458, 460, 65 L.Ed. 865 (1921), found that a Seventh Amendment "objection amount[ed] to little" when Congress assigned what was, in essence, a common-law action for ejectment to a specialized administrative tribunal. We reiterated the vitality of *Block v. Hirsh* as recently as our decision in *Pernell v. Southall Realty, supra,* 416 U.S., at 383, 94 S.Ct., at 1733, and the principle was reaffirmed in several cases between these two decisions. See n. 10, *infra.* In *Pernell,* referring to *Block v. Hirsh,* we stated that "the Seventh Amendment would not be a bar to a congressional effort to entrust landlord-tenant disputes, including those over the right to possession, to an administrative agency." *Pernell, supra,* at 383, 94 S.Ct., at 1733. Yet to the extent that such disputes involve matters that are "legal" in nature—as they clearly do—the Court's decision today means that Congress cannot do what we said in *Block* and *Pernell* that it could.[6]

Finally, the Court's ruling today ignores several additional reasons why juries have no place in bankruptcy courts and other "specialized courts of equity" like them. First, two of the principal rationales for the existence of the Seventh Amendment guarantee—the notions of "jury equity" and of juries serving as popular checks on life-tenured judges—are inapt in bankruptcy courts. As one scholar noted:

"We have kept the *civil* jury . . . as a check on the federal judge whose life tenure makes [him] suspect [under]

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. . . the Populist traditions of this country. The function of the civil jury is to diffuse the otherwise autocratic power and authority of the judge.

"This . . . function . . . has little application to non-traditional civil proceedings such as those which occur in bankruptcy. . . . The condition of autocracy which would bring the underlying values of the Seventh Amendment [into force] is not present; the right to jury trial therefore has no application." Hearings on S. 558 before the Subcommittee on the Constitution of the Senate Committee on the Judiciary, 100th Cong., 1st Sess., 5 2-573 (1987) (statement of Paul Carrington).

Others have made this same observation. See, *e.g., id.,* at 684-685 (statement of Prof. Rowe). Cf., *e.g., In re Japanese Electronic Products Antitrust Litigation,* 631 F.2d 1069, 1085 (CA3 1980). As respondent put it: "A jury in an equitable tribunal such as a bankruptcy court would in a sense be redundant." Brief for Respondent 22.

Beyond its redundancy, a requirement that juries be used in bankruptcy courts would be disruptive and would unravel the statutory scheme that Congress has created. The Court dismisses this prospect, and scoffs that it "can[not] seriously be argued that permitting jury trials" on this sort of claim would undermine the statutory bankruptcy scheme. *Ante,* at 61. Yet this argument has not only been "seriously" made, it was actually accepted by this Court in *Curtis v. Loether,* 415 U.S. 189, 94 S.Ct. 1005, 39 L.Ed.2d 260 (1974). In *Curtis,* we observed that *Katchen* had rejected a Seventh Amendment claim (similar to the one before us today), due to our "recogni[tion] that a bankruptcy court has been traditionally viewed as a court of equity, and that jury trials would 'dismember' the statutory scheme of the Bankruptcy Act." *Curtis, supra,* 415 U.S., at 195, 94 S.Ct., at 1009; see also *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268, n. 11. I fear that the Court's decision today will have the desultory effect we feared when *Curtis* was decided.

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The above is not to say that Congress can vitiate the Seventh Amendment by assigning any claim that it wishes to a specialized tribunal in which juries are not employed. Cf. *Atlas Roofing, supra,* at 461, n. 16, 97 S.Ct., at 1272, n. 16. Our cases require a second inquiry—the one that the Court focuses exclusively upon concerning the nature of the claim so assigned.

To resolve this query, the Court properly begins its analysis with a look at English practice of the 18th century. See *ante,* at 43-47. After conducting this review, the Court states with confidence that "in 18th-century England . . . a court of equity would not have adjudicated" respondent's suit. *Ante,* at 47. While I agree that this action could have been brought at law—and perhaps even that it might have been so litigated in the most common case—my review of the English cases from the relevant period leaves me unconvinced that the chancery court would have *refused* to hear this action—the Court's conclusion today.

The Court itself confesses that "courts of equity sometimes provided relief in fraudulent conveyance actions." *Ante,* at 43. The Chancery Court put it stronger, though: "Courts of Equity have most certainly been in the habit of exercising a concurrent jurisdiction with the Courts of Law on the statutes of *Elizabeth* respecting fraudulent conveyances." *Hobbs v. Hull,* 1 Cox 445, 445-446, 29 Eng.Rep. 1242 (1788). Rarely has a more plain statement of the prevailing English practice at the time of ratification of the Seventh Amendment been discovered than this one; this alone should be enough to make respondent's case. Yet instead of accepting the pronouncement of the equity court about its own jurisdiction, this Court assumes the role of High Court of Historical Review, questioning the soundness of *Hobbs'*

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decision because it was issued without adequate supporting citations. *Ante,* at 45-46. A similar criticism is levied against another case from the same period, *Ex parte Scudamore,* 3 Ves.jun. 85,

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30 Eng.Rep. 907 (Ch. 1796), which, as even the Court concedes, "demonstrates that fraudulent conveyance actions could be brought in equity." *Ante* at 45.

In addition to nitpicking respondent's supporting case law into oblivion, the Court's more general rejection of respondent's claim rests on two sources: a passing citation to a wholly inapposite case, *Buzard v. Houston,* 119 U.S. 347, 7 S. t. 249, 30 L.Ed. 451 (1886); and a more lengthy quotation from Professor Glenn's treatise on fraudulent conveyances. See *ante,* at 44. I will not deny that Professor Glenn's work supports the historical view that the Court adopts today. But notwithstanding his scholarly eminence, Professor Glenn's view of what the 18th-century English equity courts would have done with an action such as this one is not dispositive. Other scholars have looked at the same history and come to a different conclusion.[7] Still others have questioned the soundness of the distinction that Professor Glenn drew—between suits to set aside monetary conveyances and suits to avoid the conveyances of land—as unwise or unsupported. See, *e.g., In re Wencl,* 71 B.R. 879, 883, n. 2 (Bkrtcy. Ct., DC Minn.1987). Indeed, just a few pages after it rests its analysis of the 18th-century case law on Professor Glenn's writing, the Court itself dismisses this aspect of Professor Glenn's historical conclusions. See *ante,* at 46, n. 5. The Court embraces Professor Glenn's treatise where it agrees with it and calls it authoritative, while rejecting the portions it finds troublesome.

Trying to read the ambiguous history concerning fraudulent conveyance actions in equity—a task which the Court finds simple today—has perplexed jurists in each era, who have come to conflicting decisions each time that the question has found relevance. Even in *Schoenthal* § time, and under

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the statutory regime applicable when that case was decided, many courts reviewing the same historical sources considered by us today had concluded that actions such as this one sounded in equity. See *Schoenthal v. Irving Trust Co.,* 287 U.S., at 96, n. 3, 53 S.Ct., at 52, n. 3; Note, 42 Yale L.J. 450, 450-452 (1933). In more recent times, an impressive collection of courts have come to a similar conclusion, finding that actions to avoid fraudulent conveyances were historically considered equitable in nature.[8]

In sum, I do not think that a fair reading of the history—our understanding of which is inevitably obscured by the passage of time and the irretrievable loss of subtleties in interpretation clearly proves or disproves that respondent's action would have sounded in equity in England in 1791.[9]

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With the historical evidence thus in equipoise—and with the nature of the relief sought here not dispositive either, see n. 8, *supra*—we should not hesitate to defer to Congress' exercise of its power under the express constitutional grant found in Article I, § 8, cl. 4, authorizing Congress "[t]o establish . . . uniform Laws on the subject of Bankruptcies." Congress has exercised that power, defining actions such as the one before us to be among the "core" of bankruptcy proceedings, triable in a bankruptcy court before a bankruptcy judge and without a jury. I would defer to these decisions.

The Court, however, finds that some (if not all) of these congressional judgments are constitutionally suspect. While acknowledging that "[t]o be sure, we owe some deference to Congress' judgment after it has given careful consideration to" such a legislative enactment, the Court declines to defer here because "respondent has adduced no evidence that Congress considered the constitutional implications of its designation of all fraudulent conveyance actions as core proceedings." *Ante,* at 61. See also *ante,* at

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61-62, n. 16. This statement is remarkable, for it should not be assumed that Congress in enacting 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V) ignored its constitutional implications.[10] The Court

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does not say from where it draws its requirement that the Congress must provide us with some indication that it considered the constitutional dimensions of its decision before acting, as a prerequisite for obtaining our deference to those enactments.[11]

Moreover, the Court's cramped view of Congress' power under the Bankruptcy Clause to enlarge the scope of bankruptcy proceedings, ignoring that changing times dictate changes in these proceedings, stands in sharp contrast to a more generous view expressed some years ago:

"The fundamental and radically progressive nature of [congressional] extensions [in the scope of bankruptcy laws] becomes apparent upon their mere statement. . . . Taken altogether, they demonstrate in a very striking way the capacity of the bankruptcy clause to meet new conditions as they have been disclosed as a result of the tremendous growth of business and development of

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human activities from 1800 to the present day. And these acts, far-reaching though they may be, have not gone beyond the limit of congressional power; but rather have constituted extensions into a field whose boundaries may not yet be fully revealed." *Continental Illinois National Bank v. Chicago, R.I. & P.R. Co.,* 294 U.S. 648, 671, 55 S.Ct. 595, 604, 79 L.Ed. 1110 (1935).

See also *Katchen v. Landy,* 382 U.S., at 328-329, 86 S.Ct., at 472.

One of that period's leading constitutional historians expressed the same view, saying that the Framers of the Bankruptcy Clause "clearly understood that they were not building a straight-jacket to restrain the growth and shackle the spirits of their descendants for all time to come," but rather, were attempting to devise a scheme "which, while firm, was nevertheless to be flexible enough to serve the varying social needs of changing generations." C. Warren, Bankruptcy in United States History 4 (1935). Today, the Court ignores these lessons and places a straitjacket on Congress' power under the Bankruptcy Clause: a straitjacket designed in an era, as any reader of Dickens is aware, that was not known for its enlightened thinking on debtor-creditor relations.

Indeed, the Court calls into question the longstanding assumption of our cases and the bankruptcy courts that the equitable proceedings of those courts, adjudicating creditor-debtor disputes, are adjudications concerning "public rights." See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 71, 102 S.Ct. 2858, 2871, 73 L.Ed.2d 598 (1982); *id.,* at 91, 102 S.Ct., at 2881 (REHNQUIST, J., concurring in judgment); *id.,* at 92, 102 S.Ct., at 2882 (Burger, C.J., dissenting); *id.,* at 108-118, 102 S.Ct., at 2890-95 (WHITE, J., dissenting). The list of lower court opinions that have reasoned from this assumption is so lengthy that I cannot reasonably include it in the text; a mere sampling fills the margin.[12] Yet today the Court calls

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all of this into doubt merely because these cases have been subjected to "substantial scholarly criticism." *Ante,* at 56, n. 11.[13] If no part of bankruptcy proceedings involve the adjudication of public rights, as the Court implies today, then *all* bankruptcy proceedings are saved from the strictures of the Seventh Amendment only to the extent that such proceedings are the descendants of earlier analogue heard in equity in 18th-century England. Because, as almost every historian has observed, this period was marked by a far more restrictive notion of equitable jurisdiction in bankruptcies, see, *e.g.,* Warren, *supra,* at 3-5, the Court's decision today may threaten the efficacy of bankruptcy courts as they

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are now constituted. I see no reason to use the Seventh Amendment as a tool to achieve this dubious result.

III

Because I find the Court's decision at odds with our precedent, and peculiarly eager to embark on an unclear

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course in Seventh Amendment jurisprudence, I respectfully dissent.[14]

Justice BLACKMUN, with whom Justice O'CONNOR joins, dissenting.

I agree generally with what Justice WHITE has said, but write separately to clarify, particularly in my own mind, the nature of the relevant inquiry.

Once we determine that petitioners have no statutory right to a jury trial, we must embark on the Seventh Amendment inquiry set forth in *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 97 S.Ct. 1261, 51 L.Ed.2d 464 (1977). First, we must determine whether the matter to be adjudicated is "legal" rather than "equitable" in nature, a determination which turns on the nature of the claim and of the relief sought. If the claim and the relief are deemed equitable, we need go no further: the Seventh Amendment's jury-trial right applies only to actions at law.

In this case, the historical inquiry is made difficult by the fact that, before the Federal Rules of Civil Procedure unified law and equity, parties might have been drawn to the equity side of the court because they needed its procedural tools and interim remedies: discovery, accounting, the power to clear itle, and the like. In light of the frequency with which these tools were likely needed in fraud cases of any kind, it is no surprise that, as Justice WHITE points out, fraudulent conveyance actions, even if cognizable at law, often would be found on the equity docket. See generally O. Bump, Conveyances Made by Debtors to Defraud Creditors § 532 (4th ed. 1896); F. Wait, Fraudulent Conveyances and Creditors' Bills §§ 59-60 (1884); W. Roberts, Voluntary and Fraudulent

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Conveyances 525-526 (3d Am. ed. 1845). This procedural dimension of the choice between law and equity lends a tentative quality to any lessons we may draw from history.

The uncertainty in the historical record should lead us, for purposes of the present inquiry, to give the constitutional right to a jury trial the benefit of the doubt. Indeed, it is difficult to do otherwise after the Court's decision in *Schoenthal v. Irving Trust Co.,* 287 U.S. 92, 53 S.Ct. 50, 77 L.Ed. 185 (1932). *Schoenthal* turned on the legal nature of the preference claim and of the relief sought, *id.,* at 94-95, 53 S.Ct., at 51, rather than upon the legal nature of the tribunal to which "plenary proceedings" were assigned under the 1898 Bankruptcy Act.

"With the historical evidence thus in equipoise," *ante,* at 87 (WHITE, J., dissenting), but with *Schoenthal* weighing on the "legal" side of the scale, I then would turn to the second stage of the *Atlas Roofing* inquiry: I would ask whether, assuming the claim here is of a "legal" nature, Congress has assigned it to be adjudicated in a special tribunal "with which the jury would be incompatible." *Atlas Roofing,* 430 U.S., at 450, 97 S.Ct., at 1266; see also *Tull v. United States,* 481 U.S. 412, 418, n. 4, 107 S.Ct. 1831, 1835, n. 4, 95 L.Ed.2d 365 (1987). Here, I agree with Justice WHITE that *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), as interpreted in *Atlas Roofing,* requires the conclusion that courts exercising core bankruptcy functions are equitable tribunals, in which "a jury would be out of place and would go far to dismantle the statutory scheme." *Atlas Roofing,* 430 U.S., at 454, n. 11, 97 S.Ct., at 1268, n. 11.

Having identified the tribunal to which Congress has assigned respondent's fraudulent

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conveyance claim as equitable in nature, the question remains whether the assignment is one Congress may constitutionally make. Under *Atlas Roofing,* that question turns on whether the claim involves a "public right." *Id.,* at 455, 97 S.Ct., at 1269. When Congress was faced with the task of divining the import of our fragmented decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), it gambled and predicted that a statutory right which is an integral part of a pervasive regulatory

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scheme may qualify as a "public right." Compare H.R.Rep. No. 98-9, pt. 1, pp. 6, 13 (1983) (House Report), with S.Rep. No. 98-55, pp. 32-40 (1983) (Senate Report); see *Thomas v. Union Carbide Agricultural Products Co.,* 473 U.S. 568, 586, 594, 105 S.Ct. 3325, 3335, 3339, 87 L.Ed.2d 409 (1985); see also *id.,* at 599, 105 S.Ct., at 3342 (BRENNAN, J., concurring in judgment) ("[A] bankruptcy adjudication, though technically a dispute among private parties, may well be properly characterized as a matter of public rights"). Doing its best to observe the constraints of *Northern Pipeline* while at the same time preserving as much as it could of the policy goals of the major program of bankruptcy reform the decision in *Northern Pipeline* dismantled, see House Report, at 7, Senate Report, at 6-7, Congress struck a compromise. It identified those proceedings which it viewed as integral to the bankruptcy scheme as "core" (doing its best to exclude "*Marathon*-type State law cases"), and assigned them to a specialized equitable tribunal. *Id.,* at 2.

I agree with Justice WHITE, *ante,* at 88-89, that it would be mproper for this Court to employ, in its Seventh Amendment analysis, a century-old conception of what is and is not central to the bankruptcy process, a conception that Congress has expressly rejected. To do so would, among other vices, trivialize the efforts Congress has engaged in for more than a decade to bring the bankruptcy system into the modern era.

There are, nonetheless, some limits to what Congress constitutionally may designate as a "core proceeding," if the designation has an impact on constitutional rights. Congress, for example, could not designate as "core bankruptcy proceedings" state-law contract actions brought by debtors against third parties. Otherwise, *Northern Pipeline* would be rendered a nullity. In this case, however, Congress has not exceeded these limits.

Although causes of action to recover fraudulent conveyances exist outside the federal bankruptcy laws, the problems created by fraudulent conveyances are of particular sig-

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nificance to the bankruptcy process. Indeed, for this reason, the Bankruptcy Code long has included substantive legislation regarding fraudulent conveyances and preferences. And the cause of action respondent brought in this case arises under federal law. See 11 U.S.C. §§ 548(a)(2) and 550(a). This substantive legislation is not a jurisdictional artifice. It reflects, instead, Congress' longstanding view that fraudulent conveyances and preferences on the eve of bankruptcy are common methods through which debtors and creditors act to undermine one of the central goals of the bankruptcy process: the fair distribution of assets among creditors. Congress' conclusion that the proper functioning of the bankruptcy system requires that expert judges handle these claims, and that the claims be given higher priority than they would receive on a crowded district court's civil jury docket (see Senate Report, at 3; House Report, at 7-8), is entitled to our respect.

The fact that the reorganization plan in this case provided that the creditor's representatives would bring fraudulent conveyance actions only after the plan was approved does not render the relationship between fraudulent conveyance actions and the bankruptcy process "adventitious." *Ante,* at 60, n. 15 (majority opinion). Creditors would be less likely to approve a plan which forced them to undertake the burden

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of collecting fraudulently transferred assets if they were not assured that their claims would receive expert and expedited treatment.

In sum, it must be acknowledged that Congress has legislated treacherously close to the constitutional line by denying a jury trial in a fraudulent conveyance action in which the defendant has no claim against the estate. Nonetheless, given the significant federal interests involved, and the importance of permitting Congress at long last to fashion a modern bankruptcy system which places the basic rudiments of the bankruptcy process in the hands of an expert equitable tribunal, I cannot say that Congress has crossed the constitutional line on the facts of this case. By holding otherwise, the Court

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today throws Congress into still another round of bankruptcy court reform, without compelling reason. There was no need for us to rock the boat in this case. Accordingly, I dissent.

1. Section 1330(a) provides:

"The district courts shall have original jurisdiction without regard to amount in controversy of any *nonjury civil action* against a foreign state as defined in section 1603(a) of this title as to any claim for relief in personam with respect to which the foreign state is not entitled to immunity either under sections 1605-1607 of this title or under any applicable international agreement." (Emphasis added.)

2. Indeed, respondent strenuously supported the Court of Appeals' conclusion, which echoed that of the District Court, see A p. to Pet. for Cert. 22, that the "FSIA is inapplicable to the case at bar," 835 F.2d 1341, 1347 (CA11 1988), not only on the court's rationale that "the transfers in question and the suit to recover those transfers occurred before Granfinanciera was nationalized," *ibid.*, but on the more sweeping rationale that Granfinanciera never proved that it was an instrumentality of a foreign state because it had never really been nationalized. See Brief for Appellee in No. 86-5738 (CA11), pp. 21-30; Brief for Appellee in No. 86-1292 (SD Fla.), pp. 32-36. Admittedly, respondent's present position that the FSIA does not confer immunity on Granfinanciera because it was not an instrumentality of a foreign state when the alleged wrongs occurred or when respondent filed suit is not necessarily incompatible with his claim that Granfinanciera cannot qualify for a jury trial under the FSIA because it requested a jury trial after it was nationalized. Respondent has not attempted, however, to reconcile these views and did not make the second claim until he filed his merits brief in this Court.

3. The current statutory provision for jury trials in bankruptcy proceedings—28 U.S.C. § 1411 (1982 ed., Supp. V), enacted as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (1984 Amendments), Pub.L. 98-353, 98 Stat. 333—is notoriously ambiguous. Section 1411(a) provides: "[T]his chapter and title 11 do not affect any right to trial by jury that an individual has under applicable nonbankruptcy law with regard to a personal injury or wrongful death tort claim." Although this section might suggest that jury trials are available only in personal injury and wrongful death actions, that conclusion is debatable. Section 1411(b) provides that "[t]he district court may order the issues arising [in connection with involuntary bankruptcy petitions] to be tried without a jury," suggesting that the court lacks similar discretion to deny jury trials on at least some issues presented in connection with voluntary petitions. The confused legislative history of these provisions has further puzzled commentators. See, *e.g.*, Gibson, Jury Trials in Bankruptcy: Obeying the Commands of Article III and the Seventh Amendment, 72 Minn.L.Rev. 967, 989-996 (1988) (hereinafter Gibson); Note, the Bankruptcy Amendments and Federal Judgeship Act of 1984: The Impact on the Right of Jury Trial in Bankruptcy Court, 16 Tex.Tech.L.Rev. 535, 543-546 (1985). Whatever the proper construction of § 1411, petitioners concede that this section does not entitle them to

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a jury trial. Section 122(b) of the 1984 Amendments, 98 Stat. 346, bars application of § 1411 to "cases under title 11 of the United States Code that are pending on the date of enactment of this Act or to proceedings arising in or related to such cases," and Chase & Sanborn's petition for reorganization was pending on that date. Nor does § 1411's predecessor—28 U.S.C. § 1480(a), which stated that "this chapter and title 11 do not affect any right to trial by jury, in a case under title 11 or in a proceeding arising under title 11 or arising in or related to a case under title 11, that is provided by any statute in effect on September 30, 1979"—seem to afford petitioners a statutory basis for their claim. As they recognize, § 1480 was apparently repealed by the 1984 Amendments. See Gibson 989, and n. 96; King, Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984, 38 Vand.L.Rev. 675, 703, and n. 79 (1985); Brief for Respondent 5, n. 11. Petitioners therefore appear correct in concluding that, "absent any specific legislation in force providing jury trials for cases filed before July 10, 1984, but tried afterwards, [their] right to jury trial in this proceeding must necessarily be predicated entirely on the Seventh Amendment." Brief for Petitioners 33, n. 7. See also Brief for Respondent 10, and n. 15.

4. This quite distinct inquiry into whether Congress has permissibly entrusted the resolution of certain disputes to an administrative agency or specialized court of equity, and whether jury trials would impair the functioning of the legislative scheme, appears to be what the Court contemplated when in *Ross v. Bernhard,* 396 U.S. 531, 538, n. 10, 90 S.Ct. 733, 738, n. 10, 24 L.Ed.2d 729 (1970), it identified "the practical abilities and limitations of juries" as an additional factor to be consulted in determining whether the Seventh Amendment confers a jury trial right. See *Tull v. United States,* 481 U.S., at 418, n. 4, 107 S.Ct., at 1835, n. 4; *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 454-455, 97 S.Ct. 1261, 1268-1269, 51 L.Ed.2d 464 (1977). We consider this issue in Part IV, *infra.* Contrary to Justice WHITE'S contention, see *post,* at 79-80, we do not declare that the Seventh Amendment provides a right to a jury trial on all legal rather than equitable claims. If a claim that is legal in nature asserts a "public right," as we define that term in Part IV, then the Seventh Amendment does not entitle the parties to a jury trial if Congress assigns its adjudication to an administrative agency or specialized court of equity. See *infra,* at 51-53. The Seventh Amendment protects a litigant's right to a jury trial only if a cause of action is legal in nature and it involves a matter of "private right."

5. Rather than list 18th-century English cases to support the contention that fraudulent monetary transfers were traditionally cognizable in equity, respondent cites three recent cases from the Courts of Appea s. These cases, however, weaken rather than bolster respondent's argument. *In re Graham,* 747 F.2d 1383 (CA11 1984), held that there was no Seventh Amendment jury trial right in a suit for the *equitable* remedy of setting aside an alleged fraudulent conveyance of *real estate* by a bankrupt. With respect to suits like respondent's, the court expressly noted that "an action by a creditor or trustee-in-bankruptcy seeking money damages is an action at law." *Id.,* at 1387 (citations omitted). *Damsky v. Zavatt,* 289 F.2d 46 (CA2 1961), also involved a conveyance of real estate. And there, too, the court acknowledged that jury trials are ordinarily available with respect to monetary claims. See *id.,* at 54.

Both of these holdings are questionable, moreover, to the extent that they are in tension with our decision in *Whitehead v. Shattuck,* 138 U.S. 146, 11 S.Ct. 276, 34 L.Ed. 873 (1891). Although there is scholarly support for the claim that actions to recover real property are quintessentially equitable actions, see 1 G. Glenn, Fraudulent Conveyances and Preferences § 98, pp. 183-184 (rev. ed. 1940), in *Whitehead* we stated:

"[W]here an action is simply for the recovery and possession of specific real or personal property, or for the recovery of a money judgment, the action is one at law. An action for the recovery of real property, including damages for withholding it, has always been of that class. The right which in

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this case the plaintiff wishes to assert is his title to certain real property; the remedy which he wishes to obtain is its possession and enjoyment; and in a contest over the title both parties have a constitutional right to call for a jury." 138 U.S., at 151, 11 S.Ct., at 277.

See also *Pernell v. Southall Realty,* 416 U.S. 363, 370-374, 94 S.Ct. 1723, 1727-1729, 40 L.Ed.2d 198 (1974).

Finally, respondent misreads *In re Harbour,* 840 F.2d 1165, 1172-1173 (1988). The Fourth Circuit relied in that case on the same authorities to which we have referred, distinguishing between suits to recover fraudulent transfers and other bankruptcy proceedings. The court's holding that the Seventh Amendment right to a jury trial no longer extends to such actions was based not on its historical analysis, which accords with our own, but on its erroneous belief that Congress possesses the power to assign jurisdiction over all fraudulent conveyance actions to bankruptcy courts sitting without juries. The case therefore lends no support to respondent's historical argument.

6. Citing several authorities, Justice WHITE contends that "[o]ther scholars have looked at the same history and come to a different conclusion." *Post,* at 85, and n. 7. This assertion, however, lacks the support it claims. With the exception of Justice Gray's opinion in *Drake v. Rice,* 130 Mass. 410, 412 (1881), and Roberts' treatise, none of the authorities cited so much as mentions 18th-century English practice. Although Collier offers as its opinion that actions to set aside fraudulent transfers are equitable in nature, 4 Collier on Bankruptcy ¶ 548.10, p. 548-125 (15th ed. 1989), it refers only to recent cases in defending its opinion, while acknowledging that some courts have disagreed. Bump and Wait both limit their citations to state-court decisions, refusing to analyze earlier English cases. See O. Bump, Conveyances Made by Debtors to Defraud Creditors § 532 (4th ed. 1896); F. Wait, Fraudulent Conveyances and Creditors' Bills §§ 56-60 (1884). To be sure, in *Drake v. Rice,* 130 Mass., at 412, Justice Gray says that, "[b]y the law of England before the American Revolution, . . . fraudulent conveyances of choses in action, though not specified in the statute [of Elizabeth], were equally void, but from the nature of the subject the remedy of the creditor must be sought in equity." But the reason why suits to recover fraudulent transfers of choses in action had to be brought in equity, Justice Gray points out, is that they could not be attached or levied upon. *Id.,* at 413. See also O. Bump, *supra,* § 531 ("[T]here is no remedy at law when the property can not be taken on execution or by attachment"). Justice Gray's summary of 18th-century English practice does not extend to cases, such as those involving monetary transfers, where an adequate remedy existed at law. The passage Justice WHITE cites from Roberts' treatise is obscure, and does not speak squarely to the question whether 18th-century English courts of equity would hear cases where legal remedies were sufficient. See W. Roberts, Voluntary and Fraudulent Conveyances 526-527 (3d Am. ed. 1845).

7. Respondent claims to seek "avoidance" of the allegedly fraudulent transfers and restitution of the funds that were actually transferred, but maintains that petitioners have made restitution impossible because the transferred funds cannot be distinguished from the other dollars in petitioners' bank accounts. See Brief for Respondent 39-44. Because avoidance and restitution are classical equitable remedies, he says, petitioners are not entitled to a trial by jury. We find this strained attempt to circumvent precedent unpersuasive. Because dollars are fungible, and respondent has not requested an accounting or other specifically equitable form of relief, a complete remedy is available at law, and equity will not countenance an action when complete relief may be obtained at law. See, *e.g., Schoenthal v. Irving Trust Co.,* 287 U.S., at 94-95, 53 S.Ct., at 51-52. Moreover, because a plaintiff is entitled to return of any funds transferred in violation of 11 U.S.C. § 548 (1982 ed., Supp. V), and because a judge lacks equitable discretion to refuse to enter an award for less than the amount of the transfer, any distinction that might exist between "damages" and monetary relief under a different label is purely semantic,

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with no relevance to the adjudication of petitioners' Seventh Amendment claim. Cf. *Albemarle Paper Co. v. Moody,* 422 U.S. 405, 442-443, 95 S.Ct. 2362, 2384-2385, 45 L.Ed.2d 280 (1975) (REHNQUIST, J., concurring). Indeed, even if the checks respondent seeks to recover lay untouched in petitioners' offices, legal remedies would apparently have sufficed. See, *e.g., Adams v. Champion,* 294 U.S. 231, 234, 55 S.Ct. 399, 400, 79 L.Ed. 880 (1935); *Whitehead v. Shattuck, supra,* 138 U.S., at 151, 11 S.Ct., at 277.

8. Although we left the term "public rights" undefined in *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S., at 450, 458, 97 S.Ct., at 1266, 1270, we cited *Crowell v. Benson,* 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932), approvingly. In *Crowell,* we defined "private right" as "the liability of one individual to another under the law as defined," *id.,* at 51, 52 S.Ct., at 292, in contrast to cases that "arise between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments." *Id.,* at 50, 52 S.Ct., at 292.

9. This proposition was firmly established in *Atlas Roofing, supra,* at 455, 97 S.Ct., at 1269 (footnote omitted):

"Congress is not required by the Seventh Amendment to choke the already crowded federal courts with new types of litigation or prevented from committing some new types of litigation to administrative agencies with special competence in the relevant field. This is the case even if the Seventh Amendment would have required a jury where the adjudication of those rights is assigned to a federal court of law instead of an administrative agency."

10. In *Atlas Roofing,* 430 U.S., at 442, 450, n. 7, 97 S.Ct., at 1261, 1266, n. 7, we stated that "[i]n cases which do involve only 'private rights,' this Court has accepted factfinding by an administrative agency, without intervention by a jury, only as an adjunct to an Art. III court, analogizing the agency to a jury or a special master and permitting it in admiralty cases to perform the function of the special master." That statement, however, must be read in context. First, we referred explicitly only to Congress' power, where disputes concern private rights, to provide administrative factfinding instead of jury trials in *admiralty* cases. Civil causes of action in admiralty, however, are not suits at common law for Seventh Amendment purposes, and thus no constitutional right to a jury trial attaches. *Waring v. Clarke,* 5 How. 441, 460, 12 L.Ed. 226 (1847). Second, our statement should not be taken to mean that Congress may assign at least the initial factfinding in all cases involving controversies entirely between private parties to administrative agencies or other tribunals not involving juries, so long as they are established as adjuncts to Article III courts. If that were so, Congress could render the Seventh Amendment a nullity. Rather, that statement, citing *Crowell v. Benson,* 285 U.S., at 51-65, 52 S.Ct., at 292-298, means only that in *some* cases involving "private rights" *as that term was defined in* Crowell *and used in* Atlas Roofing namely, as encompassing all disputes to which the Federal Government is not a party in its sovereign capacity—may Congress dispense with juries as factfinders through its choice of an adjudicative forum. Those cases in which Congress may decline to provide jury trials are ones involving statutory rights that are integral parts of a public regulatory scheme and whose adjudication Congress has assigned to an administrative agency or specialized court of equity. Whatever terminological distinctions *Atlas Roofing* may have suggested, we now refer to those rights as "public" rather than "private."

11. We do not suggest that the restructuring of debtor-creditor relations is in fact a public right. This thesis has met with substantial scholarly criticism, see, *e.g.,* Gibson 1041, n. 347; Currie, Bankruptcy Judges and the Independent Judiciary, 16 Creighton L.Rev. 441, 452 (1983); Baird, Bankruptcy Procedure and State-Created Rights: The Lessons of Gibbons and Marathon, 1982 Sup.Ct.Rev. 25, 44, and we need not and do not seek to defend it here. Our point is that even if one accepts this thesis, the Seventh Amendment entitles petitioners to a jury trial.

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12. See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 71, 102 S.Ct. 2858, 2871, 73 L.Ed.2d 598 (1982) (opinion of BRENNAN, J.):

"[T]he restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case. The former may well be a 'public right,' but the latter obviously is not."

13. Although we said in *Katchen v. Landy,* 382 U.S., at 336, 86 S.Ct., at 476, that the petitioner *might* have been entitled to a jury trial had he presented no claim against the bankruptcy estate, our approving references not only to *Schoenthal* but also to *Adams v. Champion,* 294 U.S., at 234, 55 S.Ct. 399, 400, 79 L.Ed. 880, and *Buffum v. Barceloux Co.,* 289 U.S. 227, 235-236, 53 S.Ct. 539, 542-543, 77 L.Ed. 1140 (1933), see 382 U.S., at 327-328, 86 S.Ct., at 471-472, demonstrate that we did not intend to cast doubt on the proposition that the petitioner in *Katchen* would have been entitled to a jury trial had he not entered a claim against the estate and had the bankruptcy trustee requested solely legal relief. We merely left open the possibility that a jury trial might not be required because in some cases preference avoidance actions are equitable in character.

14. In *Katchen, supra,* 382 U.S., at 335, 86 S.Ct., at 475, we adopted a rationale articulated in *Alexander v. Hillman,* 296 U.S. 222, 241-242, 56 S.Ct. 204, 210-211, 80 L.Ed. 192 (1935) (citations omitted):

" 'By presenting their claims respondents subjected themselves to all the consequences that attach to an appearance. . . .

* * * * *

" 'Respondents' contention means that, while invoking the court's jurisdiction to establish their right to participate in the distribution, they may deny its pow r to require them to account for what they misappropriated. In behalf of creditors and stockholders, the receivers reasonably may insist that, before taking aught, respondents may by the receivership court be required to make restitution. That requirement is in harmony with the rule generally followed by courts of equity that having jurisdiction of the parties to controversies brought before them, they will decide all matters in dispute and decree complete relief.' "

It warrants emphasis that this rationale differs from the notion of waiver on which the Court relied in *Commodity Futures Trading Comm'n v. Schor,* 478 U.S. 833, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986). The Court ruled in *Schor*—where no Seventh Amendment claims were presented—that the Commodities Futures Trading Commission could adjudicate state-law counterclaims to a federal action by investors against their broker consistent with Article III. The Court reached this conclusion, however, not on the ground that the Commission had possession of a disputed res, to which the investors laid claim, but on the ground that Congress did not require investors to avail themselves of the remedial scheme over which the Commission presided. The investors could have pursued their claims, albeit less expeditiously, in federal court. By electing to use the speedier, alternative procedures Congress had created, the Court said, the investors waived their right to have the state-law counterclaims against them adjudicated by an Article III court. See *id.,* at 847-850, 106 S.Ct., at 3255-3257. Parallel reasoning is unavailable in the context of bankruptcy proceedings, because creditors lack an alternative forum to the bankruptcy court in which to pursue their claims. As *Katchen* makes clear, however, by submitting a claim against the bankruptcy estate, creditors subject themselves to the court's equitable power to disallow those claims, even though the debtor's opposing counterclaims are legal in nature and the Seventh Amendment would have entitled creditors to a jury trial had they not tendered claims against the estate.

It hardly needs pointing out that Justice WHITE's assertion, see *post,* at 71-72, that this case is controlled by the Court's statement in *Katchen* that "it makes no difference, so far as petitioner's Seventh Amendment claim is concerned, whether the bankruptcy trustee urges only a § 57g

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objection or also seeks affirmative relief," 382 U.S., at 337-338, 86 S.Ct., at 476-477, is entirely unfounded. Read in context, the Court's statement merely means that once a creditor has filed a claim against the estate, the bankruptcy trustee may recover the full amount of any preference received by the creditor-claimant, even if that amount exceeds the amount of the creditor's claim. The Court's statement says nothing about a creditor's Seventh Amendment right to a jury trial on a trustee's preference action when the creditor has *not* entered a claim against the estate.

15. The adventitious relation of a trustee's fraudulent conveyance actions to the reorganization proceedings themselves which we recognized in *Schoenthal* and *Katchen,* which federal bankruptcy legislation acknowledged until 1978 by treating them as plenary actions when the defendant had not made a claim against the estate, and for which Congress expressly provided jury trial rights until 1984—is further evidenced by the events in this case. Respondent's fraudulent conveyance action was not filed until well *after* the Bankruptcy Court had approved the plan of reorganization and Chase & Sanborn's tangible assets and business had been liquidated. Reply Brief for Petitioner 9.

16. Of course, the 1984 Amendments altered the statutory scheme that formed the backdrop to our discussion in *Atlas Roofing.* But in this connection they did so only by depriving persons who have not filed claims against the estate of a statutory right to a jury trial when the trustee sues them to recover an alleged fraudulent conveyance or preferential transfer. The 1984 Amendments did not alter the nature of the trustee's claim or the

relief to which he was entitled. To say that our failure to respect Congress' reclassification of these causes of action would "go far to dismantle the statutory scheme" simply because they partly define the new statutory scheme would be to rende this test an empty tautology.

This is not to say, of course, contrary to Justice WHITE's assertion, see *post,* at 75, n. 4, that we regard Congress' amendments to the bankruptcy statutes as an "act of whimsy." The sweeping changes Congress instituted in 1978 were clearly intended to make the reorganization process more efficient, as Justice WHITE's quotation from a Senate Report indicates. But the radical reforms of 1978, on whose legislative history his dissent relies, did not work the slightest alteration in the right to a jury trial of alleged recipients of fraudulent conveyances. That change came in 1984. Although enhanced efficiency was likely Congress' aim once again, neither Justice WHITE nor Justice BLACKMUN points to any statement from the legislative history of the 1984 Amendments confirming this supposition with respect to preference actions in particular. More important, they offer no evidence that Congress considered the propriety of its action under the Seventh Amendment. The House Report cited by Justice BLACKMUN, see *post,* 93, at advocated conferring Article III status on bankruptcy judges. Its favored approach would therefore have eliminated the problem before us by clearly *entitling* petitioners to a jury trial under the Seventh Amendment. See H.R.Rep. No. 98-9, pt. 1, pp. 7, 9, 16 (1983). This approach was rejected by the Senate. In defending an alternative proposal that ultimately prevailed, however, the Senate Report to which Justice BLACKMUN refers neglects to discuss specifically the inclusion of preference actions in the class of core proceedings or potential difficulties under the Seventh Amendment to which that assignment might give rise. See S.Rep. No. 98-55, pp. 32-40 (1983). Apparently, the Senate Judiciary Committee overlooked this problem entirely. Thus, the 1984 Amendments' denial of the right to a jury trial in preference and fraudulent conveyance actions can hardly be said to represent Congress' considered judgment of the constitutionality of this change.

17. Respondent argues, for example, that the prompt resolution of fraudulent transfer claims brought by bankruptcy trustees is often crucial to the reorganization process and that if, by demanding a jury trial, a party could delay those proceedings, it could alter the negotiating framework and unfairly extract more favorable

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terms for itself. Brief for Respondent 35. It warrants notice, however, that the provision of jury trials in fraudulent conveyance actions has apparently not been attended by substantial difficulties under previous bankruptcy statutes; that respondent has not pointed to any discussion of this allegedly serious problem in the legislative history of the 1978 Act or the 1984 Amendments; that in many cases defendants would likely not request jury trials; that causes of action to re over preferences may be assigned pursuant to the plan of reorganization rather than pursued prior to the plan's approval, as was done in this very case; and that Congress itself, in enacting 28 U.S.C. § 1411 (1982 ed., Supp. V), explicitly provided for jury trials of personal injury and wrongful-death claims, which would likely take much longer to try than most preference actions and which often involve large sums of money.

[18.] One commentator has noted:

"[T]he interpretation of *Katchen* as a 'delay and expense' exception to the seventh amendment is negated by the Court's rejection of the argument that delay, or even the more significant problem of jury prejudice, can override the seventh amendment. *Katchen* § reference to 'delay and expense' must, therefore, be read as part of the Court's consideration of whether the legal remedy had become sufficiently adequate to result in a shifting of the boundaries of law and equity. At a minimum, the delay and expense language of *Katchen* must be read in light of the petitioner's demand for a stay of the bankruptcy action and the institution of a separate suit in a different court. That is a qualitatively different type of delay and expense from the delay and expense of providing a jury trial in the same action. The latter could never override *Beacon* [*Theatres, Inc. v. Westover,* 359 U.S. 500, 79 S.Ct. 948, 3 L.Ed.2d 988 (1959),] and *Dairy Queen* [, *Inc. v. Wood,* 369 U.S. 469, 82 S.Ct. 894, 8 L.Ed.2d 44 (1962)]." Warner 39 (footnotes omitted); see *id.,* at 42, 48.

[19.] Justice WHITE accuses us of being "rather coy" about which statute we are invalidating, *post,* at 71, n. 2, and of "preferring to be obtuse" about which court must preside over the jury trial to which petitioners are entitled. *Post,* at 81. But however helpful it might be for us to adjudge every pertinent statutory and constitutional issue presented by the 1978 Act and the 1984 Amendments, we cannot properly reach out and decide matters not before us. The only question we have been called upon to answer in this case is whether the Seventh Amendment grants petitioners a right to a jury trial. We hold unequivocally that it does.

[1.] As I will discuss more fully below, the Court's opinion can be read as overruling or severely limiting the relevant portions of the following cases: *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 97 S.Ct. 1261, 51 L.Ed.2d 464 (1977); *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966); *Block v. Hirsh,* 256 U.S. 135, 41 S.Ct. 458, 65 L.Ed. 865 (1921); and *Barton v. Barbour,* 104 U.S. 126, 26 L.Ed. 672 (1881), plus perhaps some others.

[2.] Like much else about its opinion, the Court is rather coy about disclosing which federal statute it is invalidating today. Perhaps it is 28 U.S.C. § 157(b)(2)(H) (1982 ed., Supp. V), the statute which includes actions to avoid or recover fraudulent conveyances among core bankruptcy proceedings; or § 157(b)(1), which permits bankruptcy judges to enter final judgments in core proceedings (given the inclusion of fraudulent conveyance actions among these proceedings); or perhaps it is 28 U.S.C. § 1411(b) (1982 ed., Supp. V), limiting jury trial rights in bankruptcy; or perhaps some part of Title 11 itself—or some combination of the above.

There is no way for Congress, or the lower Article III courts, or the bankruptcy courts—or creditors or debtors for that matter—to know how they are expected to respond to the Court's decision, even if they wish to be diligent in conforming their behavior to today's mandate. See especially Part V, *ante,* at 64. Though the Court denies that it is being "coy" or "obtuse," it steadfastly refuses to the end to disclose which statute it finds unconstitutional today. See *ante,* at 64, n. 19.

3. The Seventh Amendment provides that "[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved."

4. In addition to the points I make below, I disagree with the Court's portrayal of Congress' expansion of bankruptcy jurisdiction to include actions such as this one as an act of whimsy. In fact, when (in 1978) Congress first swept proceedings like the fraudulent conveyance suit before us into the jurisdiction of the bankruptcy courts, it was legislating out of a sense that "traditional rights and remedies were inadequate to cope with a manifest public problem":

"A major impetus underlying this reform legislation has been the need to enlarge the jurisdiction of the bankruptcy court in order to eliminate the serious delays, expense and duplications associated with the current dichotomy between summary and plenary jurisdiction.... [T]he jurisdictional

limitations presently imposed on the bankruptcy courts have embroiled the court and the parties in voluminous litigation. . . ." S.Rep. No. 95-989, p. 17 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5803.

This rather plain statement by Congress makes it clear that it found the system in place at the time grossly inadequate, and perceived a "manifest public" need for change. See also H.R.Rep. No. 95-595, p. 445 (1977).

In response to this legislative history, the Court makes two points. First, the Court observes that these Reports concerned the 1978 Code, and not the 1984 Amendments; it was the latter, the Court notes, that stripped petitioners of their jury trial right. *Ante,* at 61-62, n. 16. While the Court's analysis is technically correct, it ignores the fact that the 1978 Code undertook—to use the Court's own description—a "radical refor[m]" of bankruptcy law, *ibid.,* including the absorption of fraudulent preference actions into what used to be the plenary jurisdiction of bankruptcy courts. It was this change which laid the groundwork for the post-*Northern Pipeline* Act at issue here. Second, and more importantly, the Court acknowledges that when Congress adopted the 1984 Amendments, it was motivated by the same "efficiency" concerns that were the basis for the 1978 legislation. *Ante,* at 61-62, n. 16. Thus, the Court concedes the fundamental point that Congress modified the traditional jurisdictional scheme concerning fraudulent conveyance actions because Congress found that this traditional approach was "inadequate to cope with a manifest public problem"; under *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 97 S.Ct. 1261, 51 L.Ed.2d 464 (1977)—even under the Court's own description of that case, *ante* at 60—this should suffice to permit Congress to limit jury trial rights on such claims.

Instead of so concluding, however, the Court retreats from *Atlas Roofing* and its earlier analysis, and holds that Congress' enactments do not control here because, in adopting them, Congress failed to make a "considered judgment of the constitutionality of [these] change[s]." *Ante,* at 62, n. 16. As I observe below, *infra,* at 87-88, elevating this inquiry to bellwether status is unprecedented in our Seventh Amendment cases—and unwise.

5. Since both of the relevant factors point against application of the Seventh Amendment here, resolving this case does not require offering some comprehensive view of how these factors are to be balanced. The ambiguity, however, is not of my creation, but rather, comes from the apparent inconsistency of our case law. For example, cases brought in state courts are *never* subject to the Seventh Amendment, no matter the nature of the claim; conversely, under the Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), the sort of state-law contract claim at issue there could *never* be assigned by Congress to anything other than an Article III tribunal, in which the Seventh Amendment would apply. See also *post,* at 93 (BLACKMUN, J., dissenting). Other cases look at both factors, without being altogether clear on their relative import.

Whatever the shortcomings of this opinion for failing to resolve the difficult balancing question, it remains superior to the Court's method of "balancing" these concerns, which amounts to no balancing at all—and instead focuses solely on the nature of claim (*i.e.*, whether it is legal, and whether it concerns a public right, see *ante*, at 42, n. 4) in determining if the Seventh Amendment applies.

6. Our decision in *Katchen*, 382 U.S., at 336, 86 S.Ct., at 476—which described the 1898 Act as "convert[ing] [a] legal claim into an equitable claim"—is often cited for the same principle; *i.e.*, as upholding "the power of Congress to take some causes of action outside the scope of the Seventh Amendment by providing for their enforcement . . . in a specialized court." See J. Friedenthal, M. Kane, & A. Miller, Civil Procedure 498 (1985).

7. See, *e.g.*, 4 Collier on Bankruptcy ¶ 548.10, p. 548-125 (15th ed. 1989); O. Bump, Conveyances Made by Debtors to Defraud Creditors § 532 (4th ed. 1896); F. Wait, Fraudulent Conveyances and Creditors' Bills §§ 56-60 (1884); *Drake v. Rice*, 130 Mass. 410, 412 (1881) (Gray, C.J.); W. Roberts, Voluntary and Fraudulent Conveyances 525-526 (3d Am. ed. 1845).

8. See, *e.g.*, *In re Graham*, 747 F.2d 1383, 1387 (CA7 1984); *Damsky v. Zavatt*, 289 F.2d 46, 53 (CA2 1961) (Friendly, J.) (an action by a bankruptcy trustee to "set aside a fraudulent conveyance has long been cognizable in equity"); *Johnson v. Gardner*, 179 F.2d 114, 116-117 (CA9 1949). See also *In re Harbour*, 840 F.2d 1165, 1172-1178 (CA4 1988); *In re I.A. Durbin, Inc.*, 62 B.R. 139, 145 (SD Fla.1986); *In re Hendon Pools of Michigan, Inc.*, 57 B.R. 801, 802-803 (ED Mich.1986); *In re Southern Industrial Banking Corp.*, 66 B.R. 370, 372-375 (Bkrtcy Ct., ED Tenn.1986).

9. Nor do I think it clear, as the Court seems to, that simply because the remedy sought by respondent can be expressed in monetary terms, the relief he seeks is therefore "legal" in nature, and not equitable. *Ante*, at 47-49. This Court has not accepted the view that "any award of monetary relief must necessarily be 'legal' relief." *Curtis v. Loether*, 415 U.S. 189, 196, 94 S.Ct. 1005, 1009, 39 L.Ed.2d 260 (1974). We have previously recognized that actions to disgorge improperly gained profits, *Tull v. United States*, 481 U.S. 412, 424, 107 S.Ct. 1831, 1839, 95 L.Ed.2d 365 (1987), to return funds rightfully belonging to another, *Curtis*, *supra*, 415 U.S., at 197, 94 S.Ct., at 1010, or to submit specific funds wrongfully withheld, *Bowen v. Massachusetts*, 487 U.S. 879, 893-896, 108 S.Ct. 2722, 2731-2733, 101 L.Ed.2d 749 (1988), are all equitable actions even though the relief they seek is monetary—because they are restitutionary in nature. Respondent's action against petitioners is of the same class, seeking a similar remedy.

Here the trustee is simply "ask[ing] the court to act in the public interest by restoring the status quo and ordering the return of that which rightfully belongs" to the estate; "[s]uch action is within . . . the highest tradition of a court of equity." *Porter v. Warner Co.*, 328 U.S. 395, 402, 66 S.Ct. 1086, 1091, 90 L.Ed. 1332 (1946). It should not matter whether respondent is seeking to have returned the precise cashier's checks that petitioner Medex had in its possession at one time, or the funds yielded to Medex by cashing those checks. To turn the case on this distinction would only give entities in Medex's position an incentive to consummate fraudulent transfers as quickly as possible: hardly a desirable one. A host of Bankruptcy Courts have recognized as much. See, *e.g.*, *In re Wencl*, 71 B.R. 879, 883-884, and n. 2 (DC Minn.1987); *In re Reda, Inc.*, 60 B.R. 178, 181 (ND Ill.1986).

10. An irony of the Court's rebuke of Congress is that Congress' decision to include actions to avoid or recover fraudulent conveyances among "core" bankruptcy proceedings found its inspiration in the "Emergency Rule" drafted and issued by the Administrative Office of the United States Courts on December 3, 1982, to govern practice in the bankruptcy courts following our decision in *Northern Pipeline*. See Emergency Rule § d(3)(A) ("Related proceedings do not include . . . proceedings to set aside preferences and

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fraudulent conveyances"); see also *Addison v. O'Leary*, 68 B.R. 487, 491 (ED Va.1986) ("[T]he jurisdictional provisions of the 1984 Bankruptcy Amendments closely parallel the Emergency Reference Rule"); G. Treister, J. Trost, L. Forman, K. Klee, & R. Levin, Fundamentals of Bankruptcy Law § 2.01(a), p. 31 (2d ed. 1988) (describing this portion of the Emergency Rule as the "forerunner" of the 1984 Amendments).

We learn today that, in retrospect, the Emergency Rule, too, was unconstitutional in its failure to include a jury trial right for actions to avoid fraudulent conveyances. It appears that it was not only Congress that failed in its duty to gave adequate "consider[ation] [to] the constitutional implications of its" actions. Cf. *ante*, at 61.

[11] This is particularly unfortunate because today's ruling may be the first time ever that the Court has struck down a congressional designation of a particular cause of action as "equitable" in nature. See Note, Congressional Provision for Nonjury Trials, 83 Yale L.J. 401, 414-415 (1973) ("[T]he Court has never rejected a congressional indication that an action is equitable in nature"); but cf. *Curtis v. Loether, supra* ("re-interpreting" congressional enactment to respond to Seventh Amendment "concerns").

In the past, we have been far more deferential to Congress' designations in this regard. See, *e.g., Mitchell v. Robert DeMario Jewelry, Inc.*, 361 U.S. 288, 290-295, 80 S.Ct. 332, 334-337, 4 L.Ed.2d 323 (1960); *Porter v. Warner, supra*, 328 U.S., at 397-402, 66 S.Ct., at 1088-91.

[12] Such cases decided since *Northern Pipeline*, from the Court of Appeals alone, include *In re Harbour*, 840 F.2d, at 1177-1178; *In re Wood*, 825 F.2d 90, 95-98 (CA5 1987); *In re Mankin*, 823 F.2d 1296, 1307-1308 (CA9 1987), cert. denied *sub nom. Munn v. Duck*, 485 U.S. 1006, 108 S.Ct. 1468, 99 L.Ed.2d 698 (1988); *In re Arnold Print Works*, 815 F.2d 165, 168-170 (CA1 1987); *Briden v. Foley*, 776 F.2d 379, 381 (CA1 1985); and *In re Kaiser*, 722 F.2d 1574, 1580, and n. 2 (CA2 1983). Many more such cases are found in the reports of the decisions of the District Courts and the Bankruptcy Courts.

[13] This is indicative of the Court's approach throughout its opinion: virtually every key holding announced today rests on a citation to scholarly authority, and not to any precedent of the Court. This includes the Court's holdings that the action at issue here was cognizable only at law in 18th-century England, *ante*, at 44; that fraudulent conveyance actions "more nearly resemble state-law contract claims . . . than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res," *ante*, at 56; and that Congress could not eliminate a jury trial right in this sort of action by placing it in "a specialized court of equity," *ante*, at 61—in short, the three critical holdings issued by the Court in its opinion.

Like the Court, I think the analysis of learned commentators is a useful tool to enhance our understanding of the law in a field such as bankruptcy. Unlike the Court, however, I would not use the views of these scholars as *the* basis for disposing of the case before us—particularly where those views counsel rejection of otherwise viable strains in our case law. See, *e.g.*, Gibson, Jury Trials in Bankruptcy, 72 Minn.L.Rev. 967, 1040-1041, n. 347 (1988) (cited *ante*, at 56, n. 11).

[14] Because I do not believe that either petitioner is entitled to a jury trial under the Seventh Amendment, I do not reach the question whether petitioner Granfinanciera is deprived of any Seventh Amendment rights it might otherwise have due to its status as an instrument of a foreign sovereign. Like the Court, I would "leave for another day" the resolution of this difficult question. *Ante*, at 40.

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180 L.Ed.2d 475

**Howard K. STERN, Executor of the Estate of Vickie Lynn Marshall, Petitioner,
v.
Elaine T. MARSHALL, Executrix of the Estate of E. Pierce Marshall.**

No. 10-179.

Supreme Court of the United States

**Argued Jan. 18, 2011.
Decided June 23, 2011.**

Kent L. Richland, Los Angeles, CA, for Petitioner.

Malcolm L. Stewart, for United States as amicus curiae, by special leave of the Court, supporting the Petitioner.

Roy T. Engler, Jr., Washington, DC, for Respondent.

Roy T. Englert, Jr., Robbins, Russell, Englert, Orseck, Untreiner & Sauber LLP, Washington, DC,

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G. Eric Brunstad, Jr., Collin O'Connor Udell, Matthew J. Delude, Dechert LLP, Hartford, CT, Seth P. Waxman, Craig Goldblatt, Danielle Spinelli, Wilmer Cutler Pickering Hale and Dorr, LLP, Washington, DC, Kenneth N. Klee, Daniel J. Bussel, Whitman L. Holt, Klee, Tuchin, Bogdanoff & Stern LLP, Los Angeles, CA, Don Jackson, Ware, Jackson, Lee & Chambers, LLP, Houston, TX, Sanford Svetcov, Robbins Geller Rudman & Dowd LLP, San Francisco, CA, Joseph A. Eisenberg, Julia J. Rider, Jeffer, Mangels, Butler & Marmaro LLP, Los Angeles, CA, for Respondent.

Philip W. Boesch, Jr., The Boesch Law Group, Santa Monica, California, Bruce S. Ross, Vivian L. Thoreen, Holland & Knight LLP, Los Angeles, California, Kent L. Richland, Alan Diamond, Edward L. Xanders, Greines, Martin, Stein & Richland LLP, Los Angeles, California, for Petitioner Howard K. Stern, Executor of the Estate of Vickie Lynn Marshall.

CHIEF JUSTICE ROBERTS delivered the opinion of the Court.

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This "suit has, in course of time, become so complicated, that ... no two ... lawyers can talk about it for five minutes, without coming to a total disagreement as to all the premises. Innumerable children have been born into the cause: innumerable young people have married into it;" and, sadly, the original parties "have died out of it." A "long procession of [judges] has come in and gone out" during that time, and still the suit "drags its weary length before the Court."

Those words were not written about this case, see C. Dickens, Bleak House, in 1 Works of Charles Dickens 4–5 (1891), but they could have been. This is the second time we have had occasion to weigh in on this long-running dispute between Vickie Lynn Marshall and E. Pierce Marshall over the fortune of J. Howard Marshall II, a man believed to have been one of the richest people in Texas. The Marshalls' litigation has worked its way through state and federal courts in Louisiana, Texas, and California, and two of those courts—a Texas state probate court and the Bankruptcy Court for the Central District of California—have reached contrary decisions on its merits. The Court of Appeals below held that the Texas state decision controlled, after concluding that the Bankruptcy Court lacked the authority to enter final judgment on a counterclaim that Vickie brought against

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Pierce in her bankruptcy proceeding.[1] To determine whether the Court of Appeals was correct in that regard, we must resolve two issues: (1) whether the Bankruptcy Court had the statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie's counterclaim;

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and (2) if so, whether conferring that authority on the Bankruptcy Court is constitutional.

Although the history of this litigation is complicated, its resolution ultimately turns on very basic principles. Article III, § 1, of the Constitution commands that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." That Article further provides that the judges of those courts shall hold their offices during good behavior, without diminution of salary. *Ibid.* Those requirements

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of Article III were not honored here. The Bankruptcy Court in this case exercised the judicial power of the United States by entering final judgment on a common law tort claim, even though the judges of such courts enjoy neither tenure during good behavior nor salary protection. We conclude that, although the Bankruptcy Court had the statutory authority to enter judgment on Vickie's counterclaim, it lacked the constitutional authority to do so.

I

Because we have already recounted the facts and procedural history of this case in detail, see *Marshall v. Marshall,* 547 U.S. 293, 300–305, 126 S.Ct. 1735, 164 L.Ed.2d 480 (2006), we do not repeat them in full here. Of current relevance are two claims Vickie filed in an attempt to secure half of J. Howard's fortune. Known to the public as Anna Nicole Smith, Vickie was J. Howard's third wife and married him about a year before his death.

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Id., at 300, 126 S.Ct. 1735; see *In reMarshall,* 392 F.3d 1118, 1122 (C.A.9 2004). Although J. Howard bestowed on Vickie many monetary and other gifts during their courtship and marriage, he did not include her in his will. 547 U.S., at 300, 126 S.Ct. 1735. Before J. Howard passed away, Vickie filed suit in Texas state probate court, asserting that Pierce—J. Howard's younger son—fraudulently induced J. Howard to sign a living trust that did not include her, even though J. Howard meant to give her half his property. Pierce denied any fraudulent activity and defended the validity of J. Howard's trust and, eventually, his will. 392 F.3d, at 1122–1123, 1125.

After J. Howard's death, Vickie filed a petition for bankruptcy in the Central District of California. Pierce filed a complaint in that bankruptcy proceeding, contending that Vickie had defamed him by inducing her lawyers to tell members of the press that he had engaged in fraud to gain control of his father's assets. 547 U.S., at 300–301, 126 S.Ct. 1735; *In re Marshall,* 600 F.3d 1037, 1043–1044 (C.A.9 2010). The complaint sought a declaration that Pierce's defamation claim was not dischargeable in the bankruptcy proceedings. *Ibid.* ; see 11 U.S.C. § 523(a). Pierce subsequently filed a proof of claim for the defamation action, meaning that he sought to recover damages for it from Vickie's bankruptcy estate. See § 501(a). Vickie responded to Pierce's initial complaint by asserting truth as a defense to the alleged defamation and by filing a counterclaim for tortious interference with the gift she expected from J. Howard. As she had in state court, Vickie alleged that Pierce had wrongfully prevented J. Howard from taking the legal steps necessary to provide her with half his property. 547 U.S., at 301, 126 S.Ct. 1735.

On November 5, 1999, the Bankruptcy Court issued an order granting Vickie summary judgment on Pierce's claim for defamation. On September 27, 2000, after a bench trial, the Bankruptcy Court issued a judgment on Vickie's counterclaim in her favor. The court later awarded Vickie over $400 million in compensatory damages and $25 million in punitive

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damages. 600 F.3d, at 1045; see 253 B.R. 550, 561–562 (Bkrtcy.Ct.C.D.Cal.2000) ; 257 B.R. 35, 39–40 (Bkrtcy.Ct.C.D.Cal.2000).

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In post-trial proceedings, Pierce argued that the Bankruptcy Court lacked jurisdiction over Vickie's counterclaim. In particular, Pierce renewed a claim he had made earlier in the litigation, asserting that the Bankruptcy Court's authority over the counterclaim was limited because Vickie's counterclaim was not a "core proceeding" under 28 U.S.C. § 157(b)(2)(C). See 257 B.R., at 39. As explained below, bankruptcy courts may hear and enter final

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judgments in "core proceedings" in a bankruptcy case. In non-core proceedings, the bankruptcy courts instead submit proposed findings of fact and conclusions of law to the district court, for that court's review and issuance of final judgment. The Bankruptcy Court in this case concluded that Vickie's counterclaim was "a core proceeding" under § 157(b)(2)(C), and the court therefore had the "power to enter judgment" on the counterclaim under § 157(b)(1). *Id.*, at 40.

The District Court disagreed. It recognized that "Vickie's counterclaim for tortious interference falls within the literal language" of the statute designating certain proceedings as "core," see § 157(b)(2)(C), but understood this Court's precedent to "suggest[ ] that it would be unconstitutional to hold that any and all counterclaims are core." 264 B.R. 609, 629–630 (C.D.Cal.2001) (citing *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 79, n. 31, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (plurality opinion)). The District Court accordingly concluded that a "counterclaim should not be characterized as core" when it "is only somewhat related to the claim against which it is asserted, and when the unique characteristics and context of the counterclaim place it outside of the normal type of set-off or other counterclaims that customarily arise." 264 B.R., at 632.

Because the District Court concluded that Vickie's counterclaim was not core, the court determined that it was required

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to treat the Bankruptcy Court's judgment as "proposed[,] rather than final," and engage in an " independent review" of the record. *Id.*, at 633; see 28 U.S.C. § 157(c)(1). Although the Texas state court had by that time conducted a jury trial on the merits of the parties' dispute and entered a judgment in Pierce's favor, the District Court declined to give that judgment preclusive effect and went on to decide the matter itself. 271 B.R. 858, 862–867 (C.D.Cal.2001) ; see 275 B.R. 5, 56–58 (C.D.Cal.2002). Like the Bankruptcy Court, the District Court found that Pierce had tortiously interfered with Vickie's expectancy of a gift from J. Howard. The District Court awarded Vickie compensatory and punitive damages, each in the amount of $44,292,767.33. *Id.*, at 58.

The Court of Appeals reversed the District Court on a different ground, 392 F.3d, at 1137, and we—in the first visit of the case to this Court—reversed the Court of Appeals on that issue. 547 U.S., at 314–315, 126 S.Ct. 1735. On remand from this Court, the Court of Appeals held that § 157 mandated "a two-step approach" under which a bankruptcy judge may issue a final judgment in a proceeding only if the matter both "meets Congress' definition of a core proceeding *and* arises under or arises in title 11," the Bankruptcy Code. 600 F.3d, at 1055. The court also reasoned that allowing a bankruptcy judge to enter final judgments on all counterclaims raised in bankruptcy proceedings "would certainly run afoul" of this Court's decision in *Northern Pipeline* . 600 F.3d, at 1057. With those concerns in mind, the court concluded that "a counterclaim under § 157(b)(2)(C) is properly a 'core' proceeding 'arising in a case under' the [Bankruptcy] Code only if the counterclaim is so closely related to [a creditor's] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself." *Id.*, at 1058 (internal quotation marks omitted; second brackets added). The court ruled that Vickie's counterclaim did not meet that test. *Id.*, at 1059. That holding made "the

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Texas probate court's judgment ... the earliest final judgment entered on matters relevant to this proceeding," and therefore the Court of Appeals concluded that the District Court should have "afford[ed]

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preclusive effect" to the Texas "court's determination of relevant legal and factual issues." *Id.*, at 1064–1065.[2]

We again granted certiorari. 561 U.S. -----, 131 S.Ct. 63, 177 L.Ed.2d 1152 (2010).

II

A

With certain exceptions not relevant here, the district courts of the United States have "original and exclusive jurisdiction of all cases under title 11." 28 U.S.C. § 1334(a). Congress has divided bankruptcy proceedings into three categories: those that "aris[e] under title 11"; those that "aris[e] in" a Title 11 case; and those that are "related to a case under title 11." § 157(a). District courts may refer any or all such proceedings to the bankruptcy judges of their district, *ibid.*, which is how the Bankruptcy Court in this case came to preside over Vickie's bankruptcy proceedings. District courts also may withdraw a case or proceeding referred to the bankruptcy court "for cause shown." § 157(d). Since Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the 1984 Act), bankruptcy judges for each district have been appointed to 14-year terms by the courts of appeals for the circuits in which their district is located. § 152(a)(1).

The manner in which a bankruptcy judge may act on a referred matter depends on the type of proceeding involved.

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Bankruptcy judges may hear and enter final judgments in "all core proceedings arising under title 11, or arising in a case under title 11." § 157(b)(1). "Core proceedings include, but are not limited to" 16 different types of matters, including "counterclaims by [a debtor's] estate against persons filing claims against the estate." § 157(b)(2)(C).[3] Parties

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may appeal final

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judgments of a bankruptcy court in core proceedings to the district court, which reviews them under traditional appellate standards. See § 158(a) ; Fed. Rule Bkrtcy. Proc. 8013.

When a bankruptcy judge determines that a referred "proceeding ... is not a core proceeding but ... is otherwise related to a case under title 11," the judge may only "submit proposed findings of fact and conclusions of law to the district court." § 157(c)(1). It is the district court that enters final judgment in such cases after reviewing *de novo* any matter to which a party objects. *Ibid.*

B

Vickie's counterclaim against Pierce for tortious interference is a "core proceeding" under the plain text of § 157(b)(2)(C). That provision specifies that core proceedings include "counterclaims by the estate against persons filing claims against the estate." In past cases, we have suggested that a proceeding's "core" status alone authorizes a bankruptcy judge, as a statutory matter, to enter final judgment in the proceeding. See, *e.g.*, *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 50, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989) (explaining that Congress had designated certain actions as " 'core proceedings,' which bankruptcy judges may adjudicate and in which they may issue final judgments, if a district court has referred the matter to them" (citations omitted)). We have not directly addressed the question, however, and Pierce argues that a bankruptcy judge may enter final judgment on a core proceeding only if that proceeding also "aris[es]

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in" a Title 11 case or "aris[es] under" Title 11 itself. Brief for Respondent 51 (internal quotation marks omitted).

Section 157(b)(1) authorizes bankruptcy courts to "hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11." As written, § 157(b)(1) is ambiguous. The "arising under" and "arising in" phrases might, as Pierce suggests, be read as referring to a limited category of those core proceedings

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that are addressed in that section. On the other hand, the phrases might be read as simply describing what core proceedings are: matters arising under Title 11 or in a Title 11 case. In this case the structure and context of § 157 contradict Pierce's interpretation of § 157(b)(1).

As an initial matter, Pierce's reading of the statute necessarily assumes that there is a category of core proceedings that neither arise under Title 11 nor arise in a Title 11 case. The manner in which the statute delineates the bankruptcy courts' authority, however, makes plain that no such category exists. Section 157(b)(1) authorizes bankruptcy judges to enter final judgments in "core proceedings arising under title 11, or arising in a case under title 11." Section 157(c)(1) instructs bankruptcy judges to instead submit proposed findings in "a proceeding that is not a core proceeding but that is otherwise related to a case under title 11." Nowhere does § 157 specify what bankruptcy courts are to do with respect to the category of matters that Pierce posits—core proceedings that do *not* arise under Title 11 or in a Title 11 case. To the contrary, § 157(b)(3) only instructs a bankruptcy judge to "determine,

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on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11." Two options. The statute does not suggest that any other distinctions need be made.

Under our reading of the statute, core proceedings are those that arise in a bankruptcy case or under Title 11. The detailed list of core proceedings in § 157(b)(2) provides courts with ready examples of such matters. Pierce's reading of § 157, in contrast, supposes that some core proceedings will arise in a Title 11 case or under Title 11 and some will not. Under that reading, the statute provides no guidance on how to tell which are which.

We think it significant that Congress failed to provide any framework for identifying or adjudicating the asserted category of core but not "arising" proceedings, given the otherwise

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detailed provisions governing bankruptcy court authority. It is hard to believe that Congress would go to the trouble of cataloging 16 different types of proceedings that should receive "core" treatment, but then fail to specify how to determine whether those matters arise under Title 11 or in a bankruptcy case if—as Pierce asserts—the latter inquiry is determinative of the bankruptcy court's authority.

Pierce argues that we should treat core matters that arise neither under Title 11 nor in a Title 11 case as proceedings "related to" a Title 11 case. Brief for Respondent 60 (internal quotation marks omitted). We think that a contradiction in terms. It does not make sense to describe a "core" bankruptcy proceeding as merely "related to" the bankruptcy case; oxymoron is not a typical feature of congressional drafting. See *Northern Pipeline,* 458 U.S., at 71, 102 S.Ct. 2858 (plurality opinion) (distinguishing "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, ... from the adjudication of state-created private rights"); Collier on Bankruptcy ¶ 3.02[2], p. 3–26, n. 5 (16th ed. 2010) ("The terms 'non-core' and 'related' are synonymous"); see also *id.,* at 3–26, ("The phraseology of section 157 leads to the

conclusion that there is no such thing as a core matter that is 'related to' a case under title 11. Core proceedings are, at most, those that arise in title 11 cases or arise under title 11" (footnote omitted)). And, as already discussed, the statute simply does not provide for a proceeding that is simultaneously core and yet only related to the bankruptcy case. See § 157(c)(1) (providing only for "a proceeding that is not a core proceeding but that is otherwise related to a case under title 11").

As we explain in Part III, we agree with Pierce that designating all counterclaims as "core" proceedings raises serious constitutional concerns. Pierce is also correct that we will, where possible, construe federal statutes so as "to avoid serious doubt of their constitutionality." *Commodity Futures Trading Comm'n v. Schor,* 478 U.S. 833, 841, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986) (internal

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quotation marks omitted). But that "canon of construction does not give [us] the prerogative to ignore the legislative will in order to avoid constitutional adjudication." *Ibid.* In this case, we do not think the plain text of § 157(b)(2)(C) leaves any room for the canon of avoidance. We would have to "rewrit[e]" the statute, not interpret it, to bypass the constitutional issue § 157(b)(2)(C) presents. *Id.,* at 841, 106 S.Ct. 3245 (internal quotation marks omitted). That we may not do. We agree with Vickie that § 157(b)(2)(C) permits the bankruptcy court to enter a final judgment on her tortious interference counterclaim.

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C

Pierce argues, as another alternative to reaching the constitutional question, that the Bankruptcy Court lacked jurisdiction to enter final judgment on his defamation claim. Section 157(b)(5) provides that "[t]he district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending, or in the district court in the district in which the claim arose." Pierce asserts that his defamation claim is a "personal injury tort," that the Bankruptcy Court therefore had no jurisdiction over that claim, and that the court therefore necessarily lacked jurisdiction over Vickie's counterclaim as well. Brief for Respondent 65–66.

Vickie objects to Pierce's statutory analysis across the board. To begin, Vickie contends that § 157(b)(5) does not address subject matter jurisdiction at all, but simply specifies the venue in which "personal injury tort and wrongful death claims" should be tried. See Reply Brief for Petitioner 16–17, 19; see also Tr. of Oral Arg. 23 (Deputy Solicitor General) (Section "157(b)(5) is in [the United States'] view not jurisdictional"). Given the limited scope of that provision, Vickie argues, a party may waive or forfeit any objections under § 157(b)(5), in the same way that a party may waive or forfeit an objection to the bankruptcy court finally resolving a non-core claim. Reply Brief for Petitioner 17–20;

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see § 157(c)(2) (authorizing the district court, "with the consent of all the parties to the proceeding," to refer a "related to" matter to the bankruptcy court for final judgment). Vickie asserts that in this case Pierce consented to the Bankruptcy Court's adjudication of his defamation claim, and forfeited any argument to the contrary, by failing to seek withdrawal of the claim until he had litigated it before the Bankruptcy Court for 27 months. *Id.,* at 20–23. On the merits, Vickie contends that the statutory phrase "personal injury tort and wrongful death claims" does not include non-physical torts such as defamation. *Id.,* at 25–26.

We need not determine what constitutes a "personal injury tort" in this case because we agree with Vickie that § 157(b)(5) is not jurisdictional, and that Pierce consented to the Bankruptcy Court's resolution of his defamation claim.[4] Because "[b]randing a rule as going to a court's subject-matter jurisdiction alters the normal operation of our adversarial

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system," *Henderson v. Shinseki,* 562 U.S. ----, ---- - ----, 131 S.Ct. 1197, 1201-03, 179 L.Ed.2d 159 (2011), we are not inclined to interpret statutes as creating a jurisdictional bar when they are not framed as such. See generally *Arbaugh v. Y & H Corp.,* 546 U.S. 500, 516, 126 S.Ct. 1235, 163 L.Ed.2d 1097 (2006) ("when Congress does not rank a statutory limitation on coverage as jurisdictional, courts should treat the restriction as nonjurisdictional in character").

Section 157(b)(5) does not have the hallmarks of a jurisdictional decree. To begin, the statutory text does not refer to either district court or bankruptcy court "jurisdiction," instead addressing only where personal injury tort claims "shall be tried."

The statutory context also belies Pierce's jurisdictional claim. Section 157 allocates the authority to enter final judgment between the bankruptcy court and the district court. See §§ 157(b)(1), (c)(1). That allocation does not implicate questions of subject matter jurisdiction. See § 157(c)(2) (parties may consent to entry of final judgment by bankruptcy judge in non-core case). By the same token, § 157(b)(5) simply specifies where a particular category of cases should be tried. Pierce does not explain why that statutory limitation may not be similarly waived.

We agree with Vickie that Pierce not only could but did consent to the Bankruptcy Court's resolution of his defamation claim. Before the Bankruptcy Court, Vickie objected to Pierce's proof of claim for defamation, arguing that Pierce's claim was unenforceable and that Pierce should not receive any amount for it. See 29 Court of Appeals Supplemental Excerpts of Record 6031, 6035 (hereinafter Supplemental Record). Vickie also noted that the Bankruptcy Court could defer ruling on her objection, given the litigation posture of Pierce's claim before the Bankruptcy Court. See *id.,* at 6031. Vickie's filing prompted Pierce to advise the Bankruptcy Court that "[a]ll parties are in agreement that the amount of the contingent Proof of Claim filed by [Pierce] shall be determined by the adversary proceedings" that had

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been commenced in the Bankruptcy Court. 31 Supplemental Record 6801. Pierce asserted that Vickie's objection should be overruled or, alternatively, that any ruling on the objection "should be continued until the resolution of the pending adversary proceeding litigation." *Ibid.* Pierce identifies no point in the record where he argued to the Bankruptcy Court that it lacked the authority to adjudicate his proof of claim because the claim sought recompense for a personal injury tort.

Indeed, Pierce apparently did not object to any court that § 157(b)(5) prohibited the Bankruptcy Court from resolving his defamation claim until over two years—and several adverse discovery rulings—after he filed that claim in June 1996. The first filing Pierce cites as raising that objection is his September 22, 1998 motion to the District Court to withdraw the reference of the case to the Bankruptcy Court. See Brief for Respondent 26-27. The District Court did initially withdraw the reference as requested, but it then returned the proceeding to the Bankruptcy Court, observing that Pierce "implicated the jurisdiction of that bankruptcy court. He chose to be a party to that litigation." App. 129. Although Pierce had objected in July 1996 to the Bankruptcy Court's exercise of jurisdiction over Vickie's counterclaim, he advised the court at that time that he was "happy to litigate [his] claim" there. 29 Supplemental Record 6101. Counsel stated that even though Pierce thought it was "probably cheaper for th[e] estate if [Pierce's claim] were sent back or joined back with the State Court litigation,"

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Pierce "did choose" the Bankruptcy Court forum and "would be more than pleased to do it [t]here." *Id.,* at 6101-6102; see also App. to Pet. for Cert.

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266, n. 17 (District Court referring to these statements).

Given Pierce's course of conduct before the Bankruptcy Court, we conclude that he consented to that court's resolution of his defamation claim (and forfeited any argument to the contrary). We have recognized "the value of waiver and forfeiture rules" in "complex" cases, *Exxon Shipping Co. v.*

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Baker, 554 U.S. 471, 487–488, n. 6, 128 S.Ct. 2605, 171 L.Ed.2d 570 (2008), and this case is no exception. In such cases, as here, the consequences of "a litigant ... 'sandbagging' the court—remaining silent about his objection and belatedly raising the error only if the case does not conclude in his favor," *Puckett v. United States,* 556 U.S. 129, ––––, 129 S.Ct. 1423, 1428–29, 173 L.Ed.2d 266 (2009) (some internal quotation marks omitted)—can be particularly severe. If Pierce believed that the Bankruptcy Court lacked the authority to decide his claim for defamation, then he should have said so—and said so promptly. See *United States v. Olano,* 507 U.S. 725, 731, 113 S.Ct. 1770, 123 L.Ed.2d 508 (1993) (" 'No procedural principle is more familiar to this Court than that a constitutional right,' or a right of any other sort, 'may be forfeited ... by the failure to make timely assertion of the right before a tribunal having jurisdiction to determine it' " (quoting *Yakus v. United States,* 321 U.S. 414, 444, 64 S.Ct. 660, 88 L.Ed. 834 (1944))). Instead, Pierce repeatedly stated to the Bankruptcy Court that he was happy to litigate there. We will not consider his claim to the contrary, now that he is sad.

III

Although we conclude that § 157(b)(2)(C) permits the Bankruptcy Court to enter final judgment on Vickie's counterclaim, Article III of the Constitution does not.

A

Article III, § 1, of the Constitution mandates that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." The same section provides that the judges of those constitutional courts "shall hold their Offices during good Behaviour" and "receive for their Services[ ] a Compensation[ ] [that] shall not be diminished" during their tenure.

As its text and our precedent confirm, Article III is "an inseparable element of the constitutional system of checks

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and balances" that "both defines the power and protects the independence of the Judicial Branch." *Northern Pipeline,* 458 U.S., at 58, 102 S.Ct. 2858 (plurality opinion). Under "the basic concept of separation of powers ... that flow[s] from the scheme of a tripartite government" adopted in the Constitution, "the 'judicial Power of the United States' ... can no more be shared" with another branch than "the Chief Executive, for example, can share with the Judiciary the veto power, or the Congress share with the Judiciary the power to override a Presidential veto." *United States v. Nixon,* 418 U.S. 683, 704, 94 S.Ct. 3090, 41 L.Ed.2d 1039 (1974) (quoting U.S. Const., Art. III, § 1).

In establishing the system of divided power in the Constitution, the Framers considered it essential that "the judiciary remain[ ] truly distinct from both the legislature and the executive." The Federalist No. 78, p. 466 (C. Rossiter ed. 1961) (A. Hamilton). As Hamilton put it, quoting Montesquieu, " 'there is no liberty if the power of judging be not separated from the legislative and executive powers.' "

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Ibid. (quoting 1 Montesquieu, Spirit of Laws 181).

We have recognized that the three branches are not hermetically sealed from one another, see

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Nixon v. Administrator of General Services, 433 U.S. 425, 443, 97 S.Ct. 2777, 53 L.Ed.2d 867 (1977), but it remains true that Article III imposes some basic limitations that the other branches may not transgress. Those limitations serve two related purposes. "Separation-of-powers principles are intended, in part, to protect each branch of government from incursion by the others. Yet the dynamic between and among the branches is not the only object of the Constitution's concern. The structural principles secured by the separation of powers protect the individual as well." *Bond v. United States,* 564 U.S. ----, ----, 131 S.Ct. 2355, ----, 180 L.Ed.2d 269, 2011 WL 2369334, *8 (2011).

Article III protects liberty not only through its role in implementing the separation of powers, but also by specifying the defining characteristics of Article III judges. The colonists had been subjected to judicial abuses at the hand

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of the Crown, and the Framers knew the main reasons why: because the King of Great Britain "made Judges dependent on his Will alone, for the tenure of their offices, and the amount and payment of their salaries." The Declaration of Independence ¶ 11. The Framers undertook in Article III to protect citizens subject to the judicial power of the new Federal Government from a repeat of those abuses. By appointing judges to serve without term limits, and restricting the ability of the other branches to remove judges or diminish their salaries, the Framers sought to ensure that each judicial decision would be rendered, not with an eye toward currying favor with Congress or the Executive, but rather with the "[c]lear heads ... and honest hearts" deemed "essential to good judges." 1 Works of James Wilson 363 (J. Andrews ed. 1896).

Article III could neither serve its purpose in the system of checks and balances nor preserve the integrity of judicial decisionmaking if the other branches of the Federal Government could confer the Government's "judicial Power" on entities outside Article III. That is why we have long recognized that, in general, Congress may not "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee v. Hoboken Land & Improvement Co.,* 59 U.S. 272, 18 How. 272, 284, 15 L.Ed. 372 (1856). When a suit is made of "the stuff of the traditional actions at common law tried by the courts at Westminster in 1789," *Northern Pipeline,* 458 U.S., at 90, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment), and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III courts. The Constitution assigns that job—resolution of "the mundane as well as the glamorous, matters of common law and statute as well as constitutional law, issues of fact as well as issues of law"—to the Judiciary. *Id.,* at 86–87, n. 39, 102 S.Ct. 2858 (plurality opinion).

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B

This is not the first time we have faced an Article III challenge to a bankruptcy court's resolution of a debtor's suit. In *Northern Pipeline,* we considered whether bankruptcy judges serving under the Bankruptcy Act of 1978—appointed by the President and confirmed by the Senate, but lacking the tenure and salary guarantees of Article III —could "constitutionally be vested with jurisdiction to decide [a] state-law contract claim" against an entity

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that was not otherwise part of the bankruptcy proceedings. 458 U.S., at 53, 87, n. 40, 102 S.Ct. 2858 (plurality opinion); see *id.,* at 89–92, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment). The Court concluded that assignment of such state law claims for resolution by those judges "violates Art. III of the Constitution." *Id.,* at 52, 87, 102 S.Ct. 2858 (plurality opinion); *id.,* at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment).

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The plurality in *Northern Pipeline* recognized that there was a category of cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution. That opinion concluded that this "public rights" exception extended "only to matters arising between" individuals and the Government "in connection with the performance of the constitutional functions of the executive or legislative departments ... that historically could have been determined exclusively by those" branches. *Id.*, at 67–68, 102 S.Ct. 2858 (internal quotation marks omitted). A full majority of the Court, while not agreeing on the scope of the exception, concluded that the doctrine did not encompass adjudication of the state law claim at issue in that case. *Id.*, at 69–72, 102 S.Ct. 2858; see *id.*, at 90–91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment) ("None of the [previous cases addressing Article III power] has gone so far as to sanction the type of adjudication to which Marathon will be subjected .... To whatever extent different powers granted under [the 1978] Act might be sustained under the 'public rights' doctrine of *Murray's Lessee* ...

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and succeeding cases, I am satisfied that the adjudication of Northern's lawsuit cannot be so sustained").[5]

A full majority of Justices in *Northern Pipeline* also rejected the debtor's argument that the bankruptcy court's exercise of jurisdiction was constitutional because the bankruptcy judge was acting merely as an adjunct of the district court or court of appeals. *Id.*, at 71–72, 81–86, 102 S.Ct. 2858 (plurality opinion); *id.*, at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment) ("the bankruptcy court is not an 'adjunct' of either the district court or the court of appeals").

After our decision in *Northern Pipeline*, Congress revised the statutes governing bankruptcy jurisdiction and bankruptcy judges. In the 1984 Act, Congress provided that the judges of the new bankruptcy courts would be appointed by the courts of appeals for the circuits in which their districts are located. 28 U.S.C. § 152(a). And, as we have explained, Congress permitted the newly constituted bankruptcy courts to enter final judgments only in "core" proceedings. See*supra*, at 2603 – 2604.

With respect to such "core" matters, however, the bankruptcy courts under the 1984 Act exercise the same powers they wielded under the Bankruptcy Act of 1978 (1978 Act), 92 Stat. 2549. As in *Northern Pipeline*, for example, the newly constituted bankruptcy courts are charged under § 157(b)(2)(C) with resolving "[a]ll matters of fact and law in whatever domains of the law to which" a counterclaim may lead. 458 U.S., at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment); see, *e.g.*, 275 B.R., at 50–51 (noting that Vickie's counterclaim required the bankruptcy court to determine whether Texas recognized a cause of action for tortious interference with an *inter vivos* gift—something the Supreme Court of Texas had yet to do). As in *Northern Pipeline*, the new courts in core proceedings "issue final judgments,

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which are binding and enforceable even in the absence of an appeal." 458 U.S., at 85–86, 102 S.Ct. 2858 (plurality opinion). And, as in *Northern Pipeline*, the district courts review the judgments of the bankruptcy courts in core proceedings only under the usual limited appellate standards. That requires marked deference to, among other things, the bankruptcy judges' findings of fact. See § 158(a) ; Fed. Rule Bkrtcy. Proc. 8013 (findings of fact "shall not be set aside unless clearly erroneous").

C

Vickie and the dissent argue that the Bankruptcy Court's entry of final judgment on her state common law counterclaim was constitutional, despite the similarities between the bankruptcy courts under the 1978 Act and those exercising core jurisdiction under the 1984 Act. We disagree. It is clear that the Bankruptcy Court in this case

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exercised the "judicial Power of the United States" in purporting to resolve and enter final judgment on a state common law claim, just as the court did in *Northern Pipeline* . No "public right" exception excuses the failure to comply with Article III in doing so, any more than in *Northern Pipeline* . Vickie argues that this case is different because the defendant is a creditor in the bankruptcy. But the debtors' claims in the cases on which she relies were themselves federal claims under bankruptcy law, which would be completely resolved in the bankruptcy process of allowing or disallowing claims. Here Vickie's claim is a state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in bankruptcy. *Northern Pipeline* and our subsequent decision in *Granfinanciera,* 492 U.S. 33, 109 S.Ct. 2782, rejected the application of the "public rights" exception in such cases.

Nor can the bankruptcy courts under the 1984 Act be dismissed as mere adjuncts of Article III courts, any more than could the bankruptcy courts under the 1978 Act. The judicial powers the courts exercise in cases such as this remain

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the same, and a court exercising such broad powers is no mere adjunct of anyone.

1

Vickie's counterclaim cannot be deemed a matter of "public right" that can be decided outside the Judicial Branch. As explained above, in *Northern Pipeline* we rejected the argument that the public rights doctrine permitted a bankruptcy court to adjudicate a state law suit brought by a debtor against a company that had not filed a claim against the estate. See 458 U.S., at 69–72, 102 S.Ct. 2858 (plurality opinion); *id.,* at 90–91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment). Although our discussion of the public rights exception since that time has not been entirely consistent, and the exception has been the subject of some debate, this case does not fall within any of the various formulations of the concept that appear in this Court's opinions.

We first recognized the category of public rights in *Murray's Lessee v. Hoboken Land & Improvement Co.,* 59 U.S. 272, 18 How. 272, 15 L.Ed. 372 (1856). That case involved the Treasury Department's sale of property belonging to a customs collector who had failed to transfer payments to the Federal Government that he had collected on its behalf. *Id.,* at 274, 275. The plaintiff, who claimed title to the same land through a different transfer, objected that the Treasury Department's calculation of the deficiency and sale of the property was void, because it was a judicial act that could not be assigned to the Executive under Article III. *Id.,* at 274–275, 282–283.

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"To avoid misconstruction upon so grave a subject," the Court laid out the principles guiding its analysis. *Id.,* at 284. It confirmed that Congress cannot "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Ibid.* The Court also recognized that "[a]t the same time there are matters, involving public rights, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination,

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but which congress may or may not bring within the cognizance of the courts of the United States, as it may deem proper." *Ibid.*

As an example of such matters, the Court referred to "[e]quitable claims to land by the inhabitants of ceded territories" and cited cases in which land issues were conclusively resolved by Executive Branch officials. *Ibid.* (citing *Foley v. Harrison,* 56 U.S. 433, 15 How. 433, 14 L.Ed. 761 (1854) ; *Burgess v. Gray,* 57 U.S. 48, 16 How. 48, 14 L.Ed. 839 (1854)). In those cases "it depends upon the will of congress whether a remedy in the courts

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shall be allowed at all," so Congress could limit the extent to which a judicial forum was available. *Murray's Lessee*, 18 How., at 284. The challenge in *Murray's Lessee* to the Treasury Department's sale of the collector's land likewise fell within the "public rights" category of cases, because it could only be brought if the Federal Government chose to allow it by waiving sovereign immunity. *Id.*, at 283–284. The point of *Murray's Lessee* was simply that Congress may set the terms of adjudicating a suit when the suit could not otherwise proceed at all.

Subsequent decisions from this Court contrasted cases within the reach of the public rights exception—those arising "between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments"—and those that were instead matters "of private right, that is, of the liability of one individual to another under the law as defined." *Crowell v. Benson*, 285 U.S. 22, 50, 51, 52 S.Ct. 285, 76 L.Ed. 598 (1932).[6] See

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Atlas Roofing Co. v. Occupational Safety

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and Health Review Comm'n, 430 U.S. 442, 458, 97 S.Ct. 1261, 51 L.Ed.2d 464 (1977) (Exception extends to cases "where the Government is involved in its sovereign capacity under ... [a] statute creating enforceable public rights," while "[w]holly private tort, contract, and property cases, as well as a vast range of other cases ... are not at all implicated"); *Ex parte Bakelite Corp.*, 279 U.S. 438, 451–452, 49 S.Ct. 411, 73 L.Ed. 789 (1929). See also *Northern Pipeline, supra*, at 68, 102 S.Ct. 2858 (plurality opinion) (citing *Ex parte Bakelite Corp.* for the proposition that the doctrine extended " only to matters that historically could have been determined exclusively by" the Executive and Legislative Branches).

Shortly after *Northern Pipeline*, the Court rejected the limitation of the public rights exception to actions involving the Government as a party. The Court has continued, however, to limit the exception to cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority. In other words, it is still the case that what makes a right "public" rather than private is that the right is integrally related to particular federal government

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action. See *United States v. Jicarilla Apache Nation*, 564 U.S. ––––, ––––––––, 131 S.Ct. 2313, 180 L.Ed.2d 187, 2011 WL 2297786, *8–9 (2011) ("The distinction between 'public rights' against the Government and 'private rights' between private parties is well established," citing *Murray's Lessee* and *Crowell*).

Our decision in *Thomas v. Union Carbide Agricultural Products Co.*, for example, involved a data-sharing arrangement between companies under a federal statute providing that disputes about compensation between the companies would be decided by binding arbitration. 473 U.S. 568, 571–575, 105 S.Ct. 3325, 87 L.Ed.2d 409 (1985). This Court held that the scheme did not violate Article III, explaining that "[a]ny right to compensation ... results from [the statute] and does not depend on or replace a right to such compensation under state law." *Id.*, at 584, 105 S.Ct. 3325.

Commodity Futures Trading Commission v. Schor concerned a statutory scheme that created a procedure for customers injured by a broker's violation of the federal commodities law to seek reparations from the broker before the Commodity Futures Trading Commission (CFTC). 478 U.S. 833, 836, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986). A customer filed such a claim to recover a debit balance in his account, while the broker filed a lawsuit in Federal District Court to recover the same amount as lawfully due from the

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customer. The broker later submitted its claim to the CFTC, but after that agency ruled against the customer, the customer argued that agency jurisdiction over the broker's counterclaim violated Article III. *Id.*, at 837–838, 106 S.Ct. 3245. This Court disagreed, but only after observing that (1) the claim and the counterclaim concerned a "single dispute"—the same account balance; (2) the CFTC's assertion of authority involved only "a narrow class of common law claims" in a " 'particularized area of law' "; (3) the area of law in question was governed by "a specific and limited federal regulatory scheme" as to which the agency had "obvious expertise"; (4) the parties had freely elected to resolve their differences before the CFTC; and (5) CFTC orders were "enforceable only by order of the district court." *Id.*, at 844, 852–855, 106 S.Ct. 3245 (quoting *Northern Pipeline*, 458 U.S., at 85, 102 S.Ct. 2858); see

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478 U.S., at 843–844; 849–857, 106 S.Ct. 3245. Most significantly,

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given that the customer's reparations claim before the agency and the broker's counterclaim were competing claims to the same amount, the Court repeatedly emphasized that it was "necessary" to allow the agency to exercise jurisdiction over the broker's claim, or else "the reparations procedure would have been confounded." *Id.*, at 856, 106 S.Ct. 3245.

The most recent case in which we considered application of the public rights exception—and the only case in which we have considered that doctrine in the bankruptcy context since *Northern Pipeline* —is *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989). In *Granfinanciera* we rejected a bankruptcy trustee's argument that a fraudulent conveyance action filed on behalf of a bankruptcy estate against a noncreditor in a bankruptcy proceeding fell within the "public rights" exception. We explained that, "[i]f a statutory right is not closely intertwined with a federal regulatory program Congress has power to enact, and if that right neither belongs to nor exists against the Federal Government, then it must be adjudicated by an Article III court." *Id.*, at 54–55, 109 S.Ct. 2782. We reasoned that fraudulent conveyance suits were "quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Id.*, at 56, 109 S.Ct. 2782. As a consequence, we concluded that fraudulent conveyance actions were "more accurately characterized as a private rather than a public right as we have used those terms in our Article III decisions." *Id.*, at 55, 109 S.Ct. 2782.[7]

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Vickie's counterclaim—like the fraudulent conveyance claim at issue in *Granfinanciera* — does not fall within any of the varied formulations of the public rights exception in this Court's cases. It is not a matter that can be pursued only by grace of the other branches, as in *Murray's Lessee*, 18 How., at 284, or one that "historically could have been determined exclusively by" those branches, *Northern Pipeline, supra*, at 68, 102 S.Ct. 2858 (citing *Ex parte Bakelite Corp.*, 279 U.S., at 458, 49 S.Ct. 411). The claim is instead one under state common law between two private parties. It does not "depend[ ] on the will of congress," *Murray's Lessee, supra*, at 284; Congress has nothing to do with it.

In addition, Vickie's claimed right to relief does not flow from a federal statutory scheme, as in *Thomas*, 473 U.S., at 584–585, 105 S.Ct. 3325, or *Atlas Roofing*, 430 U.S., at 458, 97 S.Ct. 1261. It is not "completely dependent upon" adjudication of a claim created by federal law, as in *Schor*, 478 U.S., at 856, 106 S.Ct. 3245. And in contrast to the objecting party in *Schor*, *id.*, at 855–856, 106 S.Ct. 3245, Pierce did not truly consent to resolution of Vickie's claim in the bankruptcy court proceedings. He had nowhere else to go if he wished to recover from Vickie's estate. See

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Granfinanciera, supra, at 59, n. 14, 109 S.Ct. 2782 (noting that "[p]arallel reasoning [to *Schor*] is unavailable in the context of bankruptcy proceedings, because creditors lack an alternative forum

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to the bankruptcy court in which to pursue their claims").[8]

Furthermore, the asserted authority to decide Vickie's claim is not limited to a "particularized area of the law," as in *Crowell,Thomas,* and *Schor* . *Northern Pipeline,* 458 U.S., at 85, 102 S.Ct. 2858 (plurality opinion). We deal here not with an

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agency but with a court, with substantive jurisdiction reaching any area of the *corpus juris* . See *ibid.* ; *id.,* at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment). This is not a situation in which Congress devised an "expert and inexpensive method for dealing with a class of questions of fact which are particularly suited to examination and determination by an administrative agency specially assigned to that task." *Crowell,* 285 U.S., at 46, 52 S.Ct. 285; see *Schor,supra,* at 855–856, 106 S.Ct. 3245. The " experts" in the federal system at resolving common law counterclaims such as Vickie's are the Article III courts, and it is with those courts that her claim must stay.

The dissent reads our cases differently, and in particular contends that more recent cases view *Northern Pipeline* as " 'establish[ing] only that Congress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, without consent of the litigants, and subject only to ordinary appellate review.' " *Post,* at 2624 (quoting *Thomas, supra,* at 584, 105 S.Ct. 3325). Just so: Substitute "tort" for "contract," and that statement directly covers this case.

We recognize that there may be instances in which the distinction between public and private rights—at least as framed by some of our recent cases—fails to provide concrete guidance as to whether, for example, a particular agency can adjudicate legal issues under a substantive regulatory scheme. Given the extent to which this case is so markedly distinct from the agency cases discussing the public rights exception in the context of such a regime, however, we do not in this opinion express any view on how the doctrine might apply in that different context.

What is plain here is that this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment *by a court* with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime.

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If such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous " public right," then Article III would be transformed from the guardian of individual liberty and separation of powers we have long recognized into mere wishful thinking.

2

Vickie and the dissent next attempt to distinguish *Northern Pipeline* and *Granfinanciera* on the ground that Pierce, unlike the defendants in those cases, had filed a proof of claim in the bankruptcy proceedings. Given Pierce's participation in those proceedings, Vickie argues, the Bankruptcy

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Court had the authority to adjudicate her counterclaim under our decisions in *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), and *Langenkamp v. Culp,* 498 U.S. 42, 111 S.Ct. 330, 112 L.Ed.2d 343 (1990) (*per curiam*).

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We do not agree. As an initial matter, it is hard to see why Pierce's decision to file a claim should make any difference with respect to the characterization of Vickie's counterclaim. " '[P]roperty interests are created and defined by state law,' and '[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.' " *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.,* 549 U.S. 443, 451, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007) (quoting *Butner v. United States,* 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979)). Pierce's claim for defamation in no way affects the nature of Vickie's counterclaim for tortious interference as one at common law that simply attempts to augment the bankruptcy estate—the very type of claim that we held in *Northern Pipeline* and *Granfinanciera* must be decided by an Article III court.

Contrary to Vickie's contention, moreover, our decisions in *Katchen* and *Langenkamp* do not suggest a different result. *Katchen* permitted a bankruptcy referee acting under the Bankruptcy Acts of 1898 and 1938 (akin to a bankruptcy court today) to exercise what was known as "summary jurisdiction"

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over a voidable preference claim brought by the bankruptcy trustee against a creditor who had filed a proof of claim in the bankruptcy proceeding. See 382 U.S., at 325, 327–328, 86 S.Ct. 467. A voidable preference claim asserts that a debtor made a payment to a particular creditor in anticipation of bankruptcy, to in effect increase that creditor's proportionate share of the estate. The preferred creditor's claim in bankruptcy can be disallowed as a result of the preference, and the amounts paid to that creditor can be recovered by the trustee. See *id.,* at 330, 86 S.Ct. 467; see also 11 U.S.C. §§ 502(d), 547(b).

Although the creditor in *Katchen* objected that the preference issue should be resolved through a "plenary suit" in an Article III court, this Court concluded that summary adjudication in bankruptcy was appropriate, because it was not possible for the referee to rule on the creditor's proof of claim without first resolving the voidable preference issue. 382 U.S., at 329–330, 332–333, and n. 9, 334, 86 S.Ct. 467. There was no question that the bankruptcy referee could decide whether there had been a voidable preference in determining whether and to what extent to allow the creditor's claim. Once the referee did that, "nothing remains for adjudication in a plenary suit"; such a suit "would be a meaningless gesture." *Id.,* at 334, 86 S.Ct. 467. The plenary proceeding the creditor sought could be brought into the bankruptcy court because "the same issue [arose] as part of the process of allowance and disallowance of claims." *Id.,* at 336, 86 S.Ct. 467.

It was in that sense that the Court stated that "he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide the consequences of that procedure." *Id.,* at 333, n. 9, 86 S.Ct. 467. In *Katchen* one of those consequences was resolution of the preference issue as part of the process of allowing or disallowing claims, and accordingly there was no basis for the creditor to insist that the issue be resolved in an Article III court. See *id.,* at 334, 86 S.Ct. 467. Indeed, the *Katchen* Court expressly noted that it "intimate[d] no opinion concerning whether" the bankruptcy

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referee would have had "summary jurisdiction to adjudicate a demand by the [bankruptcy] trustee for affirmative relief, all of the substantial factual and legal bases for which ha[d] not been disposed of in passing on objections to the [creditor's proof of] claim." *Id.,* at 333, n. 9, 86 S.Ct. 467.

Our *per curiam* opinion in *Langenkamp* is to the same effect. We explained there that a preferential transfer claim can be heard in bankruptcy when the allegedly favored creditor has filed a claim, because *then* "the ensuing

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preference action by the trustee become[s] integral to the restructuring of the debtor-creditor relationship." 498 U.S., at 44, 111 S.Ct. 330. If, in contrast, the creditor has not filed a proof of claim, the trustee's preference action does *not* "become[ ] part of the claims-allowance process" subject to resolution by the bankruptcy court. *Ibid.* ; see *id.,* at 45, 111 S.Ct. 330.

In ruling on Vickie's counterclaim, the Bankruptcy Court was required to and did make several factual and legal determinations that were not "disposed of in passing on objections" to Pierce's proof of claim for defamation, which the court had denied almost a year earlier. *Katchen, supra,* at 332, n. 9., 86 S.Ct. 467 There was some overlap between Vickie's counterclaim and Pierce's defamation claim that led the courts below to conclude that the counterclaim was compulsory, 600 F.3d, at 1057, or at least in an "attenuated" sense related to Pierce's claim, 264 B.R., at 631. But there was never any reason to believe that the process of adjudicating Pierce's proof of claim would necessarily resolve Vickie's counterclaim. See *id.,* at 631, 632 (explaining that "the primary facts at issue on Pierce's claim were the relationship between Vickie and her attorneys and her knowledge or approval of their statements," and "the counterclaim raises issues of law entirely different from those raise[d] on the defamation claim"). The United States acknowledges the point. See Brief for United States as *Amicus Curiae,* p. (I) (question presented concerns authority of a bankruptcy court to enter final judgment on a compulsory counterclaim "when adjudication

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of the counterclaim requires resolution of issues that are not implicated by the claim against the estate"); *id.,* at 26.

The only overlap between the two claims in this case was the question whether Pierce had in fact tortiously taken control of his father's estate in the manner alleged by Vickie in her counterclaim and described in the allegedly defamatory statements. From the outset, it was clear that, even assuming the Bankruptcy Court would (as it did) rule in Vickie's favor on that question, the court could not enter judgment for Vickie unless the court additionally ruled on the questions whether Texas recognized tortious interference with an expected gift as a valid cause of action, what the elements of that action were, and whether those elements were met in this case. 275 B.R., at 50–53. Assuming Texas accepted the elements adopted by other jurisdictions, that meant Vickie would need to prove, above and beyond Pierce's tortious interference, (1) the existence of an expectancy of a gift; (2) a reasonable certainty that the expectancy would have been realized but for the interference; and (3) damages. *Id.,* at 51; see 253 B.R., at 558–561. Also, because Vickie sought punitive damages in connection with her counterclaim, the Bankruptcy Court could not finally dispose of the case in Vickie's favor without determining whether to subject Pierce to the sort of "retribution," "punishment[,] and deterrence," *Exxon Shipping Co.,* 554 U.S., at 492, 504, 128 S.Ct. 2605 (internal quotation marks omitted), those damages are designed to impose. There thus was never reason to believe that the process of ruling

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on Pierce's proof of claim would necessarily result in the resolution of Vickie's counterclaim.

In both *Katchen* and *Langenkamp,* moreover, the trustee bringing the preference action was asserting a right of recovery created by federal bankruptcy law. In *Langenkamp* , we noted that "the trustee instituted adversary proceedings under 11 U.S.C. § 547(b) to recover, as avoidable preferences," payments respondents received from the debtor before the bankruptcy filings. 498 U.S., at 43, 111 S.Ct. 330; see,

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e.g., § 547(b)(1) ("the trustee may avoid any transfer of an interest of the debtor in property—(1) to or for the benefit of a creditor"). In *Katchen,* " [t]he Trustee ... [asserted] that the payments made [to the creditor] were preferences inhibited

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by Section 60a of the Bankruptcy Act." Memorandum Opinion (Feb. 8, 1963), Tr. of Record in O.T.1965, No. 28, p. 3; see 382 U.S., at 334, 86 S.Ct. 467 (considering impact of the claims allowance process on "action by the trustee under § 60 to recover the preference"); 11 U.S.C. § 96(b) (1964 ed.) (§ 60(b) of the then-applicable Bankruptcy Act) ("preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby ... has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent"). Vickie's claim, in contrast, is in no way derived from or dependent upon bankruptcy law; it is a state tort action that exists without regard to any bankruptcy proceeding.

In light of all the foregoing, we disagree with the dissent that there are no "relevant distinction[s]" between Pierce's claim in this case and the claim at issue in *Langenkamp Post*, at 2628. We see no reason to treat Vickie's counterclaim any differently from the fraudulent conveyance action in *Granfinanciera* . 492 U.S., at 56, 109 S.Ct. 2782. *Granfinanciera* 's distinction between actions that seek "to augment the bankruptcy estate" and those that seek "a pro rata share of the bankruptcy res," *ibid.*, reaffirms that Congress may not bypass Article III simply because a proceeding may have *some* bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process. Vickie has failed to demonstrate that her counterclaim falls within one of the "limited circumstances" covered by the public rights exception, particularly given our conclusion that, "even with respect to matters that arguably fall within the scope of the 'public rights' doctrine, the presumption is in favor of Art. III courts." *Northern Pipeline*, 458 U.S., at 69, n. 23, 77, n. 29, 102 S.Ct. 2858 (plurality opinion).

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3

Vickie additionally argues that the Bankruptcy Court's final judgment was constitutional because bankruptcy courts under the 1984 Act are properly deemed "adjuncts" of the district courts. Brief for Petitioner 61–64. We rejected a similar argument in *Northern Pipeline*, see 458 U.S., at 84–86, 102 S.Ct. 2858 (plurality opinion); *id.*, at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment), and our reasoning there holds true today.

To begin, as explained above, it is still the bankruptcy court itself that exercises the essential attributes of judicial power over a matter such as Vickie's counterclaim. See *supra*, at 2610. The new bankruptcy courts, like the old, do not "ma[k]e only specialized, narrowly confined factual determinations regarding a particularized area of law" or engage in "statutorily channeled factfinding functions." *Northern Pipeline*, 458 U.S., at 85, 102 S.Ct. 2858 (plurality opinion). Instead, bankruptcy courts under the 1984 Act resolve

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"[a]ll matters of fact and law in whatever domains of the law to which" the parties' counterclaims might lead. *Id.*, at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment).

In addition, whereas the adjunct agency in *Crowell v. Benson* "possessed only a limited power to issue compensation orders ... [that] could be enforced only by order of the district court," *Northern Pipeline, supra*, at 85, 102 S.Ct. 2858, a bankruptcy court resolving a counterclaim under 28 U.S.C. § 157(b)(2)(C) has the power to enter "appropriate orders and judgments"—including final judgments—subject to review only if a party chooses to appeal, see §§ 157(b)(1), 158(a) - (b). It is thus no less the case here than it was in *Northern Pipeline* that "[t]he authority—and the responsibility—to make an informed, final determination ... remains with" the bankruptcy judge, not the district court. 458 U.S., at 81, 102 S.Ct. 2858 (plurality opinion) (internal quotation marks omitted). Given that authority, a bankruptcy court can no more be

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deemed a mere "adjunct" of the district court than a district court can be deemed such an "adjunct" of the court of appeals. We certainly

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cannot accept the dissent's notion that judges who have the power to enter final, binding orders are the "functional [ ]" equivalent of "law clerks[ ] and the Judiciary's administrative officials." *Post,* at 2627. And even were we wrong in this regard, that would only confirm that such judges should not be in the business of entering final judgments in the first place.

It does not affect our analysis that, as Vickie notes, bankruptcy judges under the current Act are appointed by the Article III courts, rather than the President. See Brief for Petitioner 59. If—as we have concluded—the bankruptcy court itself exercises "the essential attributes of judicial power [that] are reserved to Article III courts," *Schor,* 478 U.S., at 851, 106 S.Ct. 3245 (internal quotation marks omitted), it does not matter who appointed the bankruptcy judge or authorized the judge to render final judgments in such proceedings. The constitutional bar remains. See The Federalist No. 78, at 471 ("Periodical appointments, however regulated, or by whomsoever made, would, in some way or other, be fatal to [a judge's] necessary independence").

D

Finally, Vickie and her *amici* predict as a practical matter that restrictions on a bankruptcy court's ability to hear and finally resolve compulsory counterclaims will create significant delays and impose additional costs on the bankruptcy process. See, *e.g.,* Brief for Petitioner 34–36, 57–58; Brief for United States as *Amicus Curiae* 29–30. It goes without saying that "the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution." *INS v. Chadha,* 462 U.S. 919, 944, 103 S.Ct. 2764, 77 L.Ed.2d 317 (1983).

In addition, we are not convinced that the practical consequences of such limitations on the authority of bankruptcy courts to enter final judgments are as significant as Vickie and the dissent suggest. See *post,* at 2630. The dissent

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asserts that it is important that counterclaims such as Vickie's be resolved "in a bankruptcy court," and that, "to be effective, a single tribunal must have broad authority to restructure [debtor-creditor] relations." *Post,* at 2628, 2629 (emphasis deleted). But the framework Congress adopted in the 1984 Act already contemplates that certain state law matters in bankruptcy cases will be resolved by judges other than those of the bankruptcy courts.

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Section 1334(c)(2), for example, requires that bankruptcy courts abstain from hearing specified non-core, state law claims that "can be timely adjudicated[ ] in a State forum of appropriate jurisdiction." Section 1334(c)(1) similarly provides that bankruptcy courts may abstain from hearing any proceeding, including core matters, "in the interest of comity with State courts or respect for State law."

As described above, the current bankruptcy system also requires the district court to review *de novo* and enter final judgment on any matters that are "related to" the bankruptcy proceedings, § 157(c)(1), and permits the district court to withdraw from the bankruptcy court any referred case, proceeding, or part thereof, § 157(d). Pierce has not argued that the bankruptcy courts "are barred from 'hearing' all counterclaims" or proposing findings of fact and conclusions of law on those matters, but rather that it must be the district court that "finally decide[s]" them. Brief for Respondent 61. We do not think the removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute; we agree with the United States that the question presented

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here is a "narrow" one. Brief for United States as *Amicus Curiae* 23.

If our decision today does not change all that much, then why the fuss? Is there really a threat to the separation of powers where Congress has conferred the judicial power outside Article III only over certain counterclaims in bankruptcy? The short but emphatic answer is yes. A statute

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may no more lawfully chip away at the authority of the Judicial Branch than it may eliminate it entirely. "Slight encroachments create new boundaries from which legions of power can seek new territory to capture." *Reid v. Covert,* 354 U.S. 1, 39, 77 S.Ct. 1222, 1 L.Ed.2d 1148 (1957) (plurality opinion). Although "[i]t may be that it is the obnoxious thing in its mildest and least repulsive form," we cannot overlook the intrusion: "illegitimate and unconstitutional practices get their first footing in that way, namely, by silent approaches and slight deviations from legal modes of procedure." *Boyd v. United States,* 116 U.S. 616, 635, 6 S.Ct. 524, 29 L.Ed. 746 (1886). We cannot compromise the integrity of the system of separated powers and the role of the Judiciary in that system, even with respect to challenges that may seem innocuous at first blush.

* * *

Article III of the Constitution provides that the judicial power of the United States may be vested only in courts whose judges enjoy the protections set forth in that Article. We conclude today that Congress, in one isolated respect, exceeded that limitation in the Bankruptcy Act of 1984. The Bankruptcy Court below lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim. Accordingly, the judgment of the Court of Appeals is affirmed.

It is so ordered.

Justice SCALIA, concurring.

I agree with the Court's interpretation of our Article III precedents, and I accordingly join its opinion. I adhere to my view, however, that—our contrary precedents notwithstanding—"a matter of public rights ... must at a minimum arise between the government and others," *Granfinanciera, S.A. v. Nordberg,* 492 U.S. 33, 65, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989) (SCALIA, J., concurring in part and concurring in judgment) (internal quotation marks omitted).

[131 S.Ct. 2621]

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The sheer surfeit of factors that the Court was required to consider in this case should arouse the suspicion that something is seriously amiss with our jurisprudence in this area. I count at least seven different reasons given in the Court's opinion for concluding that an Article III judge was required to adjudicate this lawsuit: that it was one "under state common law" which was "not a matter that can be pursued only by grace of the other branches," *ante,* at 2614; that it was "not 'completely dependent upon' adjudication of a claim created by federal law," *ibid.;* that " Pierce did not truly consent to resolution of Vickie's claim in the bankruptcy court proceedings," *ibid.;* that "the asserted authority to decide Vickie's claim is not limited to a 'particularized area of the law,' " *ante,* at 2615; that "there was never any reason to believe that the process of adjudicating Pierce's proof of claim would necessarily resolve Vickie's counterclaim," *ante,* at 2617; that the trustee was not "asserting a right of recovery created by federal bankruptcy law," *ante,* at 2618; and that the Bankruptcy Judge "ha[d] the power to enter 'appropriate orders and judgments'—including final judgments—subject to review only if a party chooses to appeal," *ante,* at 2619.

Apart from their sheer numerosity, the more fundamental flaw in the many tests suggested by our jurisprudence is that they have nothing to do with the text or tradition of Article III. For example, Article III gives no indication that state-law claims have preferential entitlement to an Article III judge; nor does it make pertinent the

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extent to which the area of the law is "particularized." The multifactors relied upon today seem to have entered our jurisprudence almost randomly.

Leaving aside certain adjudications by federal administrative agencies, which are governed (for better or worse) by our landmark decision in *Crowell v. Benson,* 285 U.S. 22, 52 S.Ct. 285, 76 L.Ed. 598 (1932), in my view an Article III judge is required in *all* federal adjudications, unless there is a firmly established historical

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practice to the contrary. For that reason—and not because of some intuitive balancing of benefits and harms—I agree that Article III judges are not required in the context of territorial courts, courts-martial, or true "public rights" cases. See *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 71, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (plurality opinion). Perhaps historical practice permits non-Article III judges to process claims against the bankruptcy estate, see, *e.g.,* Plank, Why Bankruptcy Judges Need Not and Should Not Be Article III Judges, 72 Am. Bankr.L.J. 567, 607–609 (1998) ; the subject has not been briefed, and so I state no position on the matter. But Vickie points to no historical practice that authorizes a non-Article III judge to adjudicate a counterclaim of the sort at issue here.

Justice BREYER, with whom Justice GINSBURG, Justice SOTOMAYOR, and Justice KAGAN, join dissenting.

Pierce Marshall filed a claim in Federal Bankruptcy Court against the estate of Vickie Marshall. His claim asserted that Vickie Marshall had, through her lawyers, accused him of trying to prevent her from obtaining money that his father had wanted her to have; that her accusations violated state defamation law; and that she consequently owed Pierce Marshall damages. Vickie Marshall filed a compulsory counterclaim in which she asserted that Pierce Marshall had unlawfully interfered with her husband's efforts to grant her an *inter vivos* gift and that he consequently owed her damages.

The Bankruptcy Court adjudicated the claim and the counterclaim. In doing so,

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the court followed statutory procedures applicable to "core" bankruptcy proceedings. See 28 U.S.C. § 157(b). And ultimately the Bankruptcy Court entered judgment in favor of Vickie Marshall. The question before us is whether the Bankruptcy Court possessed jurisdiction to adjudicate Vickie Marshall's counterclaim. I agree with the Court that the bankruptcy statute,

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§ 157(b)(2)(C), authorizes a bankruptcy court to adjudicate the counterclaim. But I do not agree with the majority about the statute's constitutionality. I believe the statute is consistent with the Constitution's delegation of the "judicial Power of the United States" to the Judicial Branch of Government. Art. III, § 1. Consequently, it is constitutional.

I

My disagreement with the majority's conclusion stems in part from my disagreement about the way in which it interprets, or at least emphasizes, certain precedents. In my view, the majority overstates the current relevance of statements this Court made in an 1856 case, *Murray's Lessee v. Hoboken Land & Improvement Co.,* 59 U.S. 272, 18 How. 272, 15 L.Ed. 372 (1856), and it overstates the importance of an analysis that did not command a Court majority in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), and that was subsequently disavowed. At the same time, I fear the Court understates the importance of a watershed opinion widely thought to demonstrate the constitutional basis for the current authority of administrative agencies to adjudicate private disputes, namely, *Crowell v. Benson,* 285 U.S. 22, 52 S.Ct. 285, 76

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L.Ed. 598 (1932). And it fails to follow the analysis that this Court more recently has held applicable to the evaluation of claims of a kind before us here, namely, claims that a congressional delegation of adjudicatory authority violates separation-of-powers principles derived from Article III. See *Thomas v. Union Carbide Agricultural Products Co.*, 473 U.S. 568, 105 S.Ct. 3325, 87 L.Ed.2d 409 (1985) ; *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986).

I shall describe these cases in some detail in order to explain why I believe we should put less weight than does the majority upon the statement in *Murray's Lessee* and the analysis followed by the *Northern Pipeline* plurality and instead should apply the approach this Court has applied in *Crowell,Thomas,* and *Schor* .

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A

In *Murray's Lessee* , the Court held that the Constitution permitted an executive official, through summary, nonjudicial proceedings, to attach the assets of a customs collector whose account was deficient. The Court found evidence in common law of "summary method[s] for the recovery of debts due to the crown, and especially those due from receivers of the revenues," 18 How., at 277, and it analogized the Government's summary attachment process to the kind of self-help remedies available to private parties, *id* ., at 283. In the course of its opinion, the Court wrote:

> "[W]e do not consider congress can either withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty; nor, on the other hand, can it bring under the judicial power a matter which, from its nature, is not a subject for judicial determination. At the same time there are matters, involving public rights, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination, but which congress may or may not bring within the cognizance of

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> the courts of the United States, as it may deem proper." *Id.*, at 284.

The majority reads the first part of the statement's first sentence as authoritatively defining the boundaries of Article III. *Ante,* at 2609. I would read the statement in a less absolute way. For one thing, the statement is in effect dictum. For another, it is the remainder of the statement, announcing a distinction between "public rights" and "private rights," that has had the more lasting impact. Later Courts have seized on that distinction when *upholding* non- Article III adjudication, not when striking it down. See *Ex parte Bakelite Corp.*, 279 U.S. 438, 451–452, 49 S.Ct. 411, 73 L.Ed. 789 (1929) (Court of Customs Appeals); *Williams v. United States,* 289 U.S. 553, 579–580, 53 S.Ct. 751, 77 L.Ed. 1372 (1933) (Court of Claims). The one exception is *Northern*

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Pipeline, where the Court struck down the Bankruptcy Act of 1978. But in that case there was no majority. And a plurality, not a majority, read the statement roughly in the way the Court does today. See 458 U.S., at 67–70, 102 S.Ct. 2858.

B

At the same time, I believe the majority places insufficient weight on *Crowell,* a seminal case that clarified the scope of the dictum in *Murray's Lessee* . In that case, the Court considered whether Congress could grant to an Article I administrative agency the power to adjudicate an employee's workers' compensation claim against his employer. The Court assumed that an Article III court would review the agency's decision *de*

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novo in respect to questions of law but it would conduct a less searching review (looking to see only if the agency's award was "supported by evidence in the record") in respect to questions of fact. *Crowell,* 285 U.S., at 48–50, 52 S.Ct. 285. The Court pointed out that the case involved a dispute between private persons (a matter of "private rights") and (with one exception not relevant here) it upheld Congress' delegation of primary factfinding authority to the agency.

Justice Brandeis, dissenting (from a here-irrelvant portion of the Court's holding), wrote that the adjudicatory scheme raised only a due process question: When does due process require decision by an Article III judge? He answered that question by finding constitutional the statute's delegation of adjudicatory authority to an agency. *Id.,* at 87, 52 S.Ct. 285.

Crowell has been hailed as "the greatest of the cases validating administrative adjudication." Bator, The Constitution as Architecture: Legislative and Administrative Courts Under Article III, 65 Ind. L.J. 233, 251 (1990). Yet, in a footnote, the majority distinguishes *Crowell* as a case in which the Court upheld the delegation of adjudicatory authority to an administrative agency simply because the agency's power to make the "specialized, narrowly confined

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factual determinations" at issue arising in a "particularized area of law," made the agency a "true 'adjunct' of the District Court." *Ante,* at 2612, n. 6. Were *Crowell'* s holding as narrow as the majority suggests, one could question the validity of Congress' delegation of authority to adjudicate disputes among private parties to other agencies such as the National Labor Relations Board, the Commodity Futures Trading Commission, the Surface Transportation Board, and the Department of Housing and Urban Development, thereby resurrecting important legal questions previously thought to have been decided. See 29 U.S.C. § 160 ; 7 U.S.C. § 18 ; 49 U.S.C. § 10704 ; 42 U.S.C. § 3612(b).

C

The majority, in my view, overemphasizes the precedential effect of the plurality

[131 S.Ct. 2624]

opinion in *Northern Pipeline Ante,* at 2609 – 2610. There, the Court held unconstitutional the jurisdictional provisions of the Bankruptcy Act of 1978 granting adjudicatory authority to bankruptcy judges who lack the protections of tenure and compensation that Article III provides. Four Members of the Court wrote that Congress could grant adjudicatory authority to a non- Article III judge only where (1) the judge sits on a "territorial cour[t]" (2) the judge conducts a "courts-martial," or (3) the case involves a "public right," namely, a "matter" that "at a minimum arise[s] 'between the government and others.' " 458 U.S., at 64–70, 102 S.Ct. 2858 (plurality opinion) (quoting *Ex parte Bakelite Corp ., supra,* at 451, 49 S.Ct. 411). Two other Members of the Court, without accepting these limitations, agreed with the result because the case involved a breach-of-contract claim brought by the bankruptcy trustee on behalf of the bankruptcy estate against a third party who was not part of the bankruptcy proceeding, and none of the Court's preceding cases (which, the two Members wrote, "do not admit of easy synthesis") had "gone so far as to sanction th[is] type of adjudication." 458 U.S., at 90–91, 102 S.Ct. 2858 (Rehnquist, J. concurring in judgment).

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Three years later, the Court held that *Northern Pipeline*

> "establishes only that Congress may not vest in a non- Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, without consent of the litigants, and subject only to ordinary appellate review."

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Thomas, 473 U.S., at 584, 105 S.Ct. 3325.

D

Rather than leaning so heavily on the approach taken by the plurality in *Northern Pipeline,* I would look to this Court's more recent Article III cases *Thomas* and *Schor*— cases that commanded a clear majority. In both cases the Court took a more pragmatic approach to the constitutional question. It sought to determine whether, in the particular instance, the challenged delegation of adjudicatory authority posed a genuine and serious threat that one branch of Government sought to aggrandize its own constitutionally delegated authority by encroaching upon a field of authority that the Constitution assigns exclusively to another branch.

1

In *Thomas,* the Court focused directly upon the nature of the Article III problem, illustrating how the Court should determine whether a delegation of adjudicatory authority to a non- Article III judge violates the Constitution. The statute in question required pesticide manufacturers to submit to binding arbitration claims for compensation owed for the use by one manufacturer of the data of another to support its federal pesticide registration. After describing *Northern Pipeline* 's holding in the language I have set forth above, *supra,* at 2624, the Court stated that "*practical attention to substance* rather than doctrinaire reliance on formal categories should inform application of Article III." *Thomas,* 473 U.S., at 587, 105 S.Ct. 3325 (emphasis added). It indicated that Article III's requirements could not be "determined" by "the identity of the parties alone," *ibid.,* or by the "private rights"/"public

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rights" distinction, *id.,* at 585–586, 105 S.Ct. 3325. And it upheld the arbitration provision of the statute.

The Court pointed out that the right in question was created by a federal statute, it "represent[s] a pragmatic solution to the difficult problem of spreading [certain] costs," and the statute "does not preclude review of the arbitration proceeding by an

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Article III court." *Id* ., at 589–592, 105 S.Ct. 3325. The Court concluded:

> "Given the nature of the right at issue and the concerns motivating the Legislature, we do not think this system threatens the independent role of the Judiciary in our constitutional scheme." *Id* ., at 590, 105 S.Ct. 3325.

2

Most recently, in *Schor,* the Court described in greater detail how this Court should analyze this kind of Article III question. The question at issue in *Schor* involved a delegation of authority to an agency to adjudicate a counterclaim. A customer brought before the Commodity Futures Trading Commission (CFTC) a claim for reparations against his commodity futures broker. The customer noted that his brokerage account showed that he owed the broker money, but he said that the broker's unlawful actions had produced that debit balance, and he sought damages. The broker brought a counterclaim seeking the money that the account showed the customer owed. This Court had to decide whether agency adjudication of such a counterclaim is consistent with Article III.

In doing so, the Court expressly "declined to adopt formalistic and unbending rules." *Schor,* 478 U.S., at 851, 106 S.Ct. 3245. Rather, it "weighed a number of factors, none of which has been deemed determinative, with an eye to the practical effect that the congressional action will have on the constitutionally assigned role of the federal judiciary." *Ibid* . Those relevant factors

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include (1) "the origins and importance of the right to be adjudicated"; (2) "the extent to which

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the non- Article III forum exercises the range of jurisdiction and powers normally vested only in Article III courts"; (3) the extent to which the delegation nonetheless reserves judicial power for exercise by Article III courts; (4) the presence or "absence of consent to an initial adjudication before a non- Article III tribunal"; and (5) "the concerns that drove Congress to depart from" adjudication in an Article III court. *Id* ., at 849, 851, 106 S.Ct. 3245.

The Court added that where "private rights," rather than "public rights" are involved, the "danger of encroaching on the judicial powers" is greater. *Id* ., at 853–854, 106 S.Ct. 3245 (internal quotation marks omitted). Thus, while non- Article III adjudication of "private rights" is not necessarily unconstitutional, the Court's constitutional "examination" of such a scheme must be more "searching." *Ibid* .

Applying this analysis, the Court upheld the agency's authority to adjudicate the counterclaim. The Court conceded that the adjudication might be of a kind traditionally decided by a court and that the rights at issue were "private," not "public." *Id* ., at 853, 106 S.Ct. 3245. But, the Court said, the CFTC deals only with a " 'particularized area of law' "; the decision to invoke the CFTC forum is "left entirely to the parties"; Article III courts can review the agency's findings of fact under "the same 'weight of the evidence' standard sustained in *Crowell* " and review its "legal determinations ... *de novo* "; and the agency's "counterclaim jurisdiction" was necessary to make "workable" a "reparations procedure," which constitutes an important part of a congressionally enacted "regulatory scheme." *Id* ., at 852–856, 106 S.Ct. 3245. The Court concluded that for these and other reasons "the magnitude of any intrusion on the Judicial Branch can only be termed *de minimis.* " *Id.,* at 856, 106 S.Ct. 3245.

II

A

This case law, as applied in *Thomas* and *Schor,* requires us to determine pragmatically

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whether a congressional delegation

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of adjudicatory authority to a non- Article III judge violates the separation-of-powers principles inherent in Article III. That is to say, we must determine through an examination of certain relevant factors whether that delegation constitutes a significant encroachment by the Legislative or Executive Branches of Government upon the realm of authority that Article III reserves for exercise by the Judicial Branch of Government. Those factors include (1) the nature of the claim to be adjudicated; (2) the nature of the non- Article III tribunal; (3) the extent to which Article III courts exercise control over the proceeding; (4) the presence or absence of the parties' consent; and (5) the nature and importance of the legislative purpose served by the grant of adjudicatory authority to a tribunal with judges who lack Article III's tenure and compensation protections. The presence of " private rights" does not automatically determine the outcome of the question but requires a more "searching" examination of the relevant factors. *Schor, supra,* at 854, 106 S.Ct. 3245.

Insofar as the majority would apply more formal standards, it simply disregards recent, controlling precedent. *Thomas, supra,* at 587, 105 S.Ct. 3325 ("[P]ractical attention to substance rather than doctrinaire reliance on formal categories should inform application of Article III"); *Schor,supra,* at 851, 106 S.Ct. 3245 ("[T]he Court has declined to adopt formalistic and unbending rules" for deciding Article III cases).

B

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Applying *Schor'* s approach here, I conclude that the delegation of adjudicatory authority before us is constitutional. A grant of authority to a bankruptcy court to adjudicate compulsory counterclaims does not violate any constitutional separation-of-powers principle related to Article III.

First, I concede that *the nature of the claim to be adjudicated* argues against my conclusion. Vickie Marshall's counterclaim—a kind of tort suit—resembles "a suit at the common law." *Murray's Lessee,* 18 How., at 284. Although not

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determinative of the question, see *Schor,* 478 U.S., at 853, 106 S.Ct. 3245, a delegation of authority to a non- Article III judge to adjudicate a claim of that kind poses a heightened risk of encroachment on the Federal Judiciary, *id.,* at 854, 106 S.Ct. 3245.

At the same time the significance of this factor is mitigated here by the fact that bankruptcy courts often decide claims that similarly resemble various common-law actions. Suppose, for example, that ownership of 40 acres of land in the bankruptcy debtor's possession is disputed by a creditor. If that creditor brings a claim in the bankruptcy court, resolution of that dispute requires the bankruptcy court to apply the same state property law that would govern in a state court proceeding. This kind of dispute arises with regularity in bankruptcy proceedings.

Of course, in this instance the state-law question is embedded in a debtor's counterclaim, not a creditor's claim. But the counterclaim is "compulsory." It "arises out of the transaction or occurrence that is the subject matter of the opposing party's claim." Fed. Rule Civ. Proc. 13(a) ; Fed. Rule Bkrtcy. Proc. 7013. Thus, resolution of the counterclaim will often turn on facts identical to, or at least related to, those at issue in a creditor's claim that is undisputedly proper for the bankruptcy court to decide.

Second, *the nature of the non- Article III tribunal* argues in favor of constitutionality. That is because the tribunal is made up of judges who enjoy considerable protection

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from improper political influence. Unlike the 1978 Act which provided for the appointment of bankruptcy judges by the President with the advice and consent of the Senate, 28 U.S.C. § 152 (1976 ed., Supp. IV), current law provides that the federal courts of appeals appoint federal bankruptcy judges, § 152(a)(1) (2006 ed.). Bankruptcy judges are removable by the circuit judicial counsel (made up of federal court of appeals and district court judges) and only for cause. § 152(e). Their salaries are pegged to those of federal district court judges, § 153(a), and the cost of their courthouses and other

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work-related expenses are paid by the Judiciary, § 156. Thus, although Congress technically exercised its Article I power when it created bankruptcy courts, functionally, bankruptcy judges can be compared to magistrate judges, law clerks, and the Judiciary's administrative officials, whose lack of Article III tenure and compensation protections do not endanger the independence of the Judicial Branch.

Third, *the control exercised by Article III judges over bankruptcy proceedings* argues in favor of constitutionality. Article III judges control and supervise the bankruptcy court's determinations—at least to the same degree that Article III judges supervised the agency's determinations in *Crowell,* if not more so. Any party may appeal those determinations to the federal district court, where the federal judge will review all determinations of fact for clear error and will review all determinations of law *de novo.* Fed. Rule Bkrtcy. Proc. 8013 ; 10 Collier on Bankruptcy ¶ 8013.04 (16th ed.2011). But for the here-irrelevant matter of what *Crowell* considered to be special "constitutional" facts, the standard of review for factual findings here

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("clearly erroneous") is more stringent than the standard at issue in *Crowell* (whether the agency's factfinding was "supported by evidence in the record"). 285 U.S., at 48, 52 S.Ct. 285; see *Dickinson v. Zurko,* 527 U.S. 150, 152, 153, 119 S.Ct. 1816, 144 L.Ed.2d 143 (1999) ("unsupported by substantial evidence" more deferential than "clearly erroneous" (internal quotation marks omitted)). And, as *Crowell* noted, "there is no requirement that, in order to maintain the essential attributes of the judicial power, all determinations of fact in constitutional courts shall be made by judges." 285 U.S., at 51, 52 S.Ct. 285.

Moreover, in one important respect Article III judges maintain greater control over the bankruptcy court proceedings at issue here than they did over the relevant proceedings in any of the previous cases in which this Court has upheld a delegation of adjudicatory power. The District Court here may "withdraw, in whole or in part, any case or

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proceeding referred [to the Bankruptcy Court] ... on its own motion or on timely motion of any party, for cause shown." 28 U.S.C. § 157(d) ; cf. *Northern Pipeline,* 458 U.S., at 80, n. 31, 102 S.Ct. 2858 (plurality opinion) (contrasting pre-1978 law where "power to withdraw the case from the [bankruptcy] referee" gave district courts "control" over case with the unconstitutional 1978 statute, which provided no such district court authority).

Fourth, the fact that *the parties have consented* to Bankruptcy Court jurisdiction argues in favor of constitutionality, and strongly so. Pierce Marshall, the counterclaim defendant, is not a stranger to the litigation, forced to appear in Bankruptcy Court against his will. Cf. *id.,* at 91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment) (suit was litigated in Bankruptcy Court "over [the defendant's] objection"). Rather, he appeared voluntarily in Bankruptcy Court as one of Vickie Marshall's creditors, seeking a favorable resolution of his claim against Vickie Marshall to the detriment of her other creditors.

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He need not have filed a claim, perhaps not even at the cost of bringing it in the future, for he says his claim is "nondischargeable," in which case he could have litigated it in a state or federal court after distribution. See 11 U.S.C. § 523(a)(6). Thus, Pierce Marshall likely had "an alternative forum to the bankruptcy court in which to pursue [his] clai[m]." *Granfinanciera, S.A. v. Nordberg,* 492 U.S. 33, 59, n. 14, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989).

The Court has held, in a highly analogous context, that this type of consent argues strongly in favor of using ordinary bankruptcy court proceedings. In *Granfinanciera,* the Court held that when a bankruptcy trustee seeks to void a transfer of assets from the debtor to an individual on the ground that the transfer to that individual constitutes an unlawful "preference," the question of whether the individual has a right to a jury trial "depends upon whether the creditor has submitted a claim against the estate." *Id .,* at 58, 109 S.Ct. 2782. The following year, in

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Langenkamp v. Culp, 498 U.S. 42, 111 S.Ct. 330, 112 L.Ed.2d 343 (1990)*(per curiam),* the Court emphasized that when the individual files a claim against the estate, that individual has

> "trigger[ed] the process of 'allowance and disallowance of claims,' thereby subjecting himself to the bankruptcy court's equitable power. If the creditor is met, in turn, with a preference action from the trustee, that action becomes part of the claims-allowance process which is triable only in equity. In other words, the creditor's claim and the ensuing preference action by the trustee become integral to the restructuring of the debtor-creditor

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> relationship through the bankruptcy court's *equity jurisdiction* ." *Id.,* at 44, 111 S.Ct. 330 (quoting *Granfinanciera,* 492 U.S., at 58, 109 S.Ct. 2782; citations omitted).

As we have recognized, the jury trial question and the Article III question are highly analogous. See *id.,* at 52–53, 111 S.Ct. 330. And to that extent, *Granfinanciera* 's and *Langenkamp* 's basic reasoning and conclusion apply here: Even when private rights are at issue, non- Article III adjudication may be appropriate when both parties consent. Cf. *Northern Pipeline, supra,* at 80, n. 31, 102 S.Ct. 2858 (plurality opinion) (noting the importance of consent to bankruptcy jurisdiction). See also *Schor,* 478 U.S., at 849, 106 S.Ct. 3245 ("[A]bsence of consent to an initial adjudication before a non- Article III tribunal was relied on [in *Northern Pipeline*] as a significant factor in determining that Article III forbade such adjudication"). The majority argues that Pierce Marshall "did not truly consent" to bankruptcy jurisdiction, *ante,* at 2614 – 2615, but filing a proof of claim was sufficient in *Langenkamp* and *Granfinanciera,* and there is no relevant distinction between the claims filed in those cases and the claim filed here.

Fifth, *the nature and importance of the legislative purpose served* by the grant of adjudicatory authority to bankruptcy tribunals argues strongly in favor of constitutionality. Congress' delegation of adjudicatory powers over counterclaims

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asserted against bankruptcy claimants constitutes an important means of securing a constitutionally authorized end. Article I, § 8, of the Constitution explicitly grants Congress the "Power To ... establish ... uniform Laws on the subject of Bankruptcies throughout the United States." James Madison wrote in the Federalist Papers that the

> "power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the

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> parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question." The Federalist No. 42, p. 271 (C. Rossiter ed.1961).

Congress established the first Bankruptcy Act in 1800. 2 Stat. 19. From the beginning, the "core" of federal bankruptcy proceedings has been "the restructuring of debtor-creditor relations." *Northern Pipeline, supra,* at 71, 102 S.Ct. 2858 (plurality opinion). And, to be effective, a single tribunal must have broad authority to restructure those relations, "having jurisdiction of the parties to controversies brought before them," "decid[ing] all matters in dispute," and "decree[ing] complete relief." *Katchen v. Landy,* 382 U.S. 323, 335, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966) (internal quotation marks omitted).

The restructuring process requires a creditor to file a proof of claim in the bankruptcy court. 11 U.S.C. § 501 ; Fed. Rule Bkrtcy. Proc. 3002(a). In doing so, the creditor "triggers the process of 'allowance and disallowance of claims,' thereby subjecting himself to the bankruptcy court's equitable power." *Langenkamp, supra,* at 44, 111 S.Ct. 330 (quoting *Granfinanciera, supra,* at 58, 109 S.Ct. 2782). By filing a proof of claim, the creditor agrees to the bankruptcy court's resolution of that claim, and if the creditor wins, the creditor will receive a share of the distribution of the bankruptcy estate. When the bankruptcy estate has a related claim against that creditor, that counterclaim may offset the creditor's claim, or even

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yield additional damages that augment the estate and may be distributed to the other creditors.

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The consequent importance to the total bankruptcy scheme of permitting the trustee in bankruptcy to assert counterclaims against claimants, *and resolving those counterclaims in a bankruptcy court,* is reflected in the fact that Congress included "counterclaims by the estate against persons filing claims against the estate" on its list of "[c]ore proceedings." 28 U.S.C. § 157(b)(2)(C). And it explains the difference, reflected in this Court's opinions, between a claimant's and a nonclaimant's constitutional right to a jury trial. Compare *Granfinanciera, supra,* at 58–59, 109 S.Ct. 2782 ("Because petitioners ... have not filed claims against the estate" they retain "their Seventh Amendment right to a trial by jury"), with *Langenkamp, supra,* at 45, 111 S.Ct. 330 ("Respondents filed claims against the bankruptcy estate" and "[c]onsequently, they were not entitled to a jury trial").

Consequently a bankruptcy court's determination of such matters has more than "some bearing on a bankruptcy case." *Ante,* at 2618 (emphasis deleted). It plays a critical role in Congress' constitutionally based effort to create an efficient, effective federal bankruptcy system. At the least, that is what Congress concluded. We owe deference to that determination, which shows the absence of any legislative or executive motive, intent, purpose, or desire to encroach upon areas that Article III reserves to judges to whom it grants tenure and compensation protections.

Considering these factors together, I conclude that, as in *Schor,* "the magnitude of any intrusion on the Judicial Branch can only be termed *de minimis* ." 478 U.S., at 856, 106 S.Ct. 3245. I would similarly find the statute before us constitutional.

III

The majority predicts that as a "practical matter" today's decision "does not change all that much." *Ante,* at 2619 – 2620. But I doubt that is so. Consider a typical case: A tenant

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files for bankruptcy. The landlord files a claim for unpaid rent. The tenant asserts a counterclaim for damages

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suffered by the landlord's (1) failing to fulfill his obligations as lessor, and (2) improperly recovering possession of the premises by misrepresenting the facts in housing court. (These are close to the facts presented in *In re Beugen,* 81 B.R. 994 (Bkrtcy.Ct.N.D.Cal.1988).) This state-law counterclaim does not "ste[m] from the bankruptcy itself," *ante,* at 2618, it would not "necessarily be resolved in the claims allowance process," *ibid* ., and it would require the debtor to prove damages suffered by the lessor's failures, the extent to which the landlord's representations to the housing court were untrue, and damages suffered by improper recovery of possession of the premises, cf. *ante,* at 2617 – 2618. Thus, under the majority's holding, the federal district judge, not the bankruptcy judge, would have to hear and resolve the counterclaim.

Why is that a problem? Because these types of disputes arise in bankruptcy court with some frequency. See, *e.g., In re CBI Holding Co.,* 529 F.3d 432 (C.A.2 2008) (state-law claims and counterclaims); *In re Winstar Communications, Inc.,* 348 B.R. 234 (Bkrtcy.Ct.Del.2005) (same); *In re Ascher,* 128 B.R. 639 (Bkrtcy.Ct.N.D.Ill.1991) (same); *In re Sun West Distributors, Inc.,* 69 B.R. 861 (Bkrtcy.Ct.S.D.Cal.1987) (same). Because the volume of bankruptcy cases is staggering, involving almost 1.6 million filings last year, compared to a federal district court docket of around 280,000 civil cases and 78,000 criminal cases. Administrative Office of the United States Courts, J. Duff, Judicial Business of the United States Courts: Annual Report of the Director 14 (2010). Because unlike the "related" non-core state law claims that bankruptcy courts must abstain from hearing, *see ante,* at 2619, compulsory counterclaims involve the same factual disputes as the claims that may be finally adjudicated by the bankruptcy courts. Because

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under these circumstances, a constitutionally required game of jurisdictional

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ping-pong between courts would lead to inefficiency, increased cost, delay, and needless additional suffering among those faced with bankruptcy.

For these reasons, with respect, I dissent.

Notes:

[1] Because both Vickie and Pierce passed away during this litigation, the parties in this case are Vickie's estate and Pierce's estate. We continue to refer to them as "Vickie" and "Pierce."

[2] One judge wrote a separate concurring opinion. He concluded that "Vickie's counterclaim ... [wa]s not a core proceeding, so the Texas probate court judgment preceded the district court judgment and controls." 600 F.3d, at 1065 (Kleinfeld, J.). The concurring judge also "offer[ed] additional grounds" that he believed required judgment in Pierce's favor. *Ibid.* Pierce presses only one of those additional grounds here; it is discussed below, in Part II–C.

[3] In full, §§ 157(b)(1)-(2) provides:

"(1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title.

"(2) Core proceedings include, but are not limited to—

"(A) matters concerning the administration of the estate;

"(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;

"(C) counterclaims by the estate against persons filing claims against the estate;

"(D) orders in respect to obtaining credit;

"(E) orders to turn over property of the estate;

"(F) proceedings to determine, avoid, or recover preferences;

"(G) motions to terminate, annul, or modify the automatic stay;

"(H) proceedings to determine, avoid, or recover fraudulent conveyances;

"(I) determinations as to the dischargeability of particular debts;

"(J) objections to discharges;

"(K) determinations of the validity, extent, or priority of liens;

"(L) confirmations of plans;

"(M) orders approving the use or lease of property, including the use of cash collateral;

"(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;

"(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims; and

"(P) recognition of foreign proceedings and other matters under chapter 15 of title 11."

[4] Although Pierce suggests that consideration of "the 157(b)(5) issue" would facilitate an "easy"

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resolution of the case, Tr. of Oral Arg. 47–48, he is mistaken. Had Pierce preserved his argument under that provision, we would have been confronted with several questions on which there is little consensus or precedent. Those issues include: (1) the scope of the phrase "personal injury tort"—a question over which there is at least a three-way divide, see *In re Arnold,* 407 B.R. 849, 851–853 (Bkrtcy.Ct.M.D.N.C.2009) ; (2) whether, as Vickie argued in the Court of Appeals, the requirement that a personal injury tort claim be "tried" in the district court nonetheless permits the bankruptcy court to resolve the claim short of trial, see Appellee's/Cross–Appellant's Supplemental Brief in No. 02–56002 etc. (CA9), p. 24; see also *In re Dow Corning Corp.,* 215 B.R. 346, 349–351 (Bkrtcy.Ct.E.D.Mich.1997) (noting divide over whether, and on what grounds, a bankruptcy court may resolve a claim pretrial); and (3) even if Pierce's defamation claim could be considered only by the District Court, whether the Bankruptcy Court might retain jurisdiction over the counterclaim, cf. *Arbaugh v. Y & H Corp.,* 546 U.S. 500, 514, 126 S.Ct. 1235, 163 L.Ed.2d 1097 (2006) ("when a court grants a motion to dismiss for failure to state a federal claim, the court generally retains discretion to exercise supplemental jurisdiction, pursuant to 28 U.S.C. § 1367, over pendent state-law claims"). We express no opinion on any of these issues and simply note that the § 157(b)(5) question is not as straightforward as Pierce would have it.

[5] The dissent is thus wrong in suggesting that less than a full Court agreed on the points pertinent to this case. *Post,* at 2622 (opinion of BREYER, J.).

[6] Although the Court in *Crowell* went on to decide that the facts of the private dispute before it could be determined by a non-Article III tribunal in the first instance, subject to judicial review, the Court did so only after observing that the administrative adjudicator had only limited authority to make specialized, narrowly confined factual determinations regarding a particularized area of law and to issue orders that could be enforced only by action of the District Court. 285 U.S., at 38, 44–45, 54, 52 S.Ct. 285 ; see *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 78, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (plurality opinion). In other words, the agency in *Crowell* functioned as a true "adjunct" of the District Court. That is not the case here. See *infra,* at 2618 – 2619.

Although the dissent suggests that we understate the import of *Crowell* in this regard, the dissent itself recognizes—repeatedly—that *Crowell* by its terms addresses the determination of *facts* outside Article III. See *post,* at 2623 (*Crowell* "upheld Congress' delegation of primary factfinding authority to the agency"); *post,* at 2627 (quoting *Crowell,* 285 U.S., at 51, 52 S.Ct. 285, for the proposition that " 'there is no requirement that, in order to maintain the essential attributes of the judicial power, all determinations of fact in constitutional courts shall be made by judges' "). *Crowell* may well have additional significance in the context of expert administrative agencies that oversee particular substantive federal regimes, but we have no occasion to and do not address those issues today. See *infra,* at 2615. The United States apparently agrees that any broader significance of *Crowell* is not pertinent in this case, citing to *Crowell* in its brief only once, in the last footnote, again for the limited proposition discussed above. Brief for United States as *Amicus Curiae* 32, n. 5.

[7] We noted that we did not mean to "suggest that the restructuring of debtor-creditor relations is in fact a public right." 492 U.S., at 56, n. 11, 109 S.Ct. 2782. Our conclusion was that, "even if one accepts this thesis," Congress could not constitutionally assign resolution of the fraudulent conveyance action to a non-Article III court. *Ibid.* Because neither party asks us to reconsider the public rights framework for bankruptcy, we follow the same approach here.

[8] Contrary to the claims of the dissent, see *post,* at 2627 – 2628, Pierce did not have another forum in which to pursue his claim to recover from Vickie's prebankruptcy assets, rather than take his chances with whatever funds might remain after the Title 11 proceedings. Creditors who possess claims that do not satisfy the

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requirements for nondischargeability under 11 U.S.C. § 523 have no choice but to file their claims in bankruptcy proceedings if they want to pursue the claims at all. That is why, as we recognized in *Granfinanciera,* the notion of "consent" does not apply in bankruptcy proceedings as it might in other contexts.

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465 U.S. 513
104 S.Ct. 1188
79 L.Ed.2d 482
NATIONAL LABOR RELATIONS BOARD, Petitioner,

v.

BILDISCO AND BILDISCO, Debtor-In-Possession, et al. LOCAL 408, INTERNATIONAL BROTHERHOOD OF TEAMSTERS, etc., Petitioner v. NATIONAL LABOR RELATIONS BOARD et al.

Nos. 82-818, 82-852.

Argued Oct. 11, 1983.
Decided Feb. 22, 1984.
Syllabus

Section 365(a) of the Bankruptcy Code (Code) provides that, with certain exceptions, the trustee, subject to the Bankruptcy Court's approval, may assume or reject "any executory contract" of the debtor. In April 1980, respondent debtor (hereafter respondent), a building supplies distributor, filed a voluntary petition in bankruptcy for reorganization under Chapter 11 of the Code, and was subsequently authorized by the Bankruptcy Court to operate the business as a debtor-in-possession. At the time the petition was filed, some of respondent's employees were represented by petitioner Union with whom respondent had negotiated a collective-bargaining agreement that was to expire in April 1982. Beginning in January 1980, respondent failed to meet some of its obligations under the agreement, including the payment of health and pension benefits and the remittance to the Union of dues collected, and in May 1980 respondent refused to pay wage increases called for in the agreement. Thereafter, respondent requested and received permission from the Bankruptcy Court to reject the agreement, and the Union was allowed 30 days in which to file a claim for damages stemming from the rejection. The District Court upheld the order. In the summer of 1980, the Union filed unfair labor practice charges with the National Labor Relations Board (Board), which found that respondent had violated §§ 8(a)(5) and 8(a)(1) of the National Labor Relations Act (NLRA) by unilaterally changing the terms of the collective-bargaining agreement and by refusing to negotiate with the Union, and ordered respondent to make the pension and health contributions and to remit dues to the Union. Consolidating the Union's appeal from the District Court's order and the Board's petition for enforcement of its order, the Court of Appeals held that a collective-bargaining agreement is an executory contract subject to rejection by a debtor-in-possession under § 365(a) of the Code; that the debtor-in-possession's authority to seek rejection of the

agreement was not qualified by § 8(d) of the NLRA; but that to obtain rejection a debtor-in-possession must show not only that the agreement burdens the estate but also that the equities balance in favor of rejection. The case was remanded to the Bankruptcy Court for reconsideration in light of this standard. The Court of Appeals refused to enforce the Board's order, rejecting the Board's conclusion that respondent, as a debtor-in-possession, was the alter ego of the prepetition employer, and holding that under the Code a debtor-in-possession was deemed a "new entity" not bound by the debtor's prior collective-bargaining agreement.

Held:

1. The language "executory contract" in § 365(a) of the Code includes collective-bargaining agreements subject to the NLRA, and the Bankruptcy Court should permit rejection of such an agreement under § 365(a) if the debtor can show that the agreement burdens the estate and that the equities balance in favor of rejection. Pp. 521-527.

(a) Any inference that collective-bargaining agreements are not included within the general scope of § 365(a) because they differ for some purposes from ordinary contracts is rebutted by § 365(a)'s statutory design and by the language of § 1167 of the Code expressly exempting from §

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365(a) collective-bargaining agreements subject to the Railway Labor Act. The failure to grant a similar exemption to agreements subject to the NLRA indicates that Congress intended 365(a) to apply to all collective-bargaining agreements covered by the NLRA. Pp. 521-523.

(b) Because of the special nature of a collective-bargaining agreement, and the consequent "law of the shop" that it creates, a somewhat stricter standard than the "business judgment" standard applied to authorize rejection of an ordinary executory contract should govern the Bankruptcy Court's decision to allow rejection of a collective-bargaining agreement. But a standard that would require respondent to demonstrate that its reorganization will fail unless rejection is permitted is at odds with the flexibility and equity built into Chapter 11 and subordinates the multiple, competing considerations underlying a Chapter 11 reorganization to the issue of whether rejection of the agreement is necessary to prevent the debtor from going into liquidation. Pp. 523-526.

(c) Before acting on a petition to modify or reject a collective-bargaining agreement, the Bankruptcy Court should be pursuaded that reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution. If the parties are unable to agree, a decision on the rejection of the agreement may become necessary to the reorganization process. But since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection should not be permitted without a finding that that policy would be

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served by such action. Determining what would constitute a successful rehabilitation involves balancing the interests of the debtor, creditors, and employees, and in striking the balance the court must consider not only the degree of hardship faced by each party but also any qualitative differences between the types of hardship each may face. Pp. 526-527.

2. A debtor-in-possession does not commit an unfair labor practice when it unilaterally rejects or modifies a collective-bargaining agreement before formal rejection is approved by the Bankruptcy Court. Pp. 527-534.

(a) To hold that the debtor commits an unfair labor practice under such circumstances would undermine whatever benefit the debtor otherwise obtains by its authority to request rejection of the agreement. The difference between a Chapter 11 reorganization, wherein the debtor-in-possession has until a reorganization plan is confirmed to decide whether to accept or reject an executory contract, and a Chapter 7 liquidation, wherein the trustee has only 60 days from the order for relief in which to make such a decision, reflects Congress' considered judgment that a debtor-in-possession seeking to reorganize should be granted more latitude in making the decision than should a trustee in liquidation. Pp. 528-529.

(b) Since recovery on a claim arising from a debtor-in-possession's rejection of an executory collective-bargaining agreement after the filing of a petition in bankruptcy may be had only through administration of the claim in bankruptcy and not by a suit against the debtor-in-possession under the agreement, the Board is necessarily precluded from, in effect, enforcing the agreement by filing an unfair labor practice charge against the debtor-in-possession for violating § 8(d) of the NLRA. Such enforcement would run directly counter to the Code's express provisions and to its overall effort to give a debtor-in-possession some flexibility and breathing space. From the filing of the bankruptcy petition until formal acceptance, the collective-bargaining agreement is not an enforceable contract within the meaning of § 8(d). Accordingly, the debtor-in-possession need not comply with § 8(d) prior to seeking the Bankruptcy Court's permission to reject the agreement. It necessarily follows that any corresponding duty to bargain to impasse under § 8(a)(5) and § 8(d) before seeking rejection must also be subordinated to the exigencies of bankruptcy. Pp. 529-534.

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682 F.2d 72 (CA3 1982), affirmed.

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Lawrence G. Wallace, Washington, D.C., for N.L.R.B.

James R. Zazzali, Newark, N.J., for Local 408, Intern. Broth. of Teamsters. Jack M. Zackin, Roseland, N.J., for Bildisco and Bildisco.

Justice REHNQUIST delivered the opinion of the Court.

Two important and related questions are presented by these petitions for certiorari: (1) under what conditions can a Bankruptcy Court permit a debtor-in-possession to reject a collective-bargaining agreement; (2) may the National Labor Relations Board find a debtor-in-possession guilty of an unfair labor practice for unilaterally terminating or modifying a collective-bargaining agreement before rejection of that agreement has been approved by the Bankruptcy Court. We decide that the language "executory contract" in 11 U.S.C. § 365 of the Bankruptcy Code includes within it collective-bargaining agreements subject to the National Labor Relations Act, and that the Bankruptcy Court may approve rejection of such contracts by the debtor-in-possession upon an appropriate showing. We also decide that a debtor-in-possession does not commit an unfair labor practice when, after the filing of a bankruptcy petition but before court-approved rejection of the collective-bargaining

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agreement, it unilaterally modifies or terminates one or more provisions of the agreement. We therefore affirm the judgment of the Court of Appeals for the Third Circuit in these cases.

I

A.

On April 14, 1980, respondent Bildisco and Bildisco ("Bildisco"), a New Jersey general partnership in the business of distributing building supplies, filed a voluntary petition in bankruptcy for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 *et seq.*[1] Bildisco was subsequently authorized by the Bankruptcy Court to operate the business as debtor-in-possession under 11 U.S.C. § 1107.[2]

At the time of the filing of the petition in bankruptcy, approximately 40 to 45 percent of Bildisco's labor force was represented by Local 408 of the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of Amer-

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ica ("Union"). Bildisco had negotiated a three-year collective-bargaining agreement with the Union that was to expire on April 30, 1982, and which expressly provided that it was binding on the parties and their successors even though bankruptcy should supervene. Beginning in January, 1980, Bildisco failed to meet some of its obligations under the collective-bargaining agreement, including the payment of health and pension benefits and the remittance to the Union of dues collected under the agreement. In May, 1980, Bildisco refused to pay wage increases called for in the collective-bargaining agreement.

In December, 1980, Bildisco requested permission from the Bankruptcy Court, pursuant to 11 U.S.C. § 365(a),[3] to reject the collective-bargaining agreement. At the hearing on Bildisco's request the sole witness was one of Bildisco's general partners, who testified that rejection would save his company approximately $100,000 in 1981. The Union offered no witnesses of its own, but cross-examined the witness for Bildisco. On January 15, 1981, the Bankruptcy Court granted Bildisco permission to reject the collective-bargaining agreement and allowed the Union 30 days in which to file a claim for damages against Bildisco stemming from the rejection of the contract. The District Court upheld the order of the Bankruptcy Court, and the Union appealed to the Court of Appeals for the Third Circuit.

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B

During mid-summer 1980, the Union filed unfair labor practice charges with the National Labor Relations Board ("Board"). The General Counsel of the Board issued a complaint alleging that Bildisco had violated § 8(a)(5) and § 8(a)(1) of the National Labor Relations Act ("NLRA"), 29 U.S.C.

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§ 158(a)(5) and § 158(a)(1),[4] by unilaterally changing the terms of the collective-bargaining agreement, in failing to pay certain contractually mandated fringe benefits and wage increases and to remit dues to the Union. Ultimately the Board found that Bildisco had violated § 8(a)(5) and § 8(a)(1) of the NLRA by unilaterally changing the terms of the collective-bargaining agreement and by refusing to negotiate with the Union. Bildisco was ordered to make the pension, health, and welfare contributions and to remit dues to the Union, all as required under the collective-bargaining agreement. The Board petitioned the Court of Appeals for the Third Circuit to enforce its order.

C

The Court of Appeals consolidated the Union's appeal and the Board's petition for enforcement of its order. *In re Bildisco,* 682 F.2d 72 (CA3 1982). That court held that a collective-bargaining agreement is an executory contract subject to rejection by a debtor-in-possession under § 365(a) of the Bankruptcy Code. The authority of the debtor-in-possession to seek rejection of the collective-bargaining agreement was not qualified by the restrictions of § 8(d) of the NLRA, which established detailed guidelines for mid-term modification of collective-bargaining agreements,[5] be-

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cause in the court's view, the debtor-in-possession was a "new entity" not bound by the labor agreement. The Court of Appeals concluded, however, that given the favored status Congress has accorded collective-bargaining agreements, a debtor-in-possession had to meet a more stringent test than the usual business judgment rule to obtain rejection. The Court of Appeals accepted the standard applied by the Court of Appeals for the Second Circuit in *Shopmen's Local Union No. 455 v. Kevin Steel Products, Inc.,* 519 F.2d 698, 707

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(CA2 1975), and required the debtor-in-possession to show not only that the collective-bargaining agreement is burdensome to the estate, but also that the equities balance in favor of rejection. The case was remanded to the Bankruptcy Court for reconsideration in light of the standards enunciated.

The Court of Appeals refused to enforce the Board's order, rejecting the Board's conclusion that Bildisco, as debtor-in-possession, was the alter-ego of the pre-petition employer. Under the Bankruptcy Code, a debtor-in-possession was deemed a "new entity" not bound by the debtor's prior collective-bargaining agreement. Because rejection relates back to the filing of a petition, the Court of Appeals held that if Bildisco were permitted to reject the contract, the Board was precluded from premising an unfair labor practice on Bildisco's rejection of the labor contract. The Court of Appeals implied that if the Bankruptcy Court determined that the collective-bargaining agreement should not be rejected, the Board could find a violation of § 8(d) of the NLRA.

We granted certiorari to review the decision of the Court of Appeals because of the apparent conflict between that decision and the decision of the Court of Appeals for the Second Circuit in *Brotherhood of Railway Employees v. REA Express, Inc.,* 523 F.2d 164, *cert. denied,* 423 U.S. 1017, 96 S.Ct. 451, 46 L.Ed.2d 388 (1975).

II

Section 365(a) of the Bankruptcy Code, 11 U.S.C. § 365, provides in full:

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"(a) Except as provided in sections 765 and 766 of this title and 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."

This language by its terms includes all executory contracts except those expressly exempted, and it is not disputed by the parties that an unexpired collective-bargaining

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agreement is an executory contract.[6] Any inference that collective-bargaining agreements are not included within the general scope of § 365(a) because they differ for some purposes from ordinary contracts, see *John Wiley & Sons, Inc. v. Livingston,* 376 U.S. 543, 550 (1964), is rebutted by the statutory design of § 365(a) and by the language of § 1167 of the Bankruptcy Code. The text of § 365(a) indicates that Congress was concerned about the scope of the debtor-in-possession's power regarding certain types of executory contracts, and purposely drafted § 365(a) to limit the debtor-in-possession's power of rejection or assumption in those circumstances.[7] Yet none of the express limitations on the debtor-in-possession's general power under § 365(a) apply to collective-bargaining agreements. Section 1167, in turn, expressly exempts collective-bargaining agreements subject to the Railway Labor Act, but grants no similar exemption to agreements subject to the NLRA.[8] Obviously, Congress

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knew how to draft an exclusion for collective-bargaining agreements when it wanted to; its failure to do so in this instance indicates that Congress intended that § 365(a) apply to all collective-bargaining agreements covered by the NLRA.

None of the parties to this case dispute the foregoing proposition. But the Board contends that the standard by which the Bankruptcy Court must judge the request of a debtor-in-possession to reject a collective-bargaining contract must be stricter than the traditional "business judgment" standard applied by the courts to authorize rejection of the ordinary executory contract. See *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R. Co.,* 318 U.S. 523, 550, 63 S.Ct. 727, 742, 87 L.Ed. 959 (1943); see also *In re Minges,* 602 F.2d 38, 42 (CA2 1979); *In re Tilco, Inc.,* 558 F.2d 1369, 1372 (CA10 1977). The Union also contends that the debtor-in-possession must comply with the procedural requirements of § 8(d) of the NLRA, or at a minimum, bargain to impasse before it may request the Bankruptcy Court either to assume or to reject the collective-bargaining agreement.

Although there is no indication in § 365 of the Bankruptcy Code that rejection of collective-bargaining agreements should be governed by a standard different from that governing other executory contracts, all of the Courts of Appeals which have considered the matter have concluded that the standard should be a stricter one. See *In re Brada-Miller Freight System, Inc.,* 702 F.2d 890 (CA11 1983); *In re Bildisco,* 682 F.2d 72 (CA3 1982); see also *Local Joint Executive Board v. Hotel Circle,* 613 F.2d 210 (CA9 1980)

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(rejection under the Bankruptcy Act); *Shopmen's Local Union No. 455 v. Kevin Steel Products, Inc.,* 519 F.2d 698 (CA2 1975) (same). We agree with these Courts of Appeals that because of the special nature of a collective-bargaining contract, and the consequent "law of the shop" which it creates, see *John Wiley & Sons, supra; United Steelworkers v. Warrior & Gulf Navigation Co.,* 363 U.S. 574, 578-579, 80 S.Ct. 1347, 1350-1351, 4 L.Ed.2d 1409 (1960), a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement.

The Union and the Board argue that in light of the special nature of rights created by labor contracts, Bildisco should not be permitted to reject the collective-bargaining agreement unless

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it can demonstrate that its reorganization will fail unless rejection is permitted. This very strict standard was adopted by the Second Circuit in *Brotherhood of Railway and Airline Clerks v. REA Express, Inc.,* 523 F.2d 164, 167-169 (CA2), *cert. denied,* 423 U.S. 1017, 96 S.Ct. 451, 46 L.Ed.2d 388 (1975), decided under the former Bankruptcy Act three years before § 365(a) was passed by Congress. Under the canon of statutory construction that Congress is presumed to be aware of judicial interpretations of a statute, the Board argues that Congress should be presumed to have adopted the interpretation of the Second Circuit when it enacted § 365(a). See *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran,* 456 U.S. 353, 379-382, 102 S.Ct. 1825, 1839-1841, 72 L.Ed.2d 182 (1982); *Lorillard v. Pons,* 434 U.S. 575, 580-581, 98 S.Ct. 866, 869-870, 55 L.Ed.2d 40 (1978). The Board makes a related argument that Congress was fully aware of the strict standard for rejection established in *REA Express* and approved that standard when enacting § 365(a) of the Bankruptcy Code. In the legislative history accompanying § 82 of the Bankruptcy Act, a provision relating to municipal bankruptcies, the report of the House Committee on the Judiciary referred to *Kevin Steel Products, supra,* and *REA Express, supra,* as authority for the proposition that a stricter showing than the business judgment test was necessary to reject a collective-bargaining agreement. See H.R.Rep.

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No. 94-686, p. 17-18 (1975). Since Congress made § 365(a) applicable to municipal bankruptcies, see 11 U.S.C. § 901(a), the Board argues that this reference to *REA Express* supports an inference that Congress adopted the *REA Express* standard for rejecting collective-bargaining agreements when it enacted § 365(a).

These arguments are wholly unconvincing. Quite simply, *Kevin Steel* and *REA Express* reflect two different formulations of a standard for rejecting collective-bargaining agreements. Congress cannot be presumed to have adopted one standard over the other without some affirmative indication of which it preferred. The reference in the House report to *Kevin Steel* and *REA Express* also cannot be considered a congressional endorsement of the stricter standard imposed on rejection of collective-bargaining agreements by the Second Circuit in *REA Express,* since the report indicates no preference for either formulation. At most, the House report supports only an inference that Congress approved the use of a somewhat higher standard than the business judgment rule when appraising a request to reject a collective-bargaining agreement.

The standard adopted by the Court of Appeals for the Second Circuit in *REA Express* is fundamentally at odds with the policies of flexibility and equity built into Chapter 11 of the Bankruptcy Code. The rights of workers under collective-bargaining agreements are important, but the *REA Express* standard subordinates the multiple, competing considerations underlying a Chapter 11 reorganization to one issue: whether rejection of the collective-bargaining agreement is necessary to prevent the debtor from going into liquidation. The evidentiary burden necessary to meet this stringent standard may not be insurmountable, but it will present difficulties to the debtor-in-possession that will interfere with the reorganization process.

We agree with the Court of Appeals below, and with the Court of Appeals for the Eleventh Circuit in a related case,

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In re Brada-Miller Freight System, Inc., 702 F.2d 890 (1983), that the Bankruptcy Court should permit rejection of a collective-bargaining agreement under § 365(a) of the Bankruptcy Code if the debtor can show that the collective-bargaining agreement burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract. The standard which we think Congress intended is a higher one than that of the "business judgment" rule, but a lesser one than that embodied in the *REA Express* opinion of the Court of Appeals for the Second Circuit.

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Before acting on a petition to modify or reject a collective-bargaining agreement, however, the Bankruptcy Court should be persuaded that reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution. The NLRA requires no less. Not only is the debtor-in-possession under a duty to bargain with the union under § 8(a)(5) of the NLRA, 29 U.S.C. § 158(a)(5), see post, at 18-19, but the national labor policies of avoiding labor strife and encouraging collective bargaining, *id.*, § 1, 29 U.S.C. § 151, generally require that employers and unions reach their own agreements on terms and conditions of employment free from governmental interference. See, *e.g., Howard Johnson Co. v. Hotel Employees,* 417 U.S. 249, 94 S.Ct. 2236, 41 L.Ed.2d 46 (1974); *NLRB v. Burns Security Services,* 406 U.S. 272, 282-294, 92 S.Ct. 1571, 1579-1585, 32 L.Ed.2d 61 (1972). The Bankruptcy Court need step into this process only if the parties' inability to reach an agreement threatens to impede the success of the debtor's reorganization. If the parties are unable to agree, a decision on the rejection of the collective-bargaining agreement may become necessary to the reorganization process. At such a point, action by the Bankruptcy Court is required, while the policies of the Labor Act have been adequately served since reasonable efforts to reach agreement have been made. That court need not determine that the parties have bargained to impasse or make any other

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determination outside the field of its expertise. See *post,* at 533-534.

Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection should not be permitted without a finding that that policy would be served by such action. The Bankruptcy Court must make a reasoned finding on the record why it has determined that rejection should be permitted. Determining what would constitute a successful rehabilitation involves balancing the interests of the affected parties—the debtor, creditors, and employees. The Bankruptcy Court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them, and the impact of rejection on the employees. In striking the balance, the Bankruptcy Court must consider not only the degree of hardship faced by each party, but also any qualitative differences between the types of hardship each may face.

The Bankruptcy Court is a court of equity, and in making this determination it is in a very real sense balancing the equities, as the Court of Appeals suggested. Nevertheless, the Bankruptcy Court must focus on the ultimate goal of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization. The Bankruptcy Court's inquiry is of necessity speculative and it must have great latitude to consider any type of evidence relevant to this issue.

III

The second issue raised by this case is whether the NLRB can find a debtor-in-possession guilty of an unfair labor practice for unilaterally rejecting or modifying a collective-bargaining agreement before formal rejection by the Bankruptcy Court. Much effort has been expended

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by the parties on the question of whether the debtor is more properly characterized as an "alter ego" or a "successor employer" of the prebankruptcy debtor, as those terms have been used in our labor decisions. See *Howard Johnson Co. v. Detroit Local Joint Executive Board,* 417 U.S. 249, 259 n. 5, 94 S.Ct. 2236, 2249 n. 5, 41 L.Ed.2d 46 (1974); *NLRB v. Burns Security Services, Inc.,* 406 U.S. 272, 92 S.Ct. 1571, 32 L.Ed.2d 61 (1972); *Southport Petroleum Co. v. NLRB,* 315 U.S. 100, 106, 62 S.Ct. 452, 455, 86 L.Ed. 718 (1942). We see no profit in an

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exhaustive effort to identify which, if either, of these terms represents the closest analogy to the debtor-in-possession. Obviously if the latter were a wholly "new entity," it would be unnecessary for the Bankruptcy Code to allow it to reject executory contracts, since it would not be bound by such contracts in the first place. For our purposes, it is sensible to view the debtor-in-possession as the same "entity" which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have done absent the bankruptcy filing.

The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources. See H.R.Rep. No. 95-595, p. 220 (1977). In some cases reorganization may succeed only if new creditors infuse the ailing firm with additional capital. We recognized the desirability of an analogous infusion of capital in *Burns, supra,* 406 U.S., at 288, 92 S.Ct., at 1582; a similarly beneficial recapitalization could be jeopardized if the debtor-in-possession were saddled automatically with the debtor's prior collective-bargaining agreement. Thus, the authority to reject an executory contract is vital to the basic purpose to a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization.

While all parties to this case ultimately concede that the Bankruptcy Court may authorize rejection of a collective-bargaining agreement, the Board and the Union nonetheless insist that a debtor-in-possession violates § 8(a)(5) and § 8(d)

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of the NLRA if it unilaterally changes the terms of the collective-bargaining agreement between the date of filing the bankruptcy petition and the date on which the Bankruptcy Court authorizes rejection of the agreement.[9] But acceptance of such a contention would largely, if not completely, undermine whatever benefit the debtor-in-possession otherwise obtains by its authority to request rejection of the agreement. In a Chapter 11 reorganization, a debtor-in-possession has until a reorganization plan is confirmed to decide whether to accept or reject an executory contract, although a creditor may request the Bankruptcy Court to make such a determination within a particular time. 11 U.S.C. § 365(d)(2). In contrast, during a Chapter 7 liquidation the trustee has only 60 days from the order for relief in which to decide whether to accept or reject an executory contract. 11 U.S.C. § 365(d)(1). It seems to us that this difference between the two types of proceedings reflects the considered judgment of Congress that a debtor-in-possession seeking to reorganize should be granted more latitude in deciding whether to reject a contract than should a trustee in liquidation.

Under the Bankruptcy Code proof of claims must be presented to the Bankruptcy Court for administration, or be lost when a plan of reorganization is confirmed. See 11 U.S.C. § 501, § 502, and § 1141.[10] Actions on claims that

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have been or could have been brought before the filing of a bankruptcy petition are, with limited exceptions not relevant here, stayed through the automatic stay provisions of the Bankruptcy Code. 11 U.S.C. § 362(a). The Bankruptcy Code specifies that the rejection of an executory contract which had not been assumed constitutes a breach of the contract which relates back to the date immediately preceding the filing of a petition in bankruptcy. 11 U.S.C. § 365(g)(1).[11] Consequently, claims arising after filing, such as result from the rejection of an executory contract, must also be presented through the normal administration process by which claims are estimated and classified. See 11 U.S.C. § 502(g); *In re Hoe & Co., Inc.,* 508 F.2d 1126, 1132 (CA2 1974); *Workman v. Harrison,* 282 F.2d 693, 699 (CA10 1960). Thus suit may not be brought against the debtor-in-possession under the collective-bargaining agreement; recovery may be had only through administration of the claim in bankruptcy.[12]

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While the Board insists that § 365(g)(1) deals only with priorities of payment, the implications from the decided cases are that the relation back of contract rejection to the filing of the petition in bankruptcy involves more than just priority of claims.[13] Damages on the contract that result from the rejection of an executory contract, as noted, must be administered through bankruptcy and receive the priority provided general unsecured creditors. See 11 U.S.C. §§ 502(g), 507. If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, *Philadelphia Co. v. Dipple,* 312 U.S. 168, 174, 61 S.Ct. 538, 541, 85 L.Ed. 651 (1941), which, depending on the circumstances of a particular contract, may be what is specified in the contract, see *In re Public Ledger,* 161 F.2d 762, 770-771 (CA3 1947). See also *In re Mammoth Mart, Inc.*, 536 F.2d 950, 954-955 (CA1 1976). Should the debtor-in-possession elect to assume the executory contract, however, it assumes the contract *cum onere, In re Italian Cook Oil Corp.*, 190

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F.2d 994, 996 (CA3 1951), and the expenses and liabilities incurred may be treated as administrative expenses, which are afforded the highest priority on the debtor's estate, 11 U.S.C. § 503(b)(1)(A).

The necessary result of the foregoing discussion is that the Board is precluded from, in effect, enforcing the contract terms of the collective-bargaining agreement by filing unfair labor practices against the debtor-in-possession for violating § 8(d) of the NLRA. Though the Board's action is nominally one to enforce § 8(d) of that Act, the practical effect of the enforcement action would be to require adherence to the terms of the collective-bargaining agreement. But the filing of the petition in bankruptcy means that the collective-bargaining agreement is no longer immediately enforceable, and may never be enforceable again. Consequently, Board enforcement of a claimed violation of § 8(d) under these circumstances would run directly counter to the express provisions of the Bankruptcy Code and to the Code's overall effort to give a debtor-in-possession some flexibility and breathing space. See H.R.Rep. No. 95-595, p. 340 (1977). We conclude that from the filing of a petition in bankruptcy until formal acceptance, the collective-bargaining agreement is not an enforceable contract within the meaning of NLRA § 8(d). Cf. *Chemical Workers v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 92 S.Ct. 383, 30 L.Ed.2d 341; *Dowd Box Co. v. Courtney,* 368 U.S. 502, 510-513, 82 S.Ct. 519, 524-525, 7 L.Ed.2d 483 (1962).

The Union, but not the Board, also insists that the debtor-in-possession must comply with the mid-term contract modification procedures set forth in § 8(d) of the NLRA, 29 U.S.C. § 158(d). See ante, at n. 5. Because the collective-bargaining agreement is not an enforceable contract within the meaning of § 8(d), it follows that the debtor-in-possession need not comply with the provisions of § 8(d) prior to seeking the Bankruptcy Court's permission to reject the agreement.

Section 8(d) applies when contractual obligations are repudiated by the unilateral actions of a party to the collective-bargaining agreement. We have recognized that Congress's

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central purpose in enacting § 8(d) was to regulate the modification of collective-bargaining agreements and to facilitate agreement in place of economic warfare. *Chemical & Alkali Workers of America, Local Union No. 1 v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 187, 92 S.Ct. 383, 401, 30 L.Ed.2d 341 (1971); see also H.R.Rep. No. 510, 80th Cong., 1st Sess., p. 34 (1947) (Report of the Conference). In a Chapter 11 case, however, the "modification" in the agreement has been accomplished not by the employer's unilateral action, but rather by operation of law. Since the

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filing of a petition in bankruptcy under Chapter 11 makes the contract unenforceable, § 8(d) procedures have no application to the employer's unilateral rejection of an already unenforceable contract. Indeed, even the Board concedes that the cumbersome and rigid procedures of § 8(d) need not be imported into bankruptcy proceedings. Brief of NLRB, at 41.

The Union maintains, as a fall-back position, that even if § 8(d) procedures do not apply fully, the debtor-in-possession should be required to "bargain to impasse" prior to seeking rejection from the Bankruptcy Court. We interpret this contention to mean that the debtor-in-possession should not be permitted to seek rejection unless the duty to bargain has been excused because further negotiations would be fruitless, a standard little different from that imposed on all employers subject to the NLRA. See *NLRB v. American National Insurance Co.,* 343 U.S. 395, 404, 72 S.Ct. 824, 829, 96 L.Ed. 1027 (1952); *Taft Broadcasting Co.,* 163 N.L.R.B. 475, 478 (1967); *enforced,* 395 F.2d 622 (CADC 1968). Our rejection of the need for full compliance with § 8(d) procedures of necessity means that any corresponding duty to bargain to impasse under § 8(a)(5) and § 8(d) before seeking rejection must also be subordinated to the exigencies of bankruptcy.[14] Whether

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impasse has been reached generally is a judgment call for the Board to make; imposing such a requirement as a condition precedent to rejection of the labor contract will simply divert the Bankruptcy Court from its customary area of expertise into a field in which it presumably has little or none.

Our determination that a debtor-in-possession does not commit an unfair labor practice by failing to comply with § 8(d) prior to formal rejection of the collective-bargaining agreement does not undermine the policy of the NLRA, for that policy, as we have noted, is to protect the process of labor negotiations, not to impose particular results on the parties. *See H.K. Porter Co. v. NLRB,* 397 U.S. 99, 105, 90 S.Ct. 821, 824, 25 L.Ed.2d 146 (1970); *NLRB v. Jones & Laughlin Steel Corp.,* 301 U.S. 1, 45, 57 S.Ct. 615, 628, 81 L.Ed. 893 (1937). Nevertheless, it is important to note that the debtor-in-possession is not relieved of all obligations under the NLRA simply by filing a petition for bankruptcy. A debtor-in-possession is an "employer" within the terms of the NLRA, 29 U.S.C. § 152(1) and (2), and is obligated to bargain collectively with the employees' certified representative over the terms of a new contract pending rejection of the existing contract or following formal approval of rejection by the Bankruptcy Court. *See NLRB v. Burns Security Services, Inc.,* 406 U.S. 272, 281, 92 S.Ct. 1571, 1578, 32 L.Ed.2d 61 (1972). But while a debtor-in-possession remains obligated to bargain in good faith under NLRA § 8(a)(5) over the terms and conditions of a possible new contract, it is not guilty of an unfair labor practice by unilaterally breaching a collective-bargaining agreement before formal Bankruptcy Court action.

Accordingly, the judgment of the Court of Appeals is

Affirmed.

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Justice BRENNAN, with whom Justice WHITE, Justice MARSHALL, and Justice BLACKMUN join, concurring in part and dissenting in part.

The Court holds that under § 365 of the Bankruptcy Code,[1] a Bankruptcy Court should permit a debtor in possession [2] to reject a collective-bargaining agreement upon a showing that the agreement "burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract." *Ante,* at 526. This test properly accommodates the policies of the National Labor Relations Act (NLRA) and the Bankruptcy Code, and I therefore join Parts I and II of the Court's opinion. But I cannot agree with the Court's holding in Part III that a debtor in possession does not commit an unfair labor

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practice if he unilaterally alters the terms of an existing collective-bargaining agreement after a bankruptcy petition has been filed, but before a Bankruptcy Court has authorized the rejection of that agreement. *Ante,* at 532. In so holding, the Court has completely ignored important policies that underlie the NLRA, as well as Parts I and II of its own opinion.

I

Two sections of the NLRA govern the alteration of existing collective-bargaining agreements. Section 8(a)(5) makes

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it an unfair labor practice for an employer "to refuse to bargain collectively with the representatives of his employees. . . ." [3] Section 8(d) defines the § 8(a)(5) duty to "bargain collectively" as "the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment." [4] When a collective-bargaining agreement is "in

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effect," § 8(d) adds four additional requirements to the duty to bargain collectively: "no party to [a collective-bargaining contract] shall terminate or modify such contract unless" he (1) provides the other party to the contract with timely written notice of the proposed modification, (2) "offers to meet and confer with the other party," (3) provides timely notice to the Federal Mediation and Conciliation Service and any similar state agencies, and (4) "continues in full force and effect . . . all the terms and conditions of the existing contract for a period of sixty days after such notice is given or until the expiration date of such contract, whichever occurs later." [5] Because § 8(d) defines the duty to bargain collectively that is imposed by § 8(a)(5), an employer who terminates or modifies a collective-bargaining agreement without complying with the requirements of § 8(d) violates § 8(a)(5). See *National Labor Relations Board v. Lion Oil Co.,* 352 U.S. 282, 285, 77 S.Ct. 330, 332, 1 L.Ed.2d 331 (1956) (employer who violates § 8(d)(4) violates § 8(a)(5)).[6] A unilateral modification

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of an existing collective-bargaining agreement is, therefore, a violation of § 8(d) and § 8(a)(5). See *Chemical Workers v. Pittsburgh Plate Glass Co.,* 404 U.S. 157, 159, 185, 92 S.Ct. 383, 387, 400, 30 L.Ed.2d 341 (1971); *Lion Oil, supra,* 352 U.S., at 285, 77 S.Ct., at 332.

In this case, the National Labor Relations Board (Board) held that Bildisco had violated § 8(a)(5) of the NLRA by unilaterally altering the terms of its collective-bargaining agreement with Local 408 of the International Brotherhood of Teamsters, Chauffers, Warehousemen, and Helpers of America.[7] Specifically, the Board found that Bildisco violated the terms of that agreement by its failure to (1) increase wages, (2) make pension, health, and welfare contributions, (3) remit dues to the union that were withheld from employees' wages, and (4) pay vacation benefits. Some of these activities occurred after Bildisco filed a voluntary petition in bankruptcy under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 *et seq.,* but before the Bankruptcy Court authorized Bildisco to reject its agreement with Local 408. During this period, Bildisco was operating its business as a debtor in possession. This aspect of the case, therefore, presents the question whether a debtor in possession violates § 8(d) and, as a result, § 8(a)(5) if he unilaterally modifies the terms of a collective-bargaining agreement in the interim between the filing of a bankruptcy petition and the rejection of that agreement.

II

The Court today rejects the Board's finding that Bildisco's unilateral modifications of its collective-bargaining agree-

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ment violated § 8(a)(5). The Court supports this conclusion by asserting that enforcement of § 8(d) in the post-filing period "would run directly counter to the express provisions of the Bankruptcy Code." *Ante,* at 532. Yet, the Court points to no provision of that Code that purports to render § 8(d) inapplicable, and to no provision of the NLRA that would preclude the application of § 8(d). Indeed, the Court concedes that a debtor in possession generally must comply with the provisions of the NLRA. *Ante,* at 534.

Accordingly, in order to achieve its desired result, the Court is forced to infer from the Bankruptcy Code's general treatment of executory contracts, and from the policies that underlie that treatment, that Congress must have intended the filing of a bankruptcy petition to render § 8(d) inapplicable. *Ante,* at 529-532. The Court observes that during the post-petition period, the nondebtor party to an executory contract may not sue the debtor in possession to enforce the contract terms, *ante,* at 530, but rather can only recover the reasonable value of any benefits conferred on the estate. *Ante,* at 531.[8] By contrast, "though the Board's action is

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nominally one to enforce § 8(d) . . . the practical effect of the enforcement action would be to require adherence to the terms of the collective-bargaining agreement." *Ante,* at 532. Because the Court finds that suspending the enforceability of executory contracts serves the goals of providing the debtor in possession with "flexibility and breathing space," the Court concludes that Congress could not have intended § 8(d) to remain applicable once a bankruptcy petition has been filed.

This argument is unpersuasive. However correct the Court may be in its description of the manner in which the Bankruptcy Code treats executory contracts generally and the policies that underlie that treatment, there is an unavoid-

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able conflict between the Code and the NLRA with which the Court has simply failed to grapple. Permitting a debtor in possession unilaterally to alter a collective-bargaining agreement in order to further the goals of the Bankruptcy Code seriously undermines the goals of the NLRA. We thus have the duty to decide the issue before us in a way that accommodates the policies of *both* federal statutes. That cannot properly be done, in the Court's fashion, by concentrating on the Bankruptcy Code alone; under that approach, a holding that § 8(d) is inapplicable once a bankruptcy petition has been filed must obviously follow. One could as easily, and with as little justification, focus on the policies and provisions of the NLRA alone and conclude that Congress must have intended that § 8(d) remain applicable. Rather, it is necessary to examine the policies and provisions of both statutes to answer the question presented to the Court.

The Court's concentration on the Bankruptcy Code and its refusal to accommodate that statute with the NLRA is particularly incongruous since the analysis in Part II of its opinion rests almost exclusively on the recognition that the two statutes must be accommodated. In that Part, the Court concludes that "because of the special nature of a collective-bargaining contract . . . a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement." *Ante,* at 524. Surely, the "special nature of a collective-bargaining contract" must also be considered when determining whether Congress intended a debtor in possession to be able unilaterally to alter its terms. I can only conclude that the Court does not do so because an examination of the policies and provisions of both statutes inexorably leads to the conclusion that Congress did not intend the filing of a bankruptcy petition to affect the applicability of § 8(d), and that, as a result, a debtor in possession commits an unfair labor practice when he unilaterally alters the terms of an existing collective-

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bargaining agreement after a bankruptcy petition has been filed but prior to rejection of that agreement.[9]

III.

A.

Because the issue in this case centers on the effect of filing a bankruptcy petition on the obligations of a debtor in possession under NLRA § 8(d), it is appropriate to begin by examining whether that provision would apply even in the absence of the countervailing provisions and policies of the Bankruptcy Code. In undertaking this threshold analysis, we must remember that we have previously recognized that § 8(d) must be construed flexibly to effectuate the purposes of the NLRA. See *e.g., NLRB v. Lion Oil Co.,* 352 U.S. 282, 290, 77 S.Ct. 330, 334, 1 L.Ed.2d 331 (1956); *Mastro Plastics Corp. v. NLRB,* 350 U.S. 270, 76 S.Ct. 349, 100 L.Ed. 309 (1956). As we stated in *Lion Oil,* a construction that does not serve the goals of the statute "is to be avoided unless the words chosen by Congress clearly compel it."

In addition, in resolving this threshold question we must be mindful of the deference to the Board's construction of the NLRA required by our decisions. See e.g., NLRB v. Iron-

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workers, 434 U.S. 335, 350, 98 S.Ct. 651, 660, 54 L.Ed.2d 586 (1978); *NLRB v. Weingarten, Inc.,* 420 U.S. 251, 267, 95 S.Ct. 959, 968, 43 L.Ed.2d 171 (1975); *NLRB v. Erie Resistor Corp.,* 373 U.S. 221, 236, 83 S.Ct. 1139, 1149, 10 L.Ed.2d 308 (1963). It is the Board's position that filing a bankruptcy petition does not affect the applicability of § 8(d).[10] See, e.g., *ISG Extrusion Toolings, Inc.,* 262 NLRB 114 (1982) (debtor in possession violates § 8(d) by unilaterally altering terms of collective-bargaining agreement); *Airport Limousine Service, Inc.,* 231 NLRB 932 (1977) (receiver violates § 8(d)). Plainly, the Court's position that § 8(d) is inapplicable once a bankruptcy petition has been filed is contrary to the goals of the NLRA, and a careful examination of "the words Congress has chosen" reveals that they do not "clearly compel" this result.

By their terms, the notice and cooling-off requirements of § 8(d) apply when "there is in effect a collective-bargaining contract" and a "party to such contract" seeks to "terminate or modify" it. The Court of Appeals held that § 8(d) was inapplicable because the "debtor-in-possession is '[a] new entity . . . created with its own rights and duties, subject to the supervision of the bankruptcy court.' " 682 F.2d, at 82, quoting *Shopmen's Local Union No. 455 v. Kevin Steel Products, Inc.,* 519 F.2d 698, 704 (CA2 1975). As a result, the Court of Appeals concluded that the debtor in possession is not a "party" to a collective-bargaining agreement within the meaning of § 8(d).[11]

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The Court today properly rejects the "new entity" theory, conceding that the debtor in possession is a party within the meaning of § 8(d). *Ante,* at 528. The Court nevertheless reaches an equally unsupportable result by concluding that once a bankruptcy petition has been filed, "the collective-

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bargaining agreement is not an enforceable contract within the meaning of NLRA § 8(d)." *Ante,* at 532. Of course, the phrase "enforceable contract" does not appear in § 8(d), so the Court's point must be that the collective-bargaining agreement is not "in effect" within the meaning of that section. Surely, the plain language of the statute does not compel this result. Perhaps the Court's omission of any specific reference to this phrase indicates that it agrees that the language is not dispositive. In any event, it is simply incorrect to suggest that the collective-bargaining agreement does not retain sufficient vitality after a bankruptcy petition has been filed to be reasonably termed "in effect" within the meaning of the statute.

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Although enforcement of the contract is suspended during the interim period, the contract clearly has other characteristics that render it "in effect" during the interim period. For example, if the debtor in possession assumes the contract, that assumption relates back to the time that the bankruptcy petition was filed. 2 Collier on Bankruptcy ¶ 365.03, at 365-24 (15th ed. 1983). As a result, "any compensation earned by and payable to the employee under the contract" after the petition is filed is a first priority administrative expense. Countryman, Executory Contracts in Bankruptcy: Part II, 58 Minn.L.Rev. 479, 484 (1974). See also Fogel, Executory Contracts and Unexpired Leases in The Bankruptcy Code, 64 Minn.L.Rev. 341, 376 (1980). If the contract is eventually rejected, rejection constitutes a breach effective immediately before the date of the filing of the petition. 11 U.S.C. § 365(g). The employees will have general unsecured claims for damages resulting from that breach. 3 Collier on Bankruptcy, ¶ 502.07, at 502-99 (15th ed. 1983); Note, The Bankruptcy Law's Effect on Collective Bargaining Agreements, 81 Colum.L.Rev. 391 (1981). Some

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of these damages will stem from the employer's obligations under the contract in the post-filing period. Therefore, whether the contract is accepted or rejected, it will support a claim that arises out of the debtor's obligations in the post-petition period.[12]

Additionally, even under the Court's approach, see *ante*, at 531, during the interim between filing and rejection or assumption, the estate will be liable to the employees for the reasonable value of any services they perform. The contract rate frequently will be the measure of the reasonable value of those services. See, *e.g.*, *In re Chase Commissary*, 11 F.Supp. 288 (SDNY 1935) (rental in lease presumed to be reasonable value of use and occupancy); Fogel, *supra*, at 370 (generally courts presume lease rentals reasonable). For these reasons, it is inaccurate to say that the collective-bargaining agreement may not reasonably be considered "in effect" for purposes NLRA § 8(d).[13] Other provisions of the NLRA, as well as the policies underlying that statute require that such a contract be considered "in effect." [14]

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The definitional sections of the NLRA plainly support the conclusion that Congress did not intend the filing of a bankruptcy petition to affect the applicability of § 8(d). As the Court notes, a debtor in possession is an "employer" within the meaning of the NLRA. *Ante*, at 19.[15] Because § 8(a)(5) imposes the duty to bargain on employers, the Court properly concludes that § 8(a)(5) applies to debtors in possession. *Ibid.* And because definition of the duty to bargain includes the notice and "cooling-off" requirements of § 8(d), *Lion Oil, supra*, 352 U.S., at 285, 77 S.Ct., at 332, the logical inference is that Congress intended these restrictions of unilateral alterations to apply to debtors in possession as well. It is most unlikely that Congress intended that the obligation to bargain apply to debtors in possession but not the definition of that duty.

B

The policies underlying the NLRA in general, and § 8(d) in particular, also strongly support the application of the notice and cooling-off requirements of § 8(d) in this context. As we explained in *First National Maintenance Corp. v. NLRB*,

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452 U.S. 666, 101 S.Ct. 2573, 69 L.Ed.2d 318 (1981), "[a] fundamental aim of the National Labor Relations Act is the establishment and maintenance of industrial peace to preserve the flow of interstate commerce. Central to achievement of this purpose is the promotion of collective bargaining as a method of defusing and chanelling conflict between labor and management." *Id.*, at 674, 101 S.Ct., at 2578 (citations omitted). See also NLRA § 1, 29 U.S.C. § 152. Because of the central role played by

collective bargaining in achieving the goals of the NLRA, "[e]nforcement of the obligation to bargain collectively is crucial to the statutory scheme." *NLRB v. American National Insurance Co.*, 343 U.S. 395, 402, 72 S.Ct. 824, 828, 96 L.Ed. 1027 (1951). The notice and cooling-off requirements of § 8(d), which are components of the duty to bargain, are specifically designed to prevent labor strife resulting from unilateral modifications and terminations of collective-bargaining agreements. In *Chemical Workers v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 92 S.Ct. 383, 30 L.Ed.2d 341 (1971), we explained that "[t]he purpose of the proscription of unilateral mid-term modifications and terminations in 8(d) cannot be, therefore, simply to assure adherence to contract terms . . . . The conditions for a modification or termination set out in paragraphs (1) through (4) plainly are designed to regulate modifications and terminations so as to facilitate agreement in place of economic warfare . . . . [T]he provision 'seeks to bring about the termination and modification of collective-bargaining agreements without interrupting the flow of commerce or the production of goods.' " *Id.*, at 187, 92 S.Ct., at 402, quoting *Mastro Plastics, supra,* 350 U.S., at 284, 76 S.Ct., at 358.

Plainly, the need to prevent "economic warfare" resulting from unilateral changes in terms and conditions of employment is as great after a bankruptcy petition has been filed as it is prior to that time. I do not think that there is any question that the threat to labor peace stemming from a unilateral modification of a collective-bargaining agreement is as great one day after a bankruptcy petition is filed as it was one day

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before the petition was filed.[16] We cannot ignore these realities when construing the reach of the NLRA. Cf. *NLRB v. Erie Resistor Corp.*, 373 U.S. 221, 236, 83 S.Ct. 1139, 1149, 10 L.Ed.2d 308 (1963) (citing Board's function in applying the "general provisions of the Act to the complexities of industrial life" as a reason to defer to its judgment). Nor can we ignore the judgment of the Board that § 8(d) should remain applicable after a bankruptcy petition has been filed, because that judgment stems from the Board's "special understanding of 'the actualities of industrial relations,' " *NLRB v. Erie Resistor Corp.*, 373 U.S. 221, 236, 83 S.Ct. 1139, 1150, 10 L.Ed.2d 308 (1962), quoting *NLRB v. United Steelworkers,* 357 U.S. 357, 362-363, 78 S.Ct. 1268, 1271-1272, 2 L.Ed.2d 1383 (1963).

The basis for 8(d)'s prohibition against unilateral modifications is a congressional judgment that such modifications would be antithetical to labor peace. As we explained in a somewhat different context in *Fibreboard Paper Products Corp. v. NLRB,* 379 U.S. 203, 211, 85 S.Ct. 398, 403, 13 L.Ed.2d 233 (1964), "[t]he Act was framed with an awareness that refusals to confer and negotiate had been one of the most prolific causes of industrial strife." Permitting unilateral modifications of collective-bargaining agreements, therefore, seriously undermines policies that lie at the very heart of § 8(d) and the NLRA. In sum, were one to consider only the policies and provisions of the NLRA, there could be no question that Congress intended that § 8(d) remain applicable after a bankruptcy petition has been filed.

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C

When we turn to the relevant provisions and policies of the Bankruptcy Code, we find nothing that alters this conclusion. As I have said, *supra,* at 539, the Court is unable to point to any provision of the Bankruptcy Code that by its terms renders § 8(d) inapplicable. Nor does the Court argue that there is anything in the Code that would forbid the debtor in possession from complying with the requirements of § 8(d).[17] The question then is whether application of § 8(d) would so undermine the goals of the Bankruptcy Code that, despite the deleterious effect on the policies of the NLRA, Congress could not have intended that § 8(d) remain applicable once a bankruptcy petition has been filed.

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As the Court correctly points out, the primary goal of Chapter 11 is to enable a debtor to restructure his business so as to be able to continue operating. *Ante,* at 528. Unquestionably, the option to reject an executory contract is essential to this goal. But the option to violate a collective-bargaining agreement before it is rejected is scarcely vital to insuring successful reorganization. For if a contract is so

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burdensome that even temporary adherence will seriously jeopardize the reorganization, the debtor in possession may seek the Bankruptcy Court's permission to reject that contract. Under the test announced by the Court today, his request should be granted.[18] Indeed, because labor unrest is inimical to the prospects for a successful reorganization, and because unilateral modifications of a collective-bargaining agreement will often lead to labor strife, such unilateral modifications may more likely *decrease* the prospects for a successful reorganization.

The Court claims that requiring the debtor in possession to adhere to the terms of a collective-bargaining agreement conflicts with the "Code's overall effort to give the debtor in possession some flexibility and breathing space." *Ante,* at 532. Again the Court does not explain how enforcement of § 8(d) interferes with these policies; but I assume that the Court expects that the financial pressures created by requiring adherence to the collective-bargaining agreement would put pressure on the debtor in possession to reach a rapid and possibly premature judgment about whether to assume or reject a contract.[19] It is apparent, however, that Congress did not believe that providing the debtor in possession with unlimited time to consider his options should outweigh all other

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considerations. For example, although Chapter 11 permits a debtor in possession to accept or reject a contract "at any time before the confirmation of the plan," the nondebtor party to such a contract is permitted to request that the Court order the debtor in possession to assume or reject the contract within a specified period. 11 U.S.C. § 365(d)(2). Congress thus clearly concluded that, in certain circumstances, the rights of the nondebtor party would outweigh the need of the debtor in possession for unlimited flexibility and breathing space.

More importantly, I do not believe that the pressure to seek early rejection will frequently impede the reorganization process. As noted above, when a collective-bargaining agreement will seriously impede the reorganization, the debtor in possession should be able to obtain permission to reject the agreement. The major danger to the reorganization that stems from premature rejection of collective-bargaining agreements is that the debtor in possession will reject an agreement he would not have rejected upon further deliberation. If that agreement contains terms more favorable than any that he is later able to obtain through renegotiation the reorganization may be impaired. In the case of a collective-bargaining agreement, however, this danger is largely illusory. Because the union members will lose their jobs if the reorganization fails, it is highly likely that the debtor in possession will be able to negotiate a contract that is at least as favorable as the contract that he has rejected. *Cf. First National Maintenance Corp. v. NLRB,* 452 U.S. 666, 681 n. 19, 101 S.Ct. 2573, 2582, 69 L.Ed.2d 318 (1980) (noting instances in which unions have aided employers to save failing businesses); New York Times, October 9, 1983, § 3, p. 1, 12 (reporting instances of employees agreeing to wage reductions in response to threatened bankruptcy or plant closings). In addition, because unions have a strong incentive to avoid rejection of contracts, they frequently may be willing to enter into negotiated settlements for the interim period that will at least forestall rejection. Consequently, in

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many cases, requiring the debtor in possession to adhere to the terms of an existing agreement will not lead to early rejection at all. In sum, because

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the debtor in possession may apply to the bankruptcy court for rejection of executory contracts, holding § 8(d) applicable to the reorganization period will not seriously undermine the chances for a successful reorganization.

IV

My conclusion that Congress intended that a debtor in possession adhere to the terms of a collective-bargaining agreement in the post-petition period, when he is free to disregard all other contracts, is supported by our consistent recognition that collective-bargaining agreements are not like other agreements. What Justice Douglas wrote in 1960 remains true today:

"The collective bargaining agreement . . . is more than a contract; it is a generalized code to govern a myriad of cases which the draftsmen cannot wholly anticipate. . . . A collective bargaining agreement is an effort to erect a system of industrial self-government. When most parties enter into contractual relationship, they do so voluntarily, in the sense that there is no real compulsion to deal with one another, as opposed to dealing with other parties. This is not true of the labor agreement. The choice is generally not between entering or refusing to enter into a relationship, for that in all probability preexists the negotiations. Rather, it is between having the relationship governed by an agreed-upon rule of law or leaving each and every matter subject to a temporary resolution dependent solely upon the relative strength, at any given moment, of the contending forces." *United Steelworkers v. Warrior & Gulf Navigation Co.,* 363 U.S. 574, 578-580, 80 S.Ct. 1347, 1350-1351, 4 L.Ed.2d 1409 (1960) (citations and footnotes omitted). See also *John Wiley & Sons, Inc. v. Livingston,* 376 U.S. 543, 550, 84 S.Ct. 909, 914, 11 L.Ed.2d 898 (1963).

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The Court's holding that an employer, without committing an unfair labor practice, may disregard the terms of a collective-bargaining agreement after a bankruptcy petition has been filed deprives the parties to the agreement of their "system of industrial government." Without this system, resolution of the parties' disputes will indeed be left to "the relative strength . . . of the contending forces." *Steelworkers, supra,* 363 U.S., at 580, 80 S.Ct., at 1352. Of course, there is some tension between the policies underlying the Bankruptcy Code and a holding that § 8(d) remains applicable after a bankruptcy petition has been filed. Holding § 8(d) inapplicable in these circumstances, however, strikes at the very heart of the policies underlying that section and the NLRA, and will, I believe, spawn precisely the type of industrial strife that NLRA § 8(d) was designed to avoid. By contrast, I do not think that the prospects for a successful reorganization will be seriously impaired by holding that § 8(d) continues to apply. For this reason, I conclude that filing a bankruptcy petition does not affect the applicability of § 8(d), and that, as a result, a debtor in possession who unilaterally alters the terms of a collective-bargaining agreement commits an unfair labor practice.

1. Chapter 11 of the present Bankruptcy Code was part of the Bankruptcy Reform Act of 1978, Pub.L. 95-598, 92 Stat. 2549 (1978). The first major revision of the bankruptcy laws since 1938, the Bankruptcy Reform Act consolidated three reorganization chapters of the former Bankruptcy Act into a single business reorganization chapter, with the intention that business reorganizations should be quicker and more efficient and provide greater protection to the debtor, creditors, and the public interest. See H.R.Rep. No. 95-595, p. 5, U.S.Code Cong. & Admin.News, p. 5787 (1977).

2. Section 1107 of Title 11 provides:

"(a) Subject to any limitations on a trustee under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter."

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Although the term debtor-in-possession is not fully interchangable with the term trustee in bankruptcy under the Bankruptcy Code, with respect to the issues before us the analysis is the same whether it is the debtor-in-possession or trustee in bankruptcy who is attempting to reject a collective-bargaining agreement.

3. Subsection 365(a) of the Bankruptcy Code, 11 U.S.C. § 365, reads:

"(a) Except as provided in sections 765 and 766 of this title and 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."

4. Section 8(a) of the National Labor Relations Act, 29 U.S.C. § 158, provides in pertinent part:

"(a) Unfair labor practices by employer

It shall be an unfair labor practice for an employer—

(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section [7];

* * * * *

(5) to refuse to bargain collectively with the representatives of his employees * * *."

5. Section 8(d) of the National Labor Relations Act, 29 U.S.C. § 158(d), reads in relevant part:

"(d) Obligation to bargain collectively

For the purposes of this section, to bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotiation of an agreement, or any question arising thereunder, and the execution of a written contract incorporating any agreement reached if requested by either party, but such obligation does not compel either party to agree to a proposal or require the making of a concession: *Provided,* That where there is in effect a collective-bargaining contract covering employees in an industry affecting commerce, the duty to bargain collectively shall also mean that no party to such contract shall terminate or modify such contract, unless the party desiring such termination or modification—

(1) serves a written notice upon the other party to the contract of the proposed termination or modification sixty days prior to the expiration date thereof, or in the event such contract contains no expiration date, sixty days prior to the time it is proposed to make such termination or modification;

(2) offers to meet and confer with the other party for the purpose of negotiating a new contract or a contract containing the proposed modifications;

(3) notifies the Federal Mediation and Conciliation Service within thirty days after such notice of the existence of a dispute, . . .; and

(4) continues in full force and effect, without resorting to strike or lockout, all the terms and conditions of the existing contract for a period of sixty days after such notice is given or until the expiration date of such contract, whichever occurs later:

The duties imposed upon employers, employees, and labor organizations by paragraphs (2) to (4) * * * shall not be construed as requiring either party to discuss or agree to any modification of the terms and conditions contained in a contract for a fixed period, if such modification is to become effective before such terms and conditions can be reopened under the provisions of the contract. * * * "

6. The Bankruptcy Code furnishes no express definition of an executory contract, see 11 U.S.C. § 365(a), but the legislative history to § 365(a) indicates that Congress intended the term to mean a contract "on which performance is due to some extent on both sides." H.R.Rep. No. 95-595, p. 347 (1977), see S.Rep. No. 95-989, p. 58 (1977).

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We reject the argument of *amicus* United Mine Workers of America that a collective-bargaining agreement is not an executory contract within the meaning of § 365(a). Under their labor contract both Bildisco and the Union had reciprocal obligations, and at any point during the life of the contract, performance was due by both parties. See Labor Contract between Bildisco and Teamsters Local No. 408, Joint Appendix, pp. 78-115.

7. Although Congress granted the debtor-in-possession a broad power to assume or reject executory contracts, it qualified that power in certain situations. Very generally, subsections (b) and (c) limit the debtor-in-possession's or trustee's power of assumption in several circumstances; subsection (d) requires assumption or rejection within 60 days in cases of liquidation. Bankruptcy Code § 765 and § 766 limit the power of rejection or assumption in the case of the liquidation of a commodity brokerage business.

8. Section 1167 of Title 11 reads in full:

"(a) Notwithstanding section 365 of this title, neither the court nor the trustee may change the wages or working conditions of employees of the debtor established by a collective-bargaining agreement that is subject to the Railway Labor Act (45 U.S.C. 151 et seq.) except in accordance with section 6 of such Act (45 U.S.C. 156)."

This provision was derived from former § 77(n) of the Bankruptcy Act. Reflective of the long-standing special treatment afforded railway labor, see *Railway Labor Employees v. Hansen,* 351 U.S. 225, 232 and n. 5, 76 S.Ct. 714, 718 and n. 5, 100 L.Ed. 1112 (1951), Congress determined that "the subject of railway labor is too delicate . . . for this code to upset established relationships." H.R.Rep. No. 95-595, p. 137 (1977).

9. The dissent states that the Board's interpretation of the NLRA should be given deference. *Post,* at 542-543. While the Board's interpretation of the NLRA should be given some deference, the proposition that the Board's interpretation of statutes outside its expertise is likewise to be deferred to is novel. We see no need to defer to the Board's interpretation of Congress's intent in passing the Bankruptcy Code.

10. The Bankruptcy Code's provisions regarding the presentation of claims are permissive. See 11 U.S.C. § 501. Nevertheless, the filing of a proof of claim is a necessary condition to the allowance of an unsecured or priority claim, since a plan of reorganization is binding upon all creditors once the plan is confirmed, whether or not the claim was presented for administration. 11 U.S.C. § 1141(d)(1)(A)(i). See *In re Francis,* 15 B.R. 998, 5 C.B.C.2d 1101 (Bkrtcy. EDNY 1981); 3 Collier on Bankruptcy ¶ 501.01 (15th ed. 1983). Undisputed claims listed by the debtor-in-possession under 11 U.S.C. § 521(1) are deemed filed for purposes of administration. See 11 U.S.C. § 1111(a).

11. Subsection § 365(g)(1) of Title 11 provides:

"(g) Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or 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, or 13 of this title, immediately before the date of the filing of the petition * * *."

12. Section 502(c) provides that any contingent or unliquidated claim shall be estimated for purposes of settling a bankrupt estate. Under this provision losses occasioned by the rejection of a collective-bargaining agreement must be estimated, including unliquidated losses attributable to fringe benefits or security provisions like seniority rights. Section 502(c) is a change from prior law; under § 57d of the Bankruptcy Act the court could disallow unliquidated claims if too difficult to estimate. See 3 Collier on Bankruptcy ¶ 502.03 (15th ed. 1983). In enacting the Bankruptcy Code Congress also extended the priority for unsecured claims made by workers to cover vacation, severance, sick leave pay, and pension plan obligations and increased the amount of this priority. 11 U.S.C. § 507(a)(3); see H.R.Rep. No. 95-595, p. 357 (1977). These provisions indicate Congress's considered

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judgment regarding the extent to which special provisions should be afforded workers under the Bankruptcy Code for claims arising out of the rejection of the collective-bargaining agreement. In addition, wages paid after the filing of a petition in bankruptcy may be deemed administrative expenses and afforded the highest priority, if necessary to preserve the estate. See 11 U.S.C. § 503(b)(1)(A).

13. See, *e.g., In re Mammoth Mart, Inc.*, 536 F.2d 950, 954-955 (CA1 1976); *In re Italian Cook Oil Corp.*, 190 F.2d 994, 996 (CA3 1951); *In re United Cigar Stores Co.*, 89 F.2d 3, 6 (CA2 1937); *Durand v. NLRB*, 296 F.Supp. 1049, 1056 (WD Ark.1969); *In re Public Ledger*, 161 F.2d 762, 770-771 (CA3 1947); *In re North Atlantic & Gulf S.S. Co.*, 204 F.Supp. 899, 909 (SDNY 1962), *aff'd. sub nom, Schilling v. A/S/D/S Dannebrog*, 320 F.2d 628 (CA2 1963); *In re Price Chopper Supermarkets, Inc.*, 19 B.R. 462, 466-467 (B.Ct. SD Cal.1982).

14. Section 8(d) defines the duty to bargain created by § 8(a)(5) to include a duty to continue the terms of a collective-bargaining agreement in "full force" while following § 8(d) procedures for modifying a collective-bargaining agreement. Our determination that § 8(d) cannot be used to enforce the terms of a labor contract after the filing of a petition in bankruptcy and prior to formal rejection necessarily means that § 8(a)(5) cannot be used to achieve the same end. The Court's decision in *NLRB v. Katz*, 369 U.S. 736 (1962), that an employer's unilateral modification of terms and conditions of employment during the pendency of negotiations constitutes an unfair labor practice, contrary to the dissent's suggestion, *post*, at 13, n. 15, is not on point, since *Katz* did not address the effect of the bankruptcy laws on an employer's duty to bargain under § 8(a)(5).

1. Section 365 provides in pertinent part: "Except as provided in sections 765 and 766 of this title and 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.

2. Under section 1101 of the Bankruptcy Code, 11 U.S.C. § 1101, the debtor in possession is the debtor in any case in which "no person has qualified and is serving as a trustee." 1 A. Herzog & L. King, Bankruptcy Code § 1102, at 452 (1983). Section 1107 provides that "[s]ubject to . . . such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights . . . and powers" of a reorganization trustee other than the right to compensation. These powers include "the power to operate the debtor's business unless the court orders otherwise." 5 L. King, Collier on Bankruptcy ¶ 1101.01, 1101-2 (15th ed. 1983).

3. The complete text of § 8(a)(5) reads as follows:

"(a) It shall be an unfair labor practice for an employer—

. . . (5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of section 159(a) of this title." 29 U.S.C. § 158(a).

4. The complete text of the relevant portion of § 8(d) provides:

"For the purposes of this section, to bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotiation of an agreement, or any question arising thereunder, and the execution of a written contract incorporating any agreement reached if requested by either party, but such obligation does not compel either party to agree to a proposal or require the making of a concession: *Provided*, That where there is in effect a collective-bargaining contract covering employees in an industry affecting commerce, the duty to bargain collectively shall also mean that no party to such contract shall terminate or modify such contract, unless the party desiring such termination or modification—

(1) serves a written notice upon the other party to the contract of the proposed termination or

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modification sixty days prior to the expiration date thereof, or in the event such contract contains no expiration date, sixty days prior to the time it is proposed to make such termination or modification;

(2) offers to meet and confer with the other party for the purpose of negotiating a new contract or a contract containing the proposed modifications;

(3) notifies the Federal Mediation and Conciliation Service within thirty days after such notice of the existence of a dispute, and simultaneously therewith notifies any State or Territorial agency established to mediate and conciliate disputes with the State or Territory where the dispute occurred, provided no agreement has been reached by that time; and

(4) continues in full force and effect, without resorting to strike or lockout, all the terms and conditions of the existing contract for a period of sixty days after such notice is given or until the expiration date of such contract, whichever occurs later:

The duties imposed upon employers, employees, and labor organizations by paragraphs (2)-(4) of this subsection . . . shall not be construed as requiring either party to discuss or agree to any modification of the terms and conditions contained in a contract for a fixed period, if such modification is to become effective before such terms and conditions can be reopened under the provisions of the contract.

Any employee who engages in a strike within any notice period specified in this subsection, or who engages in any strike within the appropriate period specified in subsection (g) of this section, shall lose his status as an employee of the employer engaged in the particular labor dispute, for the purposes of sections 158 to 160 of this title, but such loss of status for such employee shall terminate if and when he is reemployed by such employer." 29 U.S.C. § 158(d).

5. *See* n. 4, *supra,* for the complete text of this portion of § 8(d).

6. Because § 8(d) begins by defining the collective bargaining as the "obligation . . . to meet . . . and confer . . . with respect to *wages, hours and other terms and conditions of employment,*" we held that notice and waiting period requirements of § 8(d) are applicable to a modification only when it "changes a term that is a mandatory rather than a permissive subject of bargaining." *Chemical Workers v. Pittsburgh Plate Glass Co.,* 404 U.S. 157, 185, 92 S.Ct. 383, 400, 30 L.Ed.2d 341 (1971).

7. The Board also held that Bildisco had violated § 8(a)(1). However, because this holding is wholly dependent on the § 8(a)(5) violation, it presents no independent issues. *See Chemical Workers, supra,* at 163 n. 6, 92 S.Ct., at 389 n. 6. *See generally* R. Gorman, Basic Text on Labor Law 132 (1976) (conduct that violated § 8(5) also violated 8(1) derivatively).

8. The Court appears to attribute the rule that the debtor in possession is liable only for the reasonable value of benefits conferred, and not for the debtor's obligations under the contract, to § 365(g)(1), 11 U.S.C. § 365(g)(1). Section 365(g)(1) does not, however, serve that function.

In pertinent part, § 365(g)(1) provides that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease . . . if such lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, or 13 of this title, immediately before the date of the filing of the petition." None of the cases relied upon by the Court, however, refer to § 365(g)(1) or its predecessor under the Bankruptcy Act as the source of the limitation of the estate's liability to the reasonable value of benefits conferred. In only one case, *In re North Atlantic & Gulf S.S. Co.,* 204 F.Supp. 899, 909 (SDNY 1962), *aff'd sub nom., Schilling v. A/S/D/S Dannebrog,* 320 F.2d 628 (CA2 1963), does the court even arguably relate the principles of retroactivity to the unenforceability of contracts in the interim period. Moreover, the legislative history of § 365(g)(1) makes it clear that the purpose of that provision is to insure that claims stemming from

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rejection are treated as general unsecured claims. The House and Senate Reports explain that

"[t]he purpose [of § 365(g)(1)] is to treat rejection claims as prepetition claims." S.Rep. No. 95-989, 95th Cong., 2d Sess. 60 (1978); H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 349 (1977). See also 2 Collier on Bankruptcy, *supra* ¶ 365.08, at 365-41. The extent to which the claim arising from rejection will be allowed is therefore determined by the rules for the allowance of prepetition claims. *See* 11 U.S.C. § 502(g); 3 Collier on Bankruptcy ¶ 502.08, at 502-100. In addition, the priority, if any, to be accorded such a claim will be determined according to the rules for prepetition claims. 11 U.S.C. § 507. Were damages stemming from rejection treated as post-petition, rather than prepetition, claims, they would be accorded first priority as administrative expenses. Bordewieck & Countryman, The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors, 11 Am.Bankr.L.J. 293, 331 (1983); 2 Collier on Bankruptcy, *supra,* ¶ 365.08, at 365-41.

Although the statutory basis for the rule that the debtor in possession is not liable for the debtor's obligations under the contract until it is assumed is not entirely clear, the leading treatise appears to attribute the rule to the concept that title to an executory contract does not pass to the estate until the contract is assumed. *Id.,* ¶ 365.03, at 365-24. See also Bordewieck and Countryman, *supra,* at 303. The debtor in possession's liability for the reasonable value of any benefits conferred stems from § 503(b) which allows administrative expenses for the "actual, necessary costs and expenses of preserving the estate." 3 Collier on Bankruptcy, *supra,* ¶ 503.04, at 503-15.

9. Despite this conclusion, I agree with the Court that the debtor in possession need not comply with the notice requirements and waiting periods imposed by § 8(d) before seeking rejection. That is, in order to obtain rejection, the debtor in possession need not, for example, demonstrate that it has given notice to the union of its desire to seek rejection and has maintained the contract in "full force and effect" without resorting to a lockout for the period required by § 8(d). I also agree that the debtor in possession need not bargain to impasse before he may seek the court's permission to reject the agreement. As the Board notes, debtors in possession may need expeditious determinations about whether they may reject a collective-bargaining agreement. The notice and waiting periods contained in § 8(d) would make a rapid determination impossible. Brief of NLRB, at 41. Nor, as the Court notes, should the bankruptcy court be required to make determinations that are wholly outside its area of expertise, such as whether the parties have bargained to impasse. *Ante,* at 526-527, 533-534. Rather, I believe that the test for determining whether rejection should be permitted enunciated in Part II of the Court's opinion strikes the proper balance between the NLRA and the Bankruptcy Code.

10. The Board has held that a trustee was not bound by a preexisting collective-bargaining agreement when there were drastic changes in the operations of the debtor company immediately after the bankruptcy petition was filed. *Blazer Industries, Inc.,* 236 NLRB 103, 109-10 (1978). Because this case involves a debtor in possession, rather than a trustee, and because there is nothing in the opinion of the Court of Appeals for the Third Circuit or the Board suggesting that drastic changes of the significance found in *Blazer* took place in Bildisco's operation, *Blazer* is simply not relevant to the issues before us today.

11. In concluding that a debtor in possession does not commit an unfair labor practice if he unilaterally alters the terms of the collective-bargaining agreement, the Court of Appeals also relied on an analogy to the doctrine of successorship, as applied by this Court in *NLRB v. Burns Security Services, Inc.,* 406 U.S. 272, 92 S.Ct. 1571, 32 L.Ed.2d 61 (1972). In my view, this reliance was misplaced.

In *Burns,* we considered the bargaining obligations of a "successor" employer. The respondent in *Burns,* Burns International Security Services, Inc., won a contract to provide security services that had been provided by the Wackenhut Corporation. A majority of the

individuals hired by Burns were former Wackenhut employees. We held that Burns was not bound by the terms of the collective-bargaining agreement between Wackenhut and its employees, but that Burns had a duty to bargain with the union that had represented those employees. Our conclusion that Burns was not bound by Wackenhut's collective-bargaining agreement was based largely on the ground that Congress did not intend to bind an employer to terms to which it had not agreed. This consideration has little relevance to this case because the debtor in possession is the same employer who agreed to the collective bargaining agreement. We also noted in *Burns* that a potential employer might be reluctant to take over a failing business if he were bound by his predecessor's labor contract. Given that the debtor is bound by the collective-bargaining agreement before he files his bankruptcy petition, holding that he remains bound after the petition is filed cannot act as a disincentive to filing the petition.

The Court of Appeals also found § 8(d) inapplicable because rejection relates back to the time immediately before the filing under § 365(g)(1). As a result, that court concluded that "no labor contract effectively existed between the union and the debtor-in-possession" after the petition was filed. 682 F.2d, at 84. As noted above, however, see n. 8, supra, § 365(g)(1) is merely intended to insure that claims for damages stemming from the rejection of a collective-bargaining agreement are treated as prepetition unsecured claims. Although the fiction of relation back under § 365(g)(1) serves a useful function under the Bankruptcy Code, extending this fiction to the NLRA is not helpful in finding the proper accommodation between those two statutes. As should be apparent from the discussion in the text, see *infra,* at 545-546, for purposes of § 8(d), it is inaccurate to suggest that the collective-bargaining agreement does not exist after the bankruptcy petition is filed.

12. In the unlikely event that the contract is neither accepted nor rejected, it will "ride through" the bankruptcy proceeding and be binding on the debtor even after a discharge is granted. *Federal's, Inc. v. Edmonton Investment Co.,* 555 F.2d 577, 579 (CA6 1977); 2 Collier on Bankruptcy, *supra,* ¶ 365.03, at 365-22. The nondebtor party's claim will therefore survive the bankruptcy proceeding. Countryman, *supra,* at 487.

13. It is noteworthy that courts considering bankruptcy cases often refer to executory contracts as remaining "in effect" unless or until they are rejected. See, *e.g., Federal's, Inc. v. Edmonton Investment Co.,* 555 F.2d 575, 579 (CA6 1977) (executory contracts "remain in effect unless" rejected during the proceedings); *Consolidated Gas Electric Light & Power Co. v. United Railways Co.,* 85 F.2d 799 (CA4 1936) (executory contract "remains in force until it is rejected"); *Smith v. Hill,* 317 F.2d 539, 542 n. 6 (CA9 1963) (executory contracts "continue in effect" unless rejected); *In Re Guardian Equipment Corp.,* 18 B.R. 864, 867 (Bkrtcy.S.D.Fla.1982) (lease that has not been assumed or rejected "remains in effect").

14. Even if we could say that the collective-bargaining agreement is not "in effect" and that the notice and waiting period requirements of § 8(d) are inapplicable, it does not necessarily follow that the debtor in possession may unilaterally alter terms and conditions of employment. For example, in *NLRB v. Katz,* 369 U.S. 736, 743, 82 S.Ct. 1107, 1111, 8 L.Ed.2d 230 (1962), although the parties had not yet concluded their negotiations for an initial collective-bargaining agreement, we held that "an employer's unilateral change in conditions of employment under negotiation is . . . a violation of § 8(a)(5) for it is a circumvention of the duty to negotiate which frustrates the objectives of § 8(a)(5) much as does a flat refusal [to negotiate]." In addition, it has been widely held that an employer generally may not make unilateral changes in matters that are mandatory subjects of bargaining even after a collective-bargaining agreement has expired. See, *e.g., Peerless Roofing Co. v. NLRB,* 641 F.2d 734, 735 (CA9 1981); *Clear Pine Mouldings, Inc. v. NLRB,* 632 F.2d 721, 729

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(CA9 1980); *Hinson v. NLRB,* 428 F.2d 133, 136 (CA8 1970).

15. Section 2(2), 29 U.S.C. § 152(2), defines the term "employer" to include "any person acting as an agent of an employer, directly or indirectly." A trustee or a debtor in possession is a "person" within the meaning of § 2(2) as § 2(1) of the NLRA, 29 U.S.C. § 152(1), defines "person" to include "trustees in cases under Title 11 [which governs bankruptcy], or receivers."

16. Recent events make it clear that the fear of labor unrest resulting from post-filing unilateral modifications is not merely a hypothetical possibility. For example, on September 24, 1983, Continental Airlines filed a Chapter 11 petition. The company immediately instituted wage reductions that ranged from 45 to 50%. New York Times, September 28, 1983, p. D6. On October 3rd, Continental's pilots and flight attendants went on strike. New York Times, October 3, 1983, p. B13. Similarly, on April 22, 1983, Wilson Foods Corporation filed a Chapter 11 petition. Three days later, the company reduced wages by 40 to 50%. New York Times, May 3, 1983, p. D2. The wage cut prompted a strike in early June. New York Times, June 11, 1983, p. 31.

17. The Court does suggest that § 502(c), which provides for the estimation of contingent and unliquidated claims, and § 507(a)(3) which grants third priority status to certain claims for compensation earned prior to the filing of the petition, "indicate Congress' considered judgment regarding the extent to which special provisions should be afforded workers under the Bankruptcy Code." *Ante,* at 531 n. 12. If, as I conclude, Congress intended § 8(d) to remain applicable after a bankruptcy petition is filed, it would, however, have been unnecessary to repeat the protections contained by that section in the Bankruptcy Code.

In addition, the Court refers to, and appears to find significance in, the automatic stay provision, 11 U.S.C. § 362(a), and the requirement that damages stemming from rejection of an executory contract be recovered through the Code's claims administration procedures. *Ante,* at 529-530. However, since the Court does not argue that the automatic stay provision would bar an NLRB proceeding to enforce § 8(d) or that any award in such proceedings would not be recovered through the bankruptcy claims administration procedures, I fail to see why the Court finds these sections relevant to our resolution of the issue before us.

18. I therefore fundamentally disagree with the Court's wholly unsupported statement that application of § 8(d) "would largely, if not completely, undermine whatever benefit the debtor-in-possession otherwise obtains by its authority to request rejection of the agreement." *Ante,* at 529.

19. The financial pressure is created primarily by the fact that the cost of the debtor in possession's compliance with § 8(d) would be accorded first priority as an administrative expense. See *In re Bel Air Chateau Hospital, Inc.,* 106 LRRM (BNA) 2834 (C.D.Cal.1980) (Board award for backpay accruing during reorganization given first priority as a cost of administration); Bordewieck & Countryman, *supra,* at 333. *Cf. Reading Co. v. Brown,* 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968) (damages resulting from negligence of receiver administering an estate under Chapter XI of the Bankruptcy Act afforded first priority as an administrative expense).

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474 U.S. 494
106 S.Ct. 755
88 L.Ed.2d 859

MIDLANTIC NATIONAL BANK, Petitioner

v.

NEW JERSEY DEPARTMENT OF ENVIRONMENTAL PROTECTION. Thomas J. O'NEILL, Trustee in Bankruptcy of Quanta Resources Corporation, Debtor, Petitioner v. CITY OF NEW YORK et al.

Nos. 84-801, 84-805.
Argued Oct. 16, 1985.
Decided Jan. 27, 1986.
Rehearing Denied March 24, 1986.

See 475 U.S. 1090, 106 S.Ct. 1482.

Syllabus

Quanta Resources Corp. (Quanta) processed waste oil at facilities located in New York and New Jersey. The New Jersey Department of Environmental Protection (NJDEP) discovered that Quanta had violated a provision of the operating permit for the New Jersey facility by accepting oil contaminated with a toxic carcinogen. During negotiations with NJDEP for the cleanup of the New Jersey site, Quanta filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, and after NJDEP had issued an order requiring cleanup, Quanta converted the action to a liquidation proceeding under Chapter 7. An investigation of the New York facility then revealed that Quanta had also accepted similarly contaminated oil at that site. The trustee notified the creditors and the Bankruptcy Court that he intended to abandon the property under § 554(a) of the Bankruptcy Code, which authorizes a trustee to "abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate." The City and the State of New York objected, contending that abandonment would threaten the public's health and safety, and would violate state and federal environmental law. The Bankruptcy Court approved the abandonment, and, after the District Court affirmed, an appeal was taken to the Court of Appeals for the Third Circuit. Meanwhile, the Bankruptcy Court also approved the trustee's proposed abandonment of the New Jersey facility over NJDEP's objection, and NJDEP took a direct appeal to the Court of Appeals. In separate judgments, the Court of Appeals reversed, holding that the Bankruptcy Court erred in permitting abandonment.

Held: A trustee in bankruptcy may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards. Congress did not intend for § 554(a) to pre-empt all state and local laws. A bankruptcy court does not have the power to authorize an abandonment without formulat-

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ing conditions that will adequately protect the public's health and safety. Pp. 500-507.

(a) Before the 1978 revisions of the Bankruptcy Code, which codified in § 554 the judicially developed rule of abandonment, the trustee's abandonment power had been limited by a judicially developed doctrine intended to protect legitimate state and federal interests. In codifying the rule of abandonment, Congress also presumably included the corollary that a trustee could not exercise his abandonment power in violation of certain state and federal laws. Pp. 500-501.

(b) Neither this Court's decisions nor Congress has granted a trustee in bankruptcy powers that would lend support to a right to abandon property in contravention of state or local laws designed to protect public health or safety. Where the Bankruptcy Code has conferred other special powers upon the trustee and where there was no common-law limitation on such powers, Congress has expressly provided that the trustee's efforts to marshal and distribute the estate's assets must yield to governmental interests in public health and safety. It cannot be assumed that Congress, having placed such

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limitations upon other aspects of trustees' operations, intended to discard the well-established judicial restriction on the abandonment power. Moreover, 28 U.S.C. § 959(b), which commands the trustee to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State," provides additional evidence that Congress did not intend for the Bankruptcy Code to pre-empt all state laws. Pp. 502-505.

(c) Additional support for restricting the abandonment power is found in repeated congressional emphasis, in other statutes, on the goal of protecting the environment against toxic pollution. Pp. 505-506.

739 F.2d 912 and 739 F.2d 927, affirmed.

POWELL, J., delivered the opinion of the Court, in which BRENNAN, MARSHALL, BLACKMUN, and STEVENS, JJ., joined. REHNQUIST, J., filed a dissenting opinion, in which BURGER, C.J., and WHITE and O'CONNOR, JJ., joined, *post*, p. 507.

William F. McEnroe, Newark, N.J., for petitioner in No. 84-805.

A. Dennis Terrell, Morristown, N.J., for petitioner in No. 84-801.

Robert Hermann, Albany, N.Y., for respondents in No. 84-805.

Mary Carol Jacobson, Trenton, N.J., for respondent in No. 84-801.

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Justice POWELL delivered the opinion of the Court.

These petitions for certiorari, arising out of the same bankruptcy proceeding, present the question whether § 554(a) of the Bankruptcy Code, 11 U.S.C. § 554(a),[1] authorizes a trustee in bankruptcy to abandon property in contravention of state laws or regulations that are reasonably designed to protect the public's health or safety.

I

Quanta Resources Corporation (Quanta) processed waste oil at two facilities, one in Long Island City, New York, and

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the other in Edgewater, New Jersey. At the Edgewater facility, Quanta handled the oil pursuant to a temporary operating permit issued by the New Jersey Department of Environmental Protection (NJDEP), respondent in No. 84-801. In June 1981, Midlantic National Bank, petitioner in No. 84-801, provided Quanta with a $600,000 loan secured by Quanta's inventory, accounts receivable, and certain equipment. The same month, NJDEP discovered that Quanta had violated a specific prohibition in its operating permit by accepting more than 400,000 gallons of oil contaminated with PCB, a highly toxic carcinogen. NJDEP ordered Quanta to cease operations at Edgewater, and the two began negotiations concerning the cleanup of the Edgewater site. But on October 6, 1981, before the conclusion of negotiations, Quanta filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. The next day, NJDEP issued an administrative order requiring Quanta to clean up the site. Quanta's financial condition remained perilous, however, and the following month, it converted the action to a liquidation proceeding under Chapter 7. Thomas J. O'Neill, petitioner in No. 84-805, was appointed trustee in bankruptcy, and subsequently oversaw abandonment of both facilities.

After Quanta filed for bankruptcy, an investigation of the Long Island City facility revealed that Quanta had accepted and stored there over 70,000 gallons of toxic, PCB-contaminated oil in deteriorating and leaking containers. Since the mortgages on that facility's real property exceeded the property's value, the estimated cost of disposing of the waste oil plainly rendered the property a net burden to the estate.

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After trying without success to sell the Long Island City property for the benefit of Quanta's creditors, the trustee notified the creditors and the Bankruptcy Court for the District of New Jersey that he intended to abandon the property pursuant to § 554(a). No party to the bankruptcy proceeding disputed the trustee's allegation that the site was "burdensome" and of "inconsequential value to the estate" within the meaning of § 554.

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The City and the State of New York (collectively New York), respondents in No. 84-805, nevertheless objected, contending that abandonment would threaten the public's health and safety, and would violate state and federal environmental law. New York rested its objection on "public policy" considerations reflected in applicable local laws, and on the requirement of 28 U.S.C. § 959(b) that a trustee "manage and operate" the property of the estate "according to the requirements of the valid laws of the State in which such property is situated." New York asked the Bankruptcy Court to order that the assets of the estate be used to bring the facility into compliance with applicable law. After briefing and argument, the court approved the abandonment, noting that "[t]he City and State are in a better position in every respect than either the Trustee or debtor's creditors to do what needs to be done to protect the public against the dangers posed by the PCB-contaminated facility." The District Court for the District of New Jersey affirmed, and New York appealed to the Court of Appeals for the Third Circuit.

Upon abandonment, the trustee removed the 24-hour guard service and shut down the fire-suppression system. It became necessary for New York to decontaminate the facility, with the exception of the polluted subsoil, at a cost of about $2.5 million.[2]

On April 23, 1983, shortly after the District Court had approved abandonment of the New York site, the trustee gave notice of his intention to abandon the personal property at the Edgewater site, consisting principally of the contaminated oil. The Bankruptcy Court approved the abandonment on May 20, over NJDEP's objection that the estate had

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sufficient funds to protect the public from the dangers posed by the hazardous waste.[3]

Because the abandonments of the New Jersey and New York facilities presented identical issues, the parties in the New Jersey litigation consented to NJDEP's taking a direct appeal from the Bankruptcy Court to the Court of Appeals pursuant to § 405(c)(1)(B) of the Bankruptcy Act of 1978.

A divided panel of the Court of Appeals for the Third Circuit reversed. *In re Quanta Resources Corp.*, 739 F.2d 912 (1984); *In re Quanta Resources Corp.*, 739 F.2d 927 (1984). Although the court found little guidance in the legislative history of § 554, it concluded that Congress had intended to codify the judge-made abandonment practice developed under the previous Bankruptcy Act. Under that law, where state law or general equitable principles protected certain public interests, those interests were not overridden by the judge-made abandonment power. The court also found evidence in other provisions of the Bankruptcy Code that Congress did not intend to pre-empt all state regulation, but only that grounded on policies outweighed by the relevant federal in-

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terests. Accordingly, the Court of Appeals held that the Bankruptcy Court erred in permitting abandonment, and remanded both cases for further proceedings.[4]

We granted certiorari and consolidated these cases to determine whether the Court of Appeals properly construed § 554, 469 U.S. 1207, 105 S.Ct. 1168, 84 L.Ed.2d 319 (1985). We now affirm.

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II

Before the 1978 revisions of the Bankruptcy Code, the trustee's abandonment power had been limited by a judicially developed doctrine intended to protect legitimate state or federal interests. This was made clear by the few relevant cases. In *Ottenheimer v. Whitaker,* 198 F.2d 289 (CA4 1952), the Court of Appeals concluded that a bankruptcy trustee, in liquidating the estate of a barge company, could not abandon several barges when the abandonment would have obstructed a navigable passage in violation of federal law. The court stated:

"The judge-made [abandonment] rule must give way when it comes into conflict with a statute enacted in order to ensure the safety of navigation; for we are not dealing with a burden imposed upon the bankrupt or his property by contract, but a duty and a burden imposed upon an owner of vessels by an Act of Congress in the public interest." *Id.*, at 290.

In *In re Chicago Rapid Transit Co.,* 129 F.2d 1 (CA7), cert. denied, *sub nom. Chicago Junction R. Co. v. Sprague,* 317 U.S. 683, 63 S.Ct. 205, 87 L.Ed. 547 (1942), the Court of Appeals held that the trustee of a debtor transit company could not cease its opera-

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tion of a branch railway line when local law required continued operation. While the court did not forbid the trustee to abandon property (*i.e.*, to reject an unexpired lease), it conditioned his actions to ensure compliance with state law. Similarly, in *In re Lewis Jones, Inc.,* 1 BCD 277 (Bkrtcy Ct. ED Pa.1974), the Bankruptcy Court invoked its equitable power to "safeguard the public interest" by requiring the debtor public utilities to seal underground steam lines before abandoning them.

Thus, when Congress enacted § 554, there were well-recognized restrictions on a trustee's abandonment power. In codifying the judicially developed rule of abandonment, Congress also presumably included the established corollary that a trustee could not exercise his abandonment power in violation of certain state and federal laws. The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. *Edmonds v. Compagnie Generale Transatlantique,* 443 U.S. 256, 266-267, 99 S.Ct. 2753, 2759-60, 61 L.Ed.2d 521 (1979). The Court has followed this rule with particular care in construing the scope of bankruptcy codifications. If Congress wishes to grant the trustee an extraordinary exemption from nonbankruptcy law, "the intention would be clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt." *Swarts v. Hammer,* 194 U.S. 441, 444, 24 S.Ct. 695, 696, 48 L.Ed. 1060 (1904); see *Palmer v. Massachusetts,* 308 U.S. 79, 85, 60 S.Ct. 34, 37, 84 L.Ed. 93 (1939) ("If this old and familiar power of the states [over local railroad service] was withdrawn when Congress gave district courts bankruptcy powers over railroads, we ought to find language fitting for so drastic a change"). Although these cases do not define for us the exact contours of the trustee's abandonment power, they do make clear that this power was subject to certain restrictions when Congress enacted § 554(a).

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III

Neither the Court nor Congress has granted a trustee in bankruptcy powers that would lend support to a right to abandon property in contravention of state or local laws designed to protect public health or safety. As we held last Term when the State of Ohio sought compensation for cleaning the toxic waste site of a bankrupt corporation:

"Finally, we do not question that anyone in possession of the site—whether it is [the debtor] or another in the event the receivership is liquidated and the trustee abandons the property, or a vendee from the receiver *or the bankruptcy*

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trustee—must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions." *Ohio v. Kovacs,* 469 U.S. 274, 285, 105 S.Ct. 705, 711, 83 L.Ed.2d 649 (1985) (emphasis added).

Congress has repeatedly expressed its legislative determination that the trustee is not to have *carte blanche* to ignore nonbankruptcy law. Where the Bankruptcy Code has conferred special powers upon the trustee and where there was no common-law limitation on that power, Congress has expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety. *Infra,* at 503-504. One cannot assume that Congress, having placed these limitations upon other aspects of trustees' operations, intended to discard a well-established judicial restriction on the abandonment power. As we held nearly two years ago in the context of the National Labor Relations Act, "the debtor-in-possession is not relieved of all obligations under the [Act] simply by filing a petition for bankruptcy." *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 534, 104 S.Ct. 1188, 1201, 79 L.Ed.2d 482 (1984).

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The automatic stay provision of the Bankruptcy Code, § 362(a),[5] has been described as "one of the fundamental debtor protections provided by the bankruptcy laws." S.Rep. No. 95-989, p. 54 (1978); H.R.Rep. No. 95-595, p. 340 (1977), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5840, 5963, 6296. Despite the importance of § 362(a) in preserving the debtor's estate, Congress has enacted several categories of exceptions to the stay that allow the Government to commence or continue legal proceedings. For example, § 362(b)(5) permits the Government to enforce "nonmonetary" judgments against a debtor's estate. It is clear from the legislative history that one of the purposes of this exception is to protect public health and safety:

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"Thus, where a governmental unit is suing a debtor to prevent or stop violation of fraud, *environmental protection,* consumer protection, *safety, or similar police or regulatory laws,* or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay." H.R.Rep. No. 95-595, *supra,* at 343 (emphasis added); S.Rep. No. 95-989, *supra,* at 52 (emphasis added), U.S.Code Cong. & Admin.News 1978, pp. 5838, 6299.

Petitioners have suggested that the existence of an express exception to the automatic stay undermines the inference of a similar exception to the abandonment power: had Congress sought to restrict similarly the scope of § 554, it would have enacted similar limiting provisions. This argument, however, fails to acknowledge the differences between the predecessors of §§ 554 and 362. As we have noted, the exceptions to the judicially created abandonment power were firmly established. But in enacting § 362 in 1978, Congress significantly broadened the scope of the automatic stay, see 1 W. Norton, Bankruptcy Law and Practice § 20.03, pp. 5-6 (1981), an expansion that had begun only five years earlier with the adoption of the Bankruptcy Rules in 1973, see *id.,* § 20.02, at 4-5. Between 1973 and 1978, some courts had stretched the expanded automatic stay to foreclose States' efforts to enforce their antipollution laws,[6] and Congress wanted to overrule these interpretations in its 1978 revision. See H.R.Rep. No. 95-595, *supra,* at 174-175, U.S.Code Cong. & Admin.News 1978, pp. 6134-6136. In the face of the greatly increased scope of § 362, it was necessary for Congress to limit this new power expressly.

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Title 28 U.S.C. § 959(b) [7] provides additional evidence that Congress did not intend for the Bankruptcy Code to pre-empt all state laws. Section 959(b) commands the trustee to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State." Petitioners have contended that §

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959(b) is relevant only when the trustee is actually operating the business of the debtor, and not when he is liquidating it. Even though § 959(b) does not directly apply to an abandonment under § 554(a) of the Bankruptcy Code—and therefore does not de-limit the precise conditions on an abandonment—the section nevertheless supports our conclusion that Congress did not intend for the Bankruptcy Code to pre-empt all state laws that otherwise constrain the exercise of a trustee's powers.

IV

Although the reasons elaborated above suffice for us to conclude that Congress did not intend for the abandonment power to abrogate certain state and local laws, we find additional support for restricting that power in repeated congressional emphasis on its "goal of protecting the environment against toxic pollution." *Chemical Manufacturers Assn., Inc. v. Natural Resources Defense Council, Inc.*, 470 U.S. 116, 143, 105 S.Ct. 1102, 1117, 84 L.Ed.2d 90 (1985). Congress has enacted a Resource Conservation and Recovery Act, 42 U.S.C. §§ 6901-6987, to regulate the treatment, storage, and disposal of hazardous wastes by monitoring wastes from their creation until after their permanent disposal. That Act authorizes the United States to seek judicial or administrative restraint of activities involv-

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ing hazardous wastes that "may present an imminent and substantial endangerment to health or the environment." 42 U.S.C. § 6973; see also S.Rep. No. 98-284, p. 58 (1983). Congress broadened the scope of the statute and tightened the regulatory restraints in 1984.[8] In the Comprehensive Environmental Response, Compensation, and Liability Act, as amended by Pub.L. 98-80, § 2(c)(2)(B), Congress established a fund to finance cleanup of some sites and required certain responsible parties to reimburse either the fund or the parties who paid for the cleanup. The Act also empowers the Federal Government to secure such relief as may be necessary to avert "imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance." 42 U.S.C. § 9606. In the face of Congress' undisputed concern over the risks of the improper storage and disposal of hazardous and toxic substances, we are unwilling to presume that by enactment of § 554(a), Congress implicitly overturned longstanding restrictions on the common-law abandonment power.

V

In the light of the Bankruptcy trustee's restricted pre-1978 abandonment power and the limited scope of other Bankruptcy Code provisions, we conclude that Congress did not intend for § 554(a) to pre-empt all state and local laws. The

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Bankruptcy Court does not have the power to authorize an abandonment without formulating conditions that will adequately protect the public's health and safety. Accordingly, without reaching the question whether certain state laws imposing conditions on abandonment may be so onerous as to interfere with the bankruptcy adjudication itself, we hold that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards.[9] Accordingly, we affirm the judgments of the Court of Appeals for the Third Circuit.

It is so ordered.

Justice REHNQUIST, with whom THE CHIEF JUSTICE, Justice WHITE, and Justice O'CONNOR join, dissenting.

The Court today concludes that Congress did not intend the abandonment provision of the Bankruptcy Code, 11 U.S.C. § 554(a), to pre-empt "certain state and local laws." In something of a surprise ending, the Court limits the class of laws

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that can prevent an otherwise authorized abandonment by a trustee to those "reasonably designed to protect the public health or safety from identified hazards." While this limitation reduces somewhat the scope of my disagreement with the result reached, it renders both the *ratio decidendi* and the import of the Court's opinion quite unclear. More important, I remain unconvinced by the Court's arguments supporting state power to bar abandonment. The principal and only independent ground offered—that Congress codified "well-recognized restrictions of a trustee's abandonment power"—is particularly unpersuasive. It rests on a misreading of three pre-Code cases, the elevation of that

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misreading into a "well-recognized" exception to the abandonment power, and the unsupported assertion that Congress must have meant to codify the exception (or something like it). These specific shortcomings in the Court's analysis, which are addressed in greater detail below, stem at least in part from the Court's failure to discuss even in passing either the nature of abandonment or its role in federal bankruptcy.

Abandonment is "the release from the debtor's estate of property previously included in that estate." 2 W. Norton, Bankruptcy Law and Practice § 39.01 (1984), citing *Brown v. O'Keefe*, 300 U.S. 598, 602-603, 57 S.Ct. 543, 546-47, 81 L.Ed. 827 (1937). Prior to enactment of the Bankruptcy Code in 1978, there was no statutory provision specifically authorizing abandonment in liquidation cases. By analogy to the trustee's statutory power to reject executory contracts, courts had developed a rule permitting the trustee to abandon property that was worthless or not expected to sell for a price sufficiently in excess of encumbrances to offset the costs of administration. 4 L. King, Collier on Bankruptcy ¶ 554.01 (15th ed. 1985) (hereinafter Collier).[1] This judge-made rule served the overriding purpose of bankruptcy liquidation: the expeditious reduction of the debtor's property to money, for equitable distribution to creditors, *Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227, 50 S.Ct. 142, 143, 74 L.Ed. 382 (1930). 4 Collier ¶ 554.01. Forcing the trustee to administer burdensome property would contradict this purpose, slowing the administration of the estate and draining its assets.

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The Bankruptcy Code expressly incorporates the power of abandonment into federal bankruptcy legislation for the first time. The relevant provision bears repeating:

"(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate." 11 U.S.C. § 554(a) (amended 1984).

This language, absolute in its terms, suggests that a trustee's power to abandon is limited only by considerations of the property's value to the estate. It makes no mention of other factors to be balanced or weighed and permits no easy inference that Congress was concerned about state environmental regulations.[2] Indeed, as the Court notes, when Congress *was* so concerned it expressed itself clearly, specifically exempting some environmental injunctions from the automatic stay provisions of § 362 of the Code, 11 U.S.C. §§ 362(b)(4), (5) (1982 ed. and Supp. II). See *Ohio v. Kovacs*, 469 U.S. 274, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985).

Nor does the scant legislative history of § 554 support the Court's interpretation. Nowhere does that legislative his-

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tory suggest that Congress intended to limit the trustee's authority to abandon burdensome property where abandonment might be opposed by those charged with the exercise of state police or regulatory powers.

The Court seeks to turn the seemingly unqualified language and the absence of helpful legislative history to its advantage. Adopting the

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reasoning of the Court of Appeals, the Court argues that in light of Congress' failure to elaborate, § 554 must have been intended to codify prior "abandonment" case law, and that under prior law "a trustee could not exercise his abandonment power in violation of certain state and federal laws," *ante*, at 501. I disagree. We have previously expressed our unwillingness to read into unqualified statutory language exceptions or limitations based upon legislative history unless that legislative history demonstrates with extraordinary clarity that this was indeed the intent of Congress. *E.g., Garcia v. United States*, 469 U.S. 70, 75, 105 S.Ct. 479, 482-83, 83 L.Ed.2d 472 (1984). I think that upon analysis the "legislative history" relied upon by the Court here falls far short of this standard.

The Court relies on just three cases for its claimed "established corollary" to the pre-Code abandonment power. A close reading of those cases, however, reveals that none supports the rule announced today. In *Ottenheimer v. Whitaker*, 198 F.2d 289 (CA4 1952), the Court of Appeals held that a trustee could not abandon worthless barges obstructing traffic in Baltimore Harbor when the abandonment would have violated federal law. The Court concluded that the "judge-made rule [of abandonment] must give way" to "an Act of Congress in the public interest." *Id.*, at 290. *Ottenheimer* thus depended on the need to reconcile a conflict between a judicial gloss on the Bankruptcy Act and the commands of another federal statute. We implicitly confirmed the validity of such an approach two Terms ago in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523-524, 104 S.Ct. 1188, 1194-1195, 79 L.Ed.2d 482 (1984). Here, by contrast, the "conflict" is with the uncertain commands of

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state laws that the Court declines to identify.[3] In addition, the Court of Appeals relied heavily on the fact that the pre-Code law of abandonment was judge-made, which in turn raises the somewhat Delphic inquiry as to whether that court would have decided the case the same way under the present Code.

In re Lewis Jones, Inc., 1 BCD 277 (Bkrtcy.Ct. ED Pa.1974), was a Bankruptcy Court decision concluding that the principle of *Ottenheimer* did not apply because there was no conflicting statute. But because the right to abandon was based on judge-made law, the court nonetheless found itself free to protect the public interest by requiring a trustee seeking abandonment to first spend funds of the estate to seal manholes and vents in an underground pipe network. While this case admittedly comes closer to supporting the Court's position than does *Ottenheimer*, it too turns on the judge-made nature of the abandonment power. Moreover, I do not believe that the isolated decision of a single Bankruptcy Court rises to the level of "established law" that we can fairly assume Congress intended to incorporate. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 379-382, 102 S.Ct. 1825, 1839-41, 72 L.Ed.2d 182 (1982).

In *In re Chicago Rapid Transit Co.*, 129 F.2d 1 (CA7), cert. denied *sub nom. Chicago Junction R. Co. v. Sprague*, 317 U.S. 683, 63 S.Ct. 205, 87 L.Ed. 547 (1942), the District Court sitting in bankruptcy had authorized the bankrupt to abandon a lease of a rail line, and a lessor appealed. The bankrupt did not appeal the District Court's imposition of conditions on the abandonment; the propriety of those conditions thus was not before the

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Court of Appeals, which affirmed the District Court's *authorization* of abandonment. So while there may be dicta in the Court of Appeals' opinion that would support some limitation on the power of abandonment, the holding of the case certainly does not. In short, none of these cases supports the Court's view that § 554(a) contains an implicit exception for "certain state and local laws."

Even assuming these cases stand for the proposition ascribed to them in the Court's

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opinion, that opinion's brief discussion of the cases, *ante,* at 500-501, certainly does not support the claim that they reflect an "established corollary" to pre-Code abandonment law. Generally speaking, three rather isolated cases do not constitute the sort of settled law that we can fairly assume Congress intended to codify absent some expression of its intent to do so. Perhaps recognizing this, respondents place substantial reliance for their view that the exception was "well settled" on the following statement in the (pre-Code) 14th edition of Collier on Bankruptcy, accompanying a citation to *Ottenheimer* and *Chicago Rapid Transit:* "Recent cases illustrate, however, that the trustee in the exercise of the power to abandon is subject to the application of general regulations of a police nature." 4A J. Moore, Collier on Bankruptcy ¶ 70.42[2], pp. 502-504 (14th ed. 1978); see also *In re Quanta Resources Corp.,* 739 F.2d 912, 916 (1984) (quoting same language from Collier). Respondents further observe that the section of this treatise addressing abandonment was cited in a note to an early precursor of § 554, § 4-611 of the proposed Bankruptcy Act of 1973, H.R.Doc. No. 93-137, Part II, p. 181, reprinted in A. Resnick & E. Wypyski, 2 Bankruptcy Reform Act of 1978: A Legislative History, Doc. No. 22 (1979). While resourceful, this argument is wholly unpersuasive.

The reference to Collier is not part of the Code's " 'legislative history' in any meaningful sense of the term," *Board of Governors, FRS v. Dimension Financial Corp.,* 474 U.S. 361, 372, 106 S.Ct. 681, 688, 88 L.Ed.2d 691 (1986). And the proposition for which the section in Collier is cited is

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not the view that authority for abandonment is qualified by state police power, but instead the much less remarkable proposition that "[t]he concept of abandonment is well recognized in the case law. See 4A Collier ¶ 70.42[3]." In order to divine that the statutory power to abandon in the proposed Code was to be conditioned on compliance with state police power regulations, therefore, a Senator or Congressman would not merely have had to look at the legislative history of the precursor to the Code, but also would have had to read the several-page treatise section cited in that earlier legislative history.

Neither the three cases cited by the Court nor the attenuated reference to the since superseded version of Collier supports the inference that Congress, while writing § 554 in unqualified terms, intended to incorporate so ill-defined and uncertain an exception to the abandonment authority of the trustee. After suggesting that "if Congress intends for legislation to change the interpretation of a judicially created concept" it should do so expressly, *ante,* at 501, the Court concedes that these cases "do not define for us the exact contours of the trustee's abandonment power," *ibid.* The Court never identifies the source from which it draws the "exact contours" of the rule it announces today; congressional intent does not appear to be a likely candidate. Congress knew how to draft an exception covering the exercise of "certain" police powers when it wanted to. See 11 U.S.C. §§ 362(b)(4), (5) (1982 ed. and Supp. II); *supra,* at 509. It also knew how to draft a qualified abandonment provision. See § 1170(a)(2) (abandonment of railroad lines permitted only if "consistent with the public interest"). Congress' failure to so qualify § 554 indicates that it intended the relevant inquiry at an abandonment hearing to be limited to whether the property is burdensome and of inconsequential value to the estate.

I find the Court's discussion of 28 U.S.C. § 959(b) somewhat difficult to fathom. After suggesting that § 959(b)

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"provides additional evidence" for the self-evident proposition "that Congress did not intend for the Bankruptcy Code to pre-empt all state laws," *ante,* at 505, the Court concedes that the provision "does not *directly* apply to an abandonment under § 554(a) of the Bankruptcy Code," *ibid.* (emphasis added). The precise nature of its

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indirect application, however, is left unclear. Respondents contend that § 959(b) operates to bar abandonment in these cases. Assuming that temporary management or operation of a facility during liquidation is governed by § 959(b), I believe that a trustee's filing of a petition to abandon, as opposed to continued operation of a site pending a decision to abandon, does not constitute "manage[ment]" or "opera[tion]" under that provision. Not only would a contrary reading strain the language of § 959(b), cf. *In re Adelphi Hospital Corp.*, 579 F.2d 726, 729, n. 6 (CA2 1978) (*per curiam*) (in pre-Code liquidation proceeding trustee "is in no sense a manager of an institution's operations"), it also would create an exception to the abandonment power without a shred of evidence that Congress intended one. As one commentator has noted, § 554(a) "is among the few provisions in the Bankruptcy Code that do not contain explicit exceptions." Note, 85 Colum.L.Rev. 870, 883 (1985). I would not read 28 U.S.C. § 959(b) as creating an implicit exception.

Citing *SEC v. United Realty & Improvement Co.*, 310 U.S. 434, 455, 60 S.Ct. 1044, 1053, 84 L.Ed. 1293 (1940), respondents argue that the Bankruptcy Court's equitable powers support the result reached below. I disagree. While the Bankruptcy Court is a court of equity, the Bankruptcy Code "does not authorize freewheeling consideration of every conceivable equity." *Bildisco & Bildisco,* 465 U.S., at 527, 104 S.Ct., at 762. The Bankruptcy Court may not, in the exercise of its equitable powers, enforce its view of sound public policy at the expense of the interests the Code is designed to protect. In these cases, it is undisputed that the properties in question were burdensome and of inconsequential value to the estate. Forcing the trustee to expend es-

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tate assets to clean up the sites would plainly be contrary to the purposes of the Code.

I fully appreciate the Court's concern that abandonment may "aggravat[e] already existing dangers by halting security measures that preven[t] public entry, vandalism, and fire." *Ante,* at 499, n. 3. But in almost all cases, requiring the trustee to notify the relevant authorities before abandoning will give those authorities adequate opportunity to step in and provide needed security. As the Bankruptcy Court noted in No. 84-805: "The City and State are in a better position in every respect than either the Trustee or debtor's creditors to do what needs to be done to protect the public against the dangers posed by the PCB-contaminated facility." App. to Pet. for Cert. 73a. And requiring notice before abandonment in appropriate cases is perfectly consistent with the Code. It advances the State's interest in protecting the public health and safety, and, unlike the rather uncertain exception to the abandonment power propounded by the Court, at the same time allows for the orderly liquidation and distribution of the estate's assets. Here, of course, the trustee provided such notice and the relevant authorities were afforded an opportunity to take appropriate preventative and remedial measures.

I likewise would not exclude the possibility that there may be a far narrower condition on the abandonment power than that announced by the Court today, such as where abandonment by the trustee itself might create a genuine emergency that the trustee would be uniquely able to guard against. The United States in its brief as *amicus curiae* suggests, for example, that there are limits on the authority of a trustee to abandon dynamite sitting on a furnace in the basement of a schoolhouse. Although I know of no situations in which trustees have sought to abandon dynamite under such circumstances, the narrow exception that I would reserve surely would embrace that situation.

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What the Court fails to appreciate is that respondents' interest in these cases lies not just in protecting public health and safety but also in protecting the public fisc. In No. 84-805, before undertaking cleanup efforts, New York unsuccessfully sought from the Bankruptcy Court

a first lien on the Long Island City property to the extent of any expenditures it might make to bring the site into compliance with state and local law. New York did not appeal the court's denial of a first lien, and proceeded to clean up the site (except for the contaminated subsoil). It now presses a claim for reimbursement, maintaining that the trustee should not have been allowed to abandon the site. The New Jersey Department of Environmental Protection, in No. 84-801, apparently seeks to undo the abandonment and force the trustee to expend the estate's remaining assets cleaning up the site, thereby reducing the cleanup costs that must ultimately be borne by the State.[4]

The Court states that the "abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm." *Ante*, at 507, n. 9. Because the Court declines to identify those laws that it deems so "reasonably calculated," I can only speculate about its view of respondents' claim that abandonment can be conditioned on a total cleanup. One might assume, however, that since it affirms the judgments below the Court means to adopt respondents' position. The Court of Appeals, as I read its opinions in these cases, apparently would require the trustee to expend all of Quanta's available assets to clean up the sites.[5] But barring abandonment and forcing a cleanup would effectively

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place respondents' interest in protecting the public fisc ahead of the claims of other creditors. Congress simply did not intend that § 554 abandonment hearings would be used to establish the priority of particular claims in bankruptcy. While States retain considerable latitude to ensure that priority status is allotted to their cleanup claims, see *Ohio v. Kovacs*, 469 U.S., at 285-286, 105 S.Ct., at 711 (O'CONNOR, J., concurring), I believe that the Court errs by permitting them to impose conditions on the abandonment power that Congress never contemplated. Accordingly, in each of these cases I would reverse the judgment of the Court of Appeals.

1. Section 554(a) reads:

"After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate."

Technical amendments in the Bankruptcy Amendments and Federal Judgeship Act of 1984 added the words "and benefit" after "value" in § 554(a). Pub.L. 98-353, Tit. III, § 468(a), 98 Stat. 380.

2. The sole issue presented by these petitions is whether a trustee may abandon property under § 554 in contravention of local laws designed to protect the public's health and safety. New York is claiming reimbursement for its expenditures as an administrative expense. That question, however, like the question of the ultimate disposition of the property, is not before us.

3. The trustee was not required to take even relatively minor steps to reduce imminent danger, such as security fencing, drainage and diking repairs, sealing deteriorating tanks, and removing explosive agents. Moreover, the trustee's abandonment at both sites aggravated already existing dangers by halting security measures that prevented public entry, vandalism, and fire. Joint Appendix in No. 83-5142 (CA3), pp. 11-12 (affidavit of Richard Docyk, Deputy Chief Inspector for N.Y. City Fire Department); *id.*, at 26 (transcript of proceedings before De Vito, J.). The 470,000 gallons of highly toxic and carcinogenic waste oil in unguarded, deteriorating containers "present risks of explosion, fire, contamination of water supplies, destruction of natural resources, and injury, genetic damage, or death through personal contact." Brief for United States as *Amicus Curiae* 4, 23; see Joint Appendix, *supra*, at 17 (70,000 gallons at New York site); Appendix in No. 83-5730 (CA3), p. A7 (400,000 gallons at New Jersey site); *id.*, at A46 (deteriorating containers); Joint Appendix, *supra*, at 11 (deteriorating tanks); *id.*, at 26 (guard service); *id.*, at 12 (risk of fire); *id.*, at 11

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(contamination of adjacent areas); *id.*, at 20 (health effects of exposure to PCBs and their derivatives).

4. Judge Gibbons dissented, arguing that § 554 permits abandonment without any exception analogous to that provided to the automatic stay. The dissent further contended that the majority's interpretation of § 554 raised substantial questions under the Takings Clause by potentially destroying the interest of secured creditors, see *United States v. Security Industrial Bank*, 459 U.S. 70, 103 S.Ct. 407, 74 L.Ed.2d 235 (1982), and that the majority had failed to address the important underlying issue of the priority of the States' claims for reimbursement.

5. Section 362(a) provides:

"(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—

"(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

"(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

"(3) any act to obtain possession of property of the estate or of property from the estate;

"(4) any act to create, perfect, or enforce any lien against property of the estate;

"(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

"(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

"(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

"(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor."

6. See, *e.g.*, *In re Hillsdale Foundry Co.*, 1 BCD 195 (Bkrtcy Ct. WD Mich.1974) (action by Michigan Attorney General to enforce State's antipollution laws held subject to automatic stay). The House Report also referred to an unreported case from Texas where a stay prevented the State of Maine from closing down a debtor's plant that was polluting a river in violation of the State's environmental protection laws. H.R.Rep. No. 95-595, pp. 174-175 (1977). U.S.Code Cong. & Admin.News 1978, pp. 6134-6136.

7. Section 959(b) provides:

"Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."

8. Congress eliminated the small generator exception and subjected many more facilities to the regulations. Pub.L. 98-616, 98 Stat. 3221, 3248-3272 (codified at 42 U.S.C. § 6921(d) (1982 ed., Supp. III)). Another provision automatically broadens the Act's coverage by automatically assigning a hazardous rating to substances that the Environmental Protection Agency does not classify by a set deadline. 98 Stat. 3227-3231 (codified at 42 U.S.C. §§ 6924(d), (e), (f)(3), (g)(6) (1982 ed., Supp. III)). Amended enforcement provisions allow more citizen suits, 98 Stat. 3271-3272 (codified at 42 U.S.C. § 6973

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(1982 ed., Supp. III)), and authorize administrative orders or suits to compel "corrective action" after a leak has occurred. 98 Stat. 3257-3258 (codified at 42 U.S.C. § 6928(h) (1982 ed., Supp. III)).

9. This exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm.

1. Under the former Bankruptcy Act, title to the debtor's property vested in the trustee. Abandonment divested the trustee of title and revested it in the debtor. 4 Collier ¶ 554.02[2]. Under the Code, the trustee no longer takes title to the debtor's property, and he is simply divested of control over the property by the abandonment. *Ibid.* Although § 554 does not specify to whom the property is abandoned, the legislative history suggests that it is to the person having a possessory interest in the property. S.Rep. No. 95-989, p. 92 (1978); *Ohio v. Kovacs,* 469 U.S. 274, 284-285, n. 12, 105 S.Ct. 705, 710-711, n. 12, 83 L.Ed.2d 649 (1985).

2. Last Term in *Ohio v. Kovacs, supra,* which involved the dischargeability of certain environmental injunctions in bankruptcy, we briefly addressed the abandonment of hazardous waste sites:

"After notice and hearing, the trustee many abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate. 11 U.S.C. § 554. Such abandonment is to the person having the possessory interest in the property. S.Rep. No. 95-989, p. 92 (1978). . . . If the site at issue were [the debtor's] property, the trustee would shortly determine whether it was of value to the estate. If the property was worth more than the costs of bringing it into compliance with state law, the trustee would undoubtedly sell it for its net value, and the buyer would clean up the property, in which event whatever obligation [the debtor] might have had to clean up the property would have been satisfied. If the property were worth less than the cost of cleanup, the trustee would likely abandon it to its prior owner, who would have to comply with the state environmental law to the extent of his or its ability." *Id.,* at 284-285, n. 12, 105 S.Ct., at 710-711, n. 12.

3. The Court finds "additional support" for its restriction of the abandonment power in recent federal statutes concerned with protecting the environment. If these statutes operated to bar abandonment here—something neither respondents nor the Court suggests—then this might be a different case. See *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984). But the statutes do not bar abandonment, and the majority's reference to their obvious concern over the risks of storing hazardous substances is little more than a makeweight.

4. NJDEP does not contend that the estate, including any assets otherwise subject to Midlantic's secured claim, contains sufficient assets to complete the cleanup.

5. I would think that this command qualifies, in the words of the Court, as a "conditio[n] on abandonment . . . so onerous as to interfere with the bankruptcy adjudication itself," *ante,* at 507.

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479 U.S. 36
107 S.Ct. 353
93 L.Ed.2d 216

John J. KELLY, Connecticut Chief State's Attorney, et al., Petitioners

v.

Carolyn ROBINSON.

No. 85-1033.
Argued Oct. 8, 1986.
Decided Nov. 12, 1986.

Syllabus

In 1980, respondent pleaded guilty in a Connecticut state court to a larceny charge based on her wrongful receipt of welfare benefits from the Connecticut Department of Income Maintenance. She was sentenced to a prison term, but the court suspended execution of the sentence and placed her on probation for five years. As a condition of probation, the court ordered respondent to make restitution through monthly payments to the Connecticut Office of Adult Probation until the end of her probation period. Under Connecticut statutes, restitution payments are sent to the Probation Office and are then forwarded to the victim. In 1981, respondent filed a voluntary petition under Chapter 7 of the Bankruptcy Code in Bankruptcy Court, listing the restitution obligation as a debt. The Connecticut agencies, although notified, did not file proofs of claim or objections to discharge, and the Bankruptcy Court subsequently granted respondent a discharge. She made no further restitution payments. After the Probation Office informed her that it considered the restitution obligation nondischargeable, she filed a proceeding against petitioner state officials in the Bankruptcy Court, seeking a declaration that the restitution obligation was discharged. The court concluded that even if the restitution obligation was a debt subject to bankruptcy jurisdiction, it was automatically nondischargeable under § 523(a)(7) of the Bankruptcy Code, which provides that a discharge in bankruptcy does not affect any debt that "is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss." The District Court adopted the Bankruptcy Court's proposed disposition of the case, but the Court of Appeals reversed.

Held: Section 523(a)(7) preserves from discharge in Chapter 7 any condition a state criminal court imposes as part of a criminal sentence. Thus, restitution obligations, imposed as conditions of probation in state criminal proceedings, are not dischargeable. Pp. 43-53.

(a) Despite the language of the earlier Bankruptcy Act of 1898 that apparently allowed criminal penalties to be discharged, most courts refused to allow a discharge to affect a state criminal court's judgment. When the present Bankruptcy Code was enacted in 1978, there was a

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widely accepted judicial exception to discharge for criminal sentences, including restitution obligations imposed as part of such sentences. In construing the scope of bankruptcy codifications, this Court has followed the rule that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. *Midlantic National Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859. Pp. 43-47.

(b) The basis for the judicial exception here is the deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings. Although it might be true that Connecticut officials could have ensured continued enforcement of the criminal judgment against respondent by objecting to discharge under the Code, that fact does not justify an interpretation of the Code that is contrary to the long-prevailing view that fines and penalties are not affected by a discharge. Moreover, reliance on a right to appear and object to discharge would create uncertainties and impose undue burdens on state officials. The prospect of federal remission of judgments imposed by state criminal judges would hamper the flexibility of those

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judges in choosing the combination of imprisonment, fines, and restitution most likely to further the rehabilitative and deterrent goals of state criminal justice systems. Pp. 47-49.

(c) On its face, § 523(a)(7) does not compel the conclusion that a discharge voids restitution orders imposed as conditions of probation by state courts. Nothing in the House and Senate Reports indicates that this language should be read so intrusively. Section 523(a)(7) protects traditional criminal fines. Although restitution, unlike traditional fines, is forwarded to the victim and may be calculated by reference to the amount of harm the offender has caused, neither of the statute's qualifying clauses—namely, the fines must be "to and for the benefit of a governmental unit," and "not compensation for pecuniary loss"—allows the discharge of a criminal judgment that takes the form of restitution. The decision to impose restitution generally does not turn on the victim's injury, but on the penal goals of the State and the defendant's situation. Pp. 50-53.

776 F.2d 30 (CA2 1985) reversed.

POWELL, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and BRENNAN, WHITE, BLACKMUN, O'CONNOR, and SCALIA, JJ., joined. MARSHALL, J., filed a dissenting opinion, in which STEVENS, J., joined, *post*, p. 53.

Carl J. Schuman, Asst. State Atty., Wallingford, Conn., for petitioners.

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Francis X. Dineen, New Haven, Conn., for respondent.

Justice POWELL delivered the opinion of the Court.

We granted review in this case to decide whether restitution obligations, imposed as conditions of probation in state criminal proceedings, are dischargeable in proceedings under Chapter 7 of the Bankruptcy Code.

I

In 1980, Carolyn Robinson pleaded guilty to larceny in the second degree. The charge was based on her wrongful receipt of $9,932.95 in welfare benefits from the Connecticut Department of Income Maintenance. On November 14, 1980, the Connecticut Superior Court sentenced Robinson to a prison term of not less than one year nor more than three years. The court suspended execution of the sentence and

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placed Robinson on probation for five years. As a condition of probation, the judge ordered Robinson to make restitution [1] to the State of Connecticut Office of Adult Probation (Probation Office) at the rate of $100 per month, commencing January 16, 1981, and continuing until the end of her probation.[2]

On February 5, 1981, Robinson filed a voluntary petition under Chapter 7 of the Bankruptcy Code, 11 U.S.C. § 701 *et seq.*, in the United States Bankruptcy Court for the District of Connecticut. That petition listed the restitution obligation as a debt. On February 20, 1981, the Bankruptcy Court notified both of the Connecticut agencies of Robinson's petition and informed them that April 27, 1981, was the deadline for filing objections to discharge. The agencies did not file proofs of claim or objections to discharge, apparently because they took the position that the bankruptcy would not affect the conditions of Robinson's probation. Thus, the agencies did not participate in the distribution of Robinson's estate. On May 14, 1981, the Bankruptcy Court granted Robinson a discharge. See § 727.

At the time Robinson received her discharge in bankruptcy, she had paid $450 in restitution. On May 20, 1981, her attorney wrote the Probation Office that she believed the discharge had altered the conditions of Robinson's

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probation, voiding the condition that she pay restitution. Robinson made no further payments.

The Connecticut Probation Office did not respond to this letter until February 1984, when it informed Robinson that it

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considered the obligation to pay restitution nondischargeable. Robinson responded by filing an adversary proceeding in the Bankruptcy Court, seeking a declaration that the restitution obligation had been discharged, as well as an injunction to prevent the State's officials from forcing Robinson to pay.

After a trial, the Bankruptcy Court entered a memorandum and proposed order, concluding that the 1981 discharge in bankruptcy had not altered the conditions of Robinson's probation. *Robinson v. McGuigan,* 45 B.R. 423 (1984). The court adopted the analysis it had applied in a similar case decided one month earlier, *In re Pellegrino (Pellegrino v. Division of Criminal Justice),* 42 B.R. 129 (1984). In *Pellegrino,* the court began with the Bankruptcy Code's definitional sections. First, § 101(11) defines a "debt" as a "liability on a claim." In turn, § 101(4) defines a "claim" as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Finally, § 101(9) defines a "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor."

The *Pellegrino* court then examined the statute under which the Connecticut judge had sentenced the debtor to pay restitution. Restitution appears as one of the conditions of probation enumerated in Conn.Gen.Stat. § 53a-30 (1985). Under that section, restitution payments are sent to the Probation Office. The payments then are forwarded to the victim. Although the Connecticut penal code does not provide for enforcement of the probation conditions by the victim, it does authorize the trial court to issue a warrant for the arrest of a criminal defendant who has violated a condition of probation. § 53a-32.

Because the Connecticut statute does not allow the victim to enforce a right to receive payment, the court concluded

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that neither the victim nor the Probation Office had a "right to payment," and hence neither was owed a "debt" under the Bankruptcy Code. It argued: "Unlike an obligation which arises out of a contractual, statutory or common law duty, here the obligation is rooted in the traditional responsibility of a state to protect its citizens by enforcing its criminal statutes and to rehabilitate an offender by imposing a criminal sanction intended for that purpose." 42 B.R., at 133. The court acknowledged the tension between its conclusion and the Code's expansive definition of debt, but found an exception to the statutory definition in "the long-standing tradition of restraint by federal courts from interference with traditional functions of state governments." *Id.,* at 134. The court concluded that, even if the probation condition was a debt subject to bankruptcy jurisdiction, it was nondischargeable under § 523(a)(7) of the Code. That subsection provides that a discharge in bankruptcy does not affect any debt that "is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss."

The court also concluded that the purpose of the restitution condition was "to promote the rehabilitation of the offender, not to compensate the victim." 42 B.R., at 137. It specifically rejected the argument that the restitution must be deemed compensatory because the amount precisely matched the victim's loss. It noted that the state statute allows an offender to "make restitution of the fruits of his offense or make restitution, in an amount he can afford to pay or provide in a suitable manner, for the loss or damage caused thereby," Conn.Gen.Stat. § 53a-30(a)(4) (1985). In its view, the Connecticut statute focuses "upon

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the offender and not on the victim, and . . . restitution is part of the criminal penalty rather than compensation for a victim's actual loss." 42 B.R., at 137. Thus, the Bankruptcy Court held that the bankruptcy discharge had not affected the conditions of Pellegrino's probation. The United States District Court for

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the District of Connecticut adopted the Bankruptcy Court's proposed dispositions of *Pellegrino* and this case without alteration.

The Court of Appeals for the Second Circuit reversed. *In re Robinson,* 776 F.2d 30 (1985). It first examined the Code's definition of debt. Although it recognized that most courts had reached the opposite conclusion, the court decided that a restitution obligation imposed as a condition of probation is a debt. It relied on the legislative history of the Code that evinced Congress' intent to broaden the definition of "debt" from the much narrower definition of the Bankruptcy Act of 1898. The court also noted that anomalies might result from a conclusion that such an obligation is not a debt. Most importantly, nondebt status would deprive a State of the opportunity to participate in the distribution of the debtor's estate.

Having concluded that restitution obligations are debts, the court turned to the question of dischargeability. The court stated that the appropriate Connecticut agency probably could have avoided discharge of the debt if it had objected under §§ 523(a)(2) or 523(a)(4) of the Code.[3] As no objections to discharge were filed, the court concluded that the State could rely only on § 523(a)(7), the subsection that provides for automatic nondischargeability for certain debts.[4]

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The court then looked to the text of the Connecticut statute to determine whether Robinson's probation condition was "compensation for actual pecuniary loss" within the meaning of § 523(a)(7). But where the Bankruptcy Court had considered the entire state probation system, the Court of Appeals focused only on the language that allows a restitution order to be assessed "for the loss or damage caused [by the crime]," Conn.Gen.Stat. § 53a-30(a)(4) (1985). The court thought this language compelled the conclusion that the probation condition was "compensation for actual pecuniary loss." It held, therefore, that this particular condition of Robinson's probation was not protected from discharge by § 523(a)(7). Accordingly, it reversed the District Court.

We granted the State's petition for a writ of certiorari. 475 U.S. 1009, 106 S.Ct. 1181, 89 L.Ed.2d 298 (1986). We have jurisdiction to review the judgment of the Court of Appeals under 28 U.S.C. § 1254(1). We reverse.

II

The Court of Appeals' decision focused primarily on the language of §§ 101 and 523 of the Code. Of course, the "starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 756, 95 S.Ct. 1917, 1935, 44 L.Ed.2d 539 (1975) (POWELL, J., concurring). But the text is only the starting point. As Justice O'CONNOR explained last Term: " ' "In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." ' " *Offshore Logistics, Inc. v. Tallentire,* 477 U.S. 207, 222, 106 S.Ct. 2485, 2494, 91 L.Ed.2d 174 (1986) (quoting *Mastro Plastics Corp. v. NLRB,* 350 U.S. 270, 285, 76 S.Ct. 349, 359, 100 L.Ed. 309 (1956) (in turn quoting *United States v. Heirs of Boisdore,* 8 How. 113, 122, 12 L.Ed. 1009 (1849))). In this case, we must consider the language of §§ 101 and 523

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in light of the history of bankruptcy court deference to criminal judgments and in light of the interests of the States in unfettered administration of their criminal justice systems.

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A.

Courts traditionally have been reluctant to interpret federal bankruptcy statutes to remit state criminal judgments. The present text of Title 11, commonly referred to as the Bankruptcy Code, was enacted in 1978 to replace the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.[5] The treatment of criminal judgments under the Act of 1898 informs our understanding of the language of the Code.

First, § 57 of the Act established the category of "allowable" debts. See 3 Collier on Bankruptcy ¶ 57 (14th ed. 1977). Only if a debt was allowable could the creditor receive a share of the bankrupt's assets. See § 65(a). For this case, it is important to note that § 57(j) excluded from the class of allowable debts penalties owed to government entities. That section provided:

"Debts owing to the United States, a State, a county, a district, or a municipality as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose." 30 Stat. 561.

Second, § 63 established the separate category of "provable" debts. See 3A Collier on Bankruptcy ¶ 63 (14th ed. 1975). Section 17 provided that a discharge in bankruptcy "release[d] a bankrupt from all of his provable debts," subject to several exceptions listed in later portions of § 17. Although § 17 specifically excepted four types of debts from discharge, it did not mention criminal penalties of any kind. The most natural construction of the Act, therefore, would

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have allowed criminal penalties to be discharged in bankruptcy, even though the government was not entitled to a share of the bankrupt's estate. Congress had considered criminal penalties when it passed the Act; it clearly made them nonallowable. The failure expressly to make them nondischargeable at the same time offered substantial support for the view that the Act discharged those penalties.

But the courts did not interpret the Act in this way. Despite the clear statutory language, most courts refused to allow a discharge in bankruptcy to affect the judgment of a state criminal court. In the leading case, the court reasoned:

"It might be admitted that sections 63 and 17 of the bankrupt act, if only the letter of those provisions be looked to, would embrace [criminal penalties]; but it is well settled that there may be cases in which such literal construction is not admissible. . . . It may suffice to say that nothing but a ruling from a higher court would convince me that congress, by any provision of the bankrupt act, intended to permit the discharge, under its operations, of any judgment rendered by a state or federal court imposing a fine in the enforcement of criminal laws. . . . The provisions of the bankrupt act have reference alone to civil liabilities, as demands between debtor and creditors, as such, and not to punishment inflicted pro bono publico for crimes committed." *In re Moore,* 111 F. 145, 148-149 (WD Ky.1901).[6]

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This reasoning was so widely accepted by the time Congress enacted the new Code that a leading commentator could state flatly that "fines and penalties are not affected by a discharge." See 1A Collier on Bankruptcy ¶ 17.13, pp. 1609-1610, and n. 10 (14th ed. 1978).

Moreover, those few courts faced with restitution obligations imposed as part of criminal sentences applied the same reasoning to prevent a discharge in bankruptcy from affecting such a condition of a criminal sentence. For instance, four years before Congress enacted the Code, a New York Supreme Court stated:

"A discharge in bankruptcy has no effect whatsoever upon a condition of restitution of a criminal sentence. A bankruptcy proceeding is civil in nature and is intended to relieve an

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honest and unfortunate debtor of his debts and to permit him to begin his financial life anew. A condition of restitution in a sentence of probation is a part of the judgment of conviction. It does not create a debt nor a debtor-creditor relationship between the persons making and receiving restitution. As with any other condition of a probationary sentence it is intended as a means to insure the defendant will lead a law-abiding life thereafter." *State v. Mosesson,* 78 Misc.2d 217, 218, 356 N.Y.S.2d 483, 484 (1974) (citations omitted).[7]

Thus, Congress enacted the Code in 1978 against the background of an established judicial exception to discharge for criminal sentences, including restitution orders, an exception created in the face of a statute drafted with considerable care and specificity.

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Just last Term we declined to hold that the new Bankruptcy Code silently abrogated another exception created by courts construing the old Act. In *Midlantic National Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), a trustee in bankruptcy asked us to hold that the 1978 Code had implicitly repealed an exception to the trustee's abandonment power. Courts had created that exception out of deference to state health and safety regulations, a consideration comparable to the States' interests implicated by this case. We stated:

"The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications. If Congress wishes to grant the trustee an extraordinary exemption from nonbankruptcy law, 'the intention would be clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt.' " *Id.,* at 501, 106 S.Ct., at 759 (quoting *Swarts v. Hammer,* 194 U.S. 441, 444, 24 S.Ct. 695, 696, 48 L.Ed. 1060 (1904)) (citations omitted).

B

Our interpretation of the Code also must reflect the basis for this judicial exception, a deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings. The right to formulate and enforce penal sanctions is an important aspect of the sovereignty retained by the States. This Court has emphasized repeatedly "the fundamental policy against federal interference with state criminal prosecutions." *Younger v. Harris,* 401 U.S. 37, 46, 91 S.Ct. 746, 751, 27 L.Ed.2d 669 (1971). The Court of Appeals nevertheless found support for its holding in the fact that Connecticut officials probably could have ensured continued enforcement of their court's criminal judgment against Robinson had they ob-

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jected to discharge under § 523(c). Although this may be true in many cases, it hardly justifies an interpretation of the 1978 Act that is contrary to the long-prevailing view that "fines and penalties are not affected by a discharge," 1A Collier on Bankruptcy ¶ 17.13, p. 1610 (14th ed. 1978).

Moreover, reliance on a right to appear and object to discharge would create uncertainties and impose undue burdens on state officials. In some cases it would require state prosecutors to defend particular state criminal judgments before federal bankruptcy courts.[8] As Justice BRENNAN has noted, federal adjudication of matters already at issue in state criminal proceedings can be "an unwarranted and unseemly duplication of the State's own adjudicative process." *Perez v. Ledesma,* 401 U.S. 82, 121, 91 S.Ct. 674, 695, 27 L.Ed.2d 701 (1971) (opinion concurring in part and dissenting in part).[9]

Also, as Robinson's attorney conceded at oral argument, some restitution orders would not be protected from discharge even if the State did appear and enter an objection to discharge. For

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example, a judge in a negligent homicide case might sentence the defendant to probation, conditioned on the defendant's paying the victim's husband compensation for the loss the husband sustained when the defendant killed his wife. It is not clear that such a restitution order would

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fit the terms of any of the exceptions to discharge listed in § 523 other than § 523(a)(7). Thus, this interpretation of the Code would do more than force state prosecutors to defend state criminal judgments in federal bankruptcy court. In some cases, it could lead to federal remission of judgments imposed by state criminal judges.

This prospect, in turn, would hamper the flexibility of state criminal judges in choosing the combination of imprisonment, fines, and restitution most likely to further the rehabilitative and deterrent goals of state criminal justice systems.[10] We do not think Congress lightly would limit the rehabilitative and deterrent options available to state criminal judges.

In one of our cases interpreting the Act, Justice Douglas remarked: "[W]e do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." *Bank of Marin v. England,* 385 U.S. 99, 103, 87 S.Ct. 274, 277, 17 L.Ed.2d 197 (1966). This Court has recognized that the States' interest in administering their criminal justice systems free from federal interference is one of the most powerful of the considerations that should influence a court considering equitable types of relief. See *Younger v. Harris, supra,* 401 U.S., at 44-45, 91 S.Ct., at 750-751. This reflection of our federalism also must influence our interpretation of the Bankruptcy Code in this case.[11]

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III

In light of the established state of the law—that bankruptcy courts could not discharge criminal judgments—we have serious doubts whether Congress intended to make criminal penalties "debts" within the meaning of § 101(4).[12] But we need not address that question in this case, because we hold that § 523(a)(7) preserves from discharge any condition a state criminal court imposes as part of a criminal sentence.

The relevant portion of § 523(a)(7) protects from discharge any debt

"to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss."

This language is subject to interpretation. On its face, § 523(a)(7) certainly does not compel the conclusion reached by the Court of Appeals, that a discharge in bankruptcy voids restitution orders imposed as conditions of probation by state courts. Nowhere in the House and Senate Reports is there any indication that this language should be read so intru-

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sively.[13] If congress had intended, by § 523(a)(7) or by any other provision, to discharge state criminal sentences, "we can be certain that there would have been hearings, testimony, and debate concerning consequences so wasteful, so inimical to purposes previously deemed important, and so likely to arouse public outrage," *TVA v. Hill,* 437 U.S. 153, 209, 98 S.Ct. 2279, 2309, 57 L.Ed.2d 117 (1978) (POWELL, J., dissenting).

Our reading of § 523(a)(7) differs from that of the Second Circuit. On its face, it creates a broad exception for all penal sanctions, whether they be denominated fines, penalties, or forfeitures. Congress included two qualifying phrases; the fines must be both "to and for the benefit of a governmental unit," and "not compensation for actual pecuniary loss." Section 523(a)(7) protects traditional criminal fines; it codifies the judicially created exception to

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discharge for fines. We must decide whether the result is altered by the two major differences between restitution and a traditional fine. Un-

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like traditional fines, restitution is forwarded to the victim, and may be calculated by reference to the amount of harm the offender has caused.

In our view, neither of the qualifying clauses of § 523(a)(7) allows the discharge of a criminal judgment that takes the form of restitution. The criminal justice system is not operated primarily for the benefit of victims, but for the benefit of society as a whole. Thus, it is concerned not only with punishing the offender, but also with rehabilitating him. Although restitution does resemble a judgment "for the benefit of" the victim, the context in which it is imposed undermines that conclusion. The victim has no control over the amount of restitution awarded or over the decision to award restitution. Moreover, the decision to impose restitution generally does not turn on the victim's injury, but on the penal goals of the State and the situation of the defendant. As the Bankruptcy Judge who decided this case noted in *Pellegrino:* "Unlike an obligation which arises out of a contractual, statutory or common law duty, here the obligation is rooted in the traditional responsibility of a state to protect its citizens by enforcing its criminal statutes and to rehabilitate an offender by imposing a criminal sanction intended for that purpose." 42 B.R., at 133.

This point is well illustrated by the Connecticut statute under which the restitution obligation was imposed. The statute authorizes a judge to impose any of eight specified conditions of probation, as well as "any other conditions reasonably related to his rehabilitation." Conn.Gen.Stat. § 53a-30(a)(9) (1985). Clause (4) of that section authorizes a judge to require that the defendant

"make restitution of the fruits of his offense or make restitution, in an amount he can afford to pay or provide in a suitable manner, for the loss or damage caused thereby and the court may fix the amount thereof and the manner of performance."

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This clause does not require imposition of restitution in the amount of the harm caused. Instead, it provides for a flexible remedy tailored to the defendant's situation.

Because criminal proceedings focus on the State's interests in rehabilitation and punishment, rather than the victim's desire for compensation, we conclude that restitution orders imposed in such proceedings operate "for the benefit of" the State. Similarly, they are not assessed "for . . . compensation" of the victim. The sentence following a criminal conviction necessarily considers the penal and rehabilitative interests of the State.[14] Those interests are sufficient to place restitution orders within the meaning of § 523(a)(7).

In light of the strong interests of the States, the uniform construction of the old Act over three-quarters of a century, and the absence of any significant evidence that Congress intended to change the law in this area, we believe this result best effectuates the will of Congress. Accordingly, the decision of the Court of Appeals for the Second Circuit is

Reversed.

Justice MARSHALL, with whom Justice STEVENS joins, dissenting.

Petitioners failed to assert timely objections to the discharge of respondent Robinson's restitution debt, and the

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majority goes to considerable lengths to excuse this default. Respondent concedes that the restitution obligation would not have been discharged had petitioners objected in a timely fashion. Tr. of Oral Arg. 30.[1] When notified of

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respondent's bankruptcy proceeding, however, petitioners did nothing. They were told that they could file an objection to Robinson's discharge, but did not do so. Robinson's counsel informed the Connecticut Office of Adult Probation (Probation Office) of Robinson's discharge and of Robinson's belief that she need make no further payments, but the Probation Office did not respond. Not until almost three years after Robinson's discharge in bankruptcy did the Probation Office inform Robinson that it did not consider the debt discharged and that it intended to enforce the restitution order.

The Court charitably attributes petitioners' inaction to the fact that from the start petitioners took the position they assert here. *Ante*, at 39. But their representations at oral argument suggest only that they failed to object because "state agencies were admittedly somewhat confused on how to handle it," Tr. of Oral Arg. 9, and were "a little perplexed because this was the first time it happened." *Id.*, at 16. Petitioners seek a broad construction of the statute to excuse their confusion-induced waiver of the right to object and thereby guarantee that Robinson's restitution obligation would not be discharged. In my opinion, however, the statute cannot fairly be read to arrive at the result the majority reaches today.

The Court concludes that a criminal restitution obligation is nondischargeable under 11 U.S.C. § 523(a)(7) because it is

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"a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss. . . ." *Ibid.* I find unconvincing the majority's conclusion that the criminal restitution order at issue here is not "COMPENSATION for actual pecuniary loss." [2] While restitution imposed as a condition of probation under the Connecticut statute is in part a penal sanction, it is also intended to compensate victims for their injuries. The statute permits a court to require a defendant, as a condition of his probation, to "make restitution of the fruits of his offense or make restitution, in an amount he can afford to pay or provide in a suitable manner, *for the loss or damage caused thereby. . . .*" Conn.Gen.Stat. § 53a-30(a)(4) (1985) (emphasis added). Were the restitution order purely penal, the statute would not connect the amount of restitution to the damage imposed. Tying the amount of restitution to the amount of actual damage sustained by the victim strongly suggests that the payment is meant to compensate the victim. This comports with the theory underlying restitution sanctions. Restitution is not simply a punishment that incidentally compensates the victim. Indeed, compensation is an essential element of a restitution scheme, under which a wrong to the victim of a crime must be redressed not just by penalizing the offender but by restoring

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the victim, as far as possible, to "the position that [he] would have been in if the original criminal act had never occurred." R. Barnett & J. Hagel, Assessing the Criminal: Restitution, Retribution, and the Legal Process, in Assessing the Criminal: Restitution, Retribution, and the Legal Process 1, 27 (1977); see also *id.*, at 25-28. That the victim has no control over whether restitution will be imposed or in what sum does not mean that the restitution is not compensation for actual pecuniary loss.[3]

Nor do I accept that we can avoid the consequences of respondent's discharge in bankruptcy by finding that the restitution obligation was not a "debt." First, the scope of debts under the Code is expansive. "Debt" is defined in 11 U.S.C. § 101(11) as "liability on a claim," and "claim" is defined in § 101(4) as a "right to payment." The legislative history of the Code indicates that "claim" was to be given the "broadest possible definition." H.R.Rep. No. 95-595, p. 309 (1977); S.Rep. No. 95-989, p. 22 (1978), U.S.Code Cong. and Admin.News 1978, pp. 5808, 6266; see also *Ohio v. Kovacs,* 469 U.S. 274, 279, 105 S.Ct. 705, 708, 83 L.Ed.2d 649 (1985) ("[I]t is apparent that Congress desired a broad definition of a 'claim' "). In light of the

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broad scope of "debt" under the Code, I agree with the

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Court of Appeals that the Probation Office had a right to payment, notwithstanding "that the right is enforceable by the threat of revocation of probation and incarceration rather than by the threat of levy and execution on the debtor's property. The right is not the less cognizable because the obligor must suffer loss of freedom rather than loss of property upon failure to pay." *In re Robinson*, 776 F.2d 30, 38 (CA2 1985).[4]

The definition of "debt" is intentionally broad not only to ensure the debtor a meaningful discharge but also to guarantee as many creditors as possible the right to participate in the distribution of the property of the estate. See H.R.Rep. No. 95-595, *supra*, at 180, U.S.Code Cong. & Admin.News 1978, p. 6141:

"[U]nder the liquidation chapters of the [1898] Bankruptcy Act, certain creditors are not permitted to share in the estate because of the non-provable nature of their claims, and the debtor is not discharged from those claims. Thus, relief for the debtor is incomplete, and those creditors are not given an opportunity to collect in the case on their claims. The proposed law will permit a complete settlement of the affairs of a bankrupt debtor,

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and a complete discharge and fresh start" (footnote omitted).

As the Court of Appeals observed, a conclusion that the restitution obligation was not a debt "would produce the anomalous result that no holder of a right to restitution could participate in the bankruptcy proceeding or receive any distributions of the debtor's assets in liquidation. There is no evidence that Congress intended such a result." *In re Robinson*, 776 F.2d, at 35-36. On the contrary, Congress plainly intended that fines, penalties, and forfeitures be deemed debts eligible to participate in the distribution of the bankruptcy estate, and the statute provides explicitly for that participation. See 11 U.S.C. § 726(a)(4).[5] The very fact that fines, penalties, and forfeitures are made nondischargeable under § 523(a)(7) indicates that they were deemed "debts"; if they were not debts, they would not be affected by discharge, see 11 U.S.C. § 524, and there would be no need to make them nondischargeable.

While I am wholly in sympathy with the policy interests underlying the Court's opinion, "in our constitutional system the commitment to the separation of powers is too fundamental for us to pre-empt congressional action by judicially decreeing what accords with 'common sense and the public weal.' Our Constitution vests such responsibilities in the political branches." *TVA v. Hill*, 437 U.S. 153, 195, 98 S.Ct. 2279, 2302, 57 L.Ed.2d 117 (1978). Congress might have amended the Code to achieve the result reached here had it confronted the question, but "[i]t is not for us to speculate, much less act, on whether Congress would have altered its stance had the specific events of this case been anticipated." *Id.*, at 185, 98 S.Ct., at 2297. I would affirm the judgment and permit Congress, if it were so inclined, to

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amend the Bankruptcy Code specifically to make criminal restitution obligations nondischargeable in bankruptcy.[6] I respectfully dissent.

1. Connecticut Gen.Stat. § 53a-30 (1985) sets out the conditions a trial court may impose on a sentence of probation. Clause 4 of that section authorizes a condition that the defendant "make restitution of the fruits of his offense or make restitution, in an amount he can afford to pay or provide in a suitable manner, for the loss or damage caused thereby and the court may fix the amount thereof and the manner of performance."

2. There is some uncertainty about the total amount Robinson was ordered to pay. Although the judge imposed restitution in a total amount of

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$9,932.95, five years of payments at $100 a month total only $6,000.

3. Section 523(a)(2)(A) protects from discharge debts "for obtaining money, property, services, or an extension, renewal, or refinance of credit, by . . . false pretenses, a false representation, or actual fraud." Section 523(a)(4) protects from discharge debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." Under § 523(c), debts that are protected from discharge only by § 523(a)(2) or § 523(a)(4) are discharged unless the creditor files an objection to discharge during the bankruptcy proceedings. Because Robinson was convicted of larceny, one of the debts listed in § 523(a)(4), it is quite likely that the Bankruptcy Court, if it had found the obligation to be a "debt," would have found it nondischargeable under that subsection.

4. The requirement that creditors object to discharge is limited on its face to &Par; (2), (4), and (6) of § 523(a). Because ¶ 7 is not listed there, debts described in that paragraph are automatically nondischargeable, under the general rule prescribed in the opening clause of § 523(a) (providing that a "discharge under section 727 . . . of this title does not discharge an individual debtor from any debt" listed in the paragraphs that follow).

5. Congress amended the Bankruptcy Act several times between 1898 and 1978. Congress also made numerous technical changes to the Code in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub.L. 98-353, 98 Stat. 380. None of those changes are relevant to this decision.

6. Although courts differed as to the boundaries of the exception, particularly in cases involving nonmonetary sanctions, or sanctions imposed in civil proceedings, the reasoning of *Moore* was widely accepted. See, *e.g., Parker v. United States,* 153 F.2d 66, 71 (CA1 1946) (citing *Moore* and noting that "[i]t was not in the contemplation of Congress that the federal bankruptcy power should be employed to pardon a bankrupt from the consequences of a criminal offense"); *Zwick v. Freeman,* 373 F.2d 110, 116 (CA2 1967) (citing *Moore* and stating that "governmental sanctions are not regarded as debts even when they require monetary payments"). We have found only one federal-court decision allowing a discharge under the Act to affect a sentence imposed by a criminal court. *In re Alderson,* 98 F. 588 (W.Va.1899).

7. For other decisions adopting this reasoning, see *People v. Topping Bros.,* 79 Misc.2d 260, 262, 359 N.Y.S.2d 985, 987-988 (Crim.Ct.1974); *People v. Washburn,* 97 Cal.App.3d 621, 625-626, 158 Cal.Rptr. 822, 825 (1979).

8. In many cases, of course, principles of issue preclusion would obviate the need for the bankruptcy court to reexamine factual questions, or interpret state law. But differences between the elements of crimes and the provisions of § 523 frequently might hinder the application of issue preclusion. Moreover, apart from the burden on state officials of following and participating in bankruptcy proceedings, it is unseemly to require state prosecutors to submit the judgments of their criminal courts to federal bankruptcy courts.

9. Of course, federal courts often duplicate state adjudicative processes when they consider petitions for the writ of habeas corpus. But explicit reference in the Constitution, Art. I, § 9, cl. 2, as well as several federal statutes, testifies to the importance of the writ of habeas corpus. Here, the case for relitigation in the federal courts rests only on the ambiguous words of the Bankruptcy Code.

10. Restitution is an effective rehabilitative penalty because it forces the defendant to confront, in concrete terms, the harm his actions have caused. Such a penalty will affect the defendant differently than a traditional fine, paid to the State as an abstract and impersonal entity, and often calculated without regard to the harm the defendant has caused. Similarly, the direct relation between the harm and the punishment gives restitution a more precise deterrent effect than a traditional fine. See Note, Victim Restitution in the Criminal Process: A Procedural Analysis, 97 Harv.L.Rev. 931, 937-941 (1984).

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[11.] Justice Frankfurter advocated a similar approach to the interpretation of regulatory statutes that infringe upon important state interests:

"The task is one of accommodation as between assertions of new federal authority and historic functions of the individual states. Federal legislation of this character cannot therefore be construed without regard to the implications of our dual system of government. . . . The underlying assumptions of our dual form of government, and the consequent presuppositions of legislative draftsmanship which are expressive of our history and habits, cut across what might otherwise be the implied range of legislation. The history of congressional legislation . . . justif[ies] the generalization that, when the Federal Government takes over such local radiations in the vast network of our national economic enterprise and thereby radically readjusts the balance of state and national authority, those charged with the duty of legislating are reasonably explicit." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum.L.Rev. 527, 539-540 (1947).

[12.] We recognize, as the Court of Appeals emphasized, that the Code's definition of "debt" is broadly drafted, and that the legislative history, as well as the Code's various priority and dischargeability provisions, supports a broad reading of the definition. But nothing in the legislative history of these sections compels the conclusion that Congress intended to change the state of the law with respect to criminal judgments.

[13.] For the section-by-section analysis in the legislative Reports, see H.R.Rep. No. 95-595, p. 363 (1977); S.Rep. No. 95-989, p. 79 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5864, 6318. For explanations of the section by commentators, see 3 Collier on Bankruptcy ¶ 523.17 (15th ed. 1986); 1 W. Norton, Bankruptcy Law and Practice § 27.37 (1982). In fact, both of these commentators expressly state that the language does not have the intrusive effect sought by Robinson. See Collier ¶ 523.17, at 523-123, n. 4; Norton § 27.37, at 55, n. 2.

It seems likely that the limitation of § 523(a)(7) to fines assessed "for the benefit of a governmental unit" was intended to prevent application of that subsection to wholly private penalties such as punitive damages. See H.R. Doc. No. 93-137, pt. 2, pp. 116, 141 (1973). As for the reference to "compensation for actual pecuniary loss," the Senate Report indicates that the main purpose of this language was to prevent § 523(a)(7) from being applied to tax penalties. S.Rep. No. 95-989, *supra,* at 79, U.S.Code Cong. & Admin.News 1978, p. 5865.

We acknowledge that a few comments in the hearings and the Bankruptcy Laws Commission Report may suggest that the language bears the interpretation adopted by the Second Circuit. But none of those statements was made by a Member of Congress, nor were they included in the official Senate and House Reports. We decline to accord any significance to these statements. See *McCaughn v. Hershey Chocolate Co.,* 283 U.S. 488, 493-494, 51 S.Ct. 510, 512, 75 L.Ed. 1183 (1931); 2A N. Singer, Sutherland on Statutory Construction § 48.10, pp. 319 and 321, n. 11 (4th ed. 1984).

[14.] This is not the only context in which courts have been forced to evaluate the treatment of restitution orders by determining whether they are "compensatory" or "penal." Several lower courts have addressed the constitutionality of the federal Victim and Witness Protection Act, 18 U.S.C. § 3579. Under that Act, defendants have no right to jury trial as to the amount of restitution, even though the Seventh Amendment would require such a trial if the issue were decided in a civil case. See Note, The Right to a Jury Trial to Determine Restitution Under the Victim and Witness Protection Act of 1982, 63 Texas L.Rev. 671 (1984). Every Federal Court of Appeals that has considered the question has concluded that criminal defendants contesting the assessment of restitution orders are not entitled to the protections of the Seventh Amendment. See *id.,* at 672, n. 18 (citing cases).

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1. Robinson's restitution debt would doubtless have come under 11 U.S.C. §§ 523(a)(2) or (4), which respectively provide that a discharge in bankruptcy will not affect a debt "for obtaining money . . . by . . . false pretenses, a false representation, or actual fraud," or a debt "for fraud or defalcation . . ., embezzlement, or larceny." To prevent discharge of such debts, however, the creditor must make a timely objection and the debtor must receive notice and a hearing. See 11 U.S.C. § 523(c); Bkrtcy.Rule 4007(c).

2. Rather than argue solely that the restitution order fits precisely within the language of § 523(a)(7), the Court appears to rely in part on the fact that, prior to the enactment of the Bankruptcy Code, fines and penalties were rendered nondischargeable in bankruptcy under a judicially created exception to discharge. The majority contends that "Congress enacted the Code in 1978 against the background of an established judicial exception to discharge for criminal sentences," *ante,* at 46, and that Congress should not be deemed to abrogate judicially created law unless it makes explicit the intent to do so. But, far from abrogating judicially created law making fines and penalties nondischargeable as a general matter, Congress has codified that law *and* added the requirements of § 523(a)(7). The historical basis of the exception does not negate the additional limitations expressed in the statute.

3. The other qualification in § 523(a)(7), that the fine, penalty, or forfeiture must be "payable to and for the benefit of a governmental unit," is not a consideration here because the restitution order in this case meets this requirement. It does so, however, only because the victim of Robinson's larceny was a government agency. Where the victim is a private individual, it could not legitimately be said that restitution payments destined for that individual are made "for the benefit of a governmental unit." Restitution intended to repay a private victim for the damage done to him is only "for the benefit of a governmental unit" in the sense that the State, which comes within the definition of "governmental unit," see 11 U.S.C. § 101(21), is benefited every time justice is served. The Court appears to take this approach, stating: "The criminal justice system is not operated primarily for the benefit of victims, but for the benefit of society as a whole." *Ante,* at 46. If the requirement is to be read so broadly, however, *any* fine, penalty, or forfeiture would be for the benefit of a governmental unit, making this qualification in § 523(a)(7) superfluous.

4. Though Connecticut does not permit the victim to enforce the restitution order as a civil judgment, other jurisdictions do. See, *e.g.,* 18 U.S.C. § 3579(h) (any order of restitution imposed by a federal court "may be enforced by the United States or a victim named in the order to receive the restitution in the same manner as a judgment in a civil action"); Ga.Code Ann. § 17-14-13(a) (1982) ("A restitution order shall be enforceable as is a civil judgment by execution"). Under such statutes, it would be even more difficult to argue that a criminal restitution order does not create a "right to payment" and is consequently not a "debt." Compare *In re Pellegrino,* 42 B.R. 129, 132 (Bkrtcy.Ct.Conn.1984) ("Since a crime victim has no 'right to payment,' restitution is not a 'debt' under Bankruptcy Code § 101(11)"), with *In re Newton,* 15 B.R. 708, 710 (Bkrtcy.Ct.ND Ga.1981) (holding that, since Georgia law provided for enforcement of restitution orders by the victim, "in Georgia, an order of restitution is a debt").

5. The estate is distributed in payment of "claims," see 11 U.S.C. § 726. The legislative history makes clear that the terms "debt" and "claim" "are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." H.R.Rep. No. 95-595, p. 310 (1977), U.S.Code Cong. & Admin.News 1978, p. 6267.

6. The Court's solution only postpones the problem: its holding that the restitution obligation is nondischargeable under § 523(a)(7) leaves open the possibility that such obligations will be dischargeable under Chapter 13. See 11 U.S.C. § 1328(a), 3 W. Norton, Bankruptcy Law and Practice § 78.01 (1981); 5 Collier on

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Bankruptcy ¶ 1328.01[1][c] (15th ed. 1986) (broader discharge intended as incentive for debtors to complete performance under Chapter 13 plans); but see *In re Newton, supra,* at 710 (holding restitution order nondischargeable under § 1328). The Court's opinion therefore does not lay to rest the difficulties the courts will have in coordinating the Bankruptcy Code with state criminal restitution statutes.

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489 U.S. 235
109 S.Ct. 1026
103 L.Ed.2d 290
UNITED STATES, Petitioner

v.

RON PAIR ENTERPRISES, INC.

No. 87-1043.

Argued Oct. 31, 1988.
Decided Feb. 22, 1989.
Syllabus

After respondent filed a petition under Chapter 11 of the Bankruptcy Code of 1978 (Code), the Government filed proof of a prepetition claim for unpaid withholding and social security taxes, penalties, and prepetition interest. The claim was perfected through a tax lien on property owned by respondent. Respondent's ensuing reorganization plan provided for full payment of the claim but did not provide for postpetition interest. The Government objected, contending that § 506(b) of the Code—which allows the holder of an oversecured claim to recover, in addition to the prepetition amount of the claim, "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose"—allowed recovery of postpetition interest, since the property securing its claim had a value greaterthan the amount of the principal debt. The Bankruptcy Court overruled this objection, but the District Court reversed. The Court of Appeals reversed the District Court, holding that § 506(b) codified the pre-Code standard that allowed postpetition interest on an oversecured claim only where the lien on the claim was consensual in nature.

Held: Section 506(b) entitles a creditor to receive postpetition interest on a nonconsensual oversecured claim allowed in a bankruptcy proceeding. Pp. 238-249.

(a) The natural reading of the phrase in § 506(b) that "there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose" entitles the holder of an oversecured claim to postpetition interest and, in addition, the holder of a secured claim pursuant to an agreement the right to the specified fees, costs, and charges. Recovery of postpetition interest is unqualified, whereas recovery of those fees, costs, and charges is allowed only if they are reasonable and provided for in the agreement under which the claim arose. Therefore, in the absence of an agreement, postpetition interest is the only added recovery available. This reading of § 506(b) is also mandated by its grammatical structure. Since the phrase "interest on such claim" is set aside by commas, and separated from the reference to fees, costs, and charges by the conjunctive words "and any," that phrase stands independent of the language that follows. Pp. 241-242.

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(b) Allowing postpetition interest on nonconsensual oversecured liens does not contravene the intent of the Code's framers, nor does it conflict with any other section of the Code or any important state or federal interest. The legislative history does not suggest a contrary view. P. 1031.

(c) There is no significant reason why Congress would have intended, or any policy reason would compel, that consensual and nonconsensual liens be treated differently in allowing postpetition interest. Section 506(b)'s language clearly directs that postpetition interest be paid on all oversecured claims. *Midlantic National Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859, and *Kelly v. Robinson,* 479 U.S. 36, 107 S.Ct. 353, 93 L.Ed.2d 216, distinguished. Pp. 243-246.

(d) The pre-Code practice of denying postpetition interest to holders of nonconsensual liens, while allowing it to holders of consensual liens, was an exception to the exception for oversecured claims from the rule that the running of interest ceased when a bankruptcy petition was

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filed, and was recognized by only a few courts and often depended on particular circumstances. The fact that this Court has never clearly acknowledged or relied upon the refusal of some Courts of Appeals to apply the oversecured claim exception to an oversecured federal tax claim counsels against concluding that such limitation was well recognized. Also arguing against considering this limitation a clear rule are the facts that all cases that limited the exception were tax-lien cases, that the "rule" has never been extended to other forms of nonconsensual liens, and that in the few cases where it was recognized, it was only a guide to the bankruptcy trustee's exercise of his powers in the particular circumstances of the case. Pp. 246-249.

828 F.2d 367 (CA6 1987), reversed.

BLACKMUN, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and WHITE, SCALIA, and KENNEDY, JJ., joined. O'CONNOR, J., filed a dissenting opinion, in which BRENNAN, MARSHALL, and STEVENS, JJ., joined, *post*, p. 249.

Lawrence G. Wallace, Washington, D.C., for petitioner.

I. William Cohen, Detroit, Mich., for respondent.

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Justice BLACKMUN delivered the opinion of the Court.

In this case we must decide the narrow statutory issue whether § 506(b) of the Bankruptcy Code of 1978, 11 U.S.C. § 506(b) (1982 ed., Supp. IV), entitles a creditor to receive postpetition interest on a nonconsensual oversecured claim allowed in a bankruptcy proceeding. We conclude that it does, and we therefore reverse the judgment of the Court of Appeals.

I

Respondent Ron Pair Enterprises, Inc., filed a petition for reorganization under Chapter 11 of the Bankruptcy Code on May 1, 1984, in the United States Bankruptcy Court for the Eastern District of Michigan. The Government filed timely proof of a prepetition claim of $52,277.93, comprised of assessments for unpaid withholding and Social Security taxes, penalties, and prepetition interest. The claim was perfected through a tax lien on property owned by respondent. Respondent's First Amended Plan of Reorganization, filed October 1, 1985, provided for full payment of the prepetition claim, but did not provide for postpetition interest on that claim. The Government filed a timely objection, claiming that § 506(b) allowed recovery of postpetition interest, since the property securing the claim had a value greater than the amount of the principal debt. At the Bankruptcy Court hearing, the parties stipulated that the claim was oversecured, but the court subsequently overruled the Government's objection. The Government app aled to the United States District Court for the Eastern District of Michigan. That court reversed the Bankruptcy Court's judgment, concluding that the plain language of § 506(b) entitled the Government to postpetition interest.

The United States Court of Appeals for the Sixth Circuit, in its turn, reversed the District Court. 828 F.2d 367 (1987). While not directly ruling that the language of § 506(b) was ambiguous, the court reasoned that reference to pre-Code law was appropriate "in order to better understand

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the context in which the provision was drafted and therefore the language itself." *Id.*, at 370. The court went on to note that under pre-Code law the general rule was that postpetition interest on an oversecured prepetition claim was allowable only where the lien was consensual in nature. In light of this practice, and of the lack of any legislative history evincing an intent to change the standard, the court held that § 506(b) codified the pre-existing standard, and that postpetition interest was allowable only on consensual claims. Because

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this result was in direct conflict with the view of the Court of Appeals for the Fourth Circuit, see *Best Repair Co. v. United States,* 789 F.2d 1080 (1986), and with the views of other courts,[1] we granted certiorari, 485 U.S. 958, 108 S.Ct. 1218, 99 L.Ed.2d 420 (1988), to resolve the conflict.

II

Section 506,[2] enacted as part of the extensive 1978 revision of the bankruptcy laws, governs the definition and treatment

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of secured claims, *i.e.,* claims by creditors against the estate that are secured by a lien on property in which the estate has an interest. Subsection (a) of § 506 provides that a claim is secured only to the extent of the value of the property on which the lien is fixed; the remainder of that claim is considered unsecured.[3] Subsection (b) is concerned specifically with oversecured claims, that is, any claim that is for an amount less than the value of the property securing it. Thus, if a $50,000 claim were secured by a lien on property having a value of $75,000, the claim would be oversecured, provided the trustee's costs of preserving or disposing of the property were less than $25,000. Section 506(b) allows a

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holder of an oversecured claim to recover, in addition to the prepetition amount of the claim, "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."

The question before us today arises because there are two types of secured claims: (1) voluntary (or consensual) secured claims, each created by agreement between the debtor and the creditor and called a "security interest" by the Code, 11 U.S.C. § 101(45) (1982 ed., Supp.IV), and (2) involuntary secured claims, such as a judicial or statutory lien, see 11 U.S.C. §§ 101(32) and (47) (1982 ed., Supp.IV), which are fixed by operation of law and do not require the consent of the debtor. The claim against respondent's estate was of this latter kind. Prior to the passage of the 1978 Code, some Courts of Appeals drew a distinction between the two types for purposes of determining postpetition interest. The question we must answer is whether the 1978 Code recognizes and enforces this distinction, or whether Congress intended that all oversecured claims be treated the same way for purposes of postpetition interest.

III

Initially, it is worth recalling that Congress worked on the formulation of the Code for nearly a decade. It was intended to modernize the bankruptcy laws, see H.R.Rep. No. 95-595, p. 3 (1977) U.S.Code Cong. & Admin.News 1978 pp. 5787, 5963, 5964 (Report), and as a result made significant changes in both the substantive and procedural laws of bankruptcy. See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 52-53, 102 S.Ct. 2858, 2861-2862, 73 L.Ed.2d 598 (1982) (plurality opinion). In particular, Congress intended "significant changes from current law in . . . the treatment of secured creditors and secured claims." Report, at 180. In such a substantial overhaul of the system, it is not appropriate or realistic to expect Congress to have explained with particularity each step it took. Rather, as long as the statutory scheme is coherent and consistent, there generally is no

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need for a court to inquire beyond the plain language of the statute.

A.

The task of resolving the dispute over the meaning of § 506(b) begins where all such inquiries must begin: with the language of the statute itself. *Landreth Timber Co. v. Landreth,* 471 U.S. 681, 685, 105 S.Ct. 2297, 2301, 85 L.Ed.2d 692 (1985). In this case it is also where the inquiry should end, for where, as here, the statute's language is plain, "the sole function o the

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courts is to enforce it according to its terms." *Caminetti v. United States,* 242 U.S. 470, 485, 37 S.Ct. 192, 194, 61 L.Ed. 442 (1917). The language before us expresses Congress' intent—that postpetition interest be available—with sufficient precision so that reference to legislative history and to pre-Code practice is hardly necessary.

The relevant phrase in § 506(b) is: "[T]here shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." "Such claim" refers to an oversecured claim. The natural reading of the phrase entitles the holder of an oversecured claim to postpetition interest and, in addition, gives one having a secured claim created pursuant to an agreement the right to reasonable fees, costs, and charges provided for in that agreement. Recovery of postpetition interest is unqualified. Recovery of fees, costs, and charges, however, is allowed only if they are reasonable and provided for in the agreement under which the claim arose. Therefore, in the absence of an agreement, postpetition interest is the only added recovery available.

This reading is also mandated by the grammatical structure of the statute. The phrase "interest on such claim" is set aside by commas, and separated from the reference to fees, costs, and charges by the conjunctive words "and any." As a result, the phrase "interest on such claim" stands independent of the language that follows. "[I]nterest on such claim" is not part of the list made up of "fees, costs, or

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charges," nor is it joined to the following clause so that the final "provided for under the agreement" modifies it as well. See *Best Repair Co. v. United States,* 789 F.2d, at 1082. The language and punctuation Congress used cannot be read in any other way.[4] By the plain language of the statute, the two types of recovery are distinct.[5]

B

The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 571, 102 S.Ct. 3245, 3250, 73 L.Ed.2d 973 (1982). In such cases, the intention of the drafters, rather than the strict language, controls. *Ibid.* It is clear that allowing postpetition interest on

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nonconsensual oversecured liens does not contravene the intent of the framers of the Code. Allowing such interest does not conflict with any other section of the Code, or with any important state or federal interest; nor is a contrary view suggested by the legislative history.[6] Respondent has not articulated, nor can we discern, any significant reason why Congress would have intended, or any policy reason would compel, that the two types of secured claims be treated differently in allowing postpetition interest.

C

Respondent urges that pre-Code practice drew a distinction between consensual and nonconsensual liens for the purpose of determining entitlement to postpetition interest, and that Congress' failure to repudiate that distinction requires us to enforce it. It is respondent's view, as it was the view of the Court of Appeals, that *Midlantic National Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), and *Kelly v. Robinson,* 479 U.S. 36, 107 S.Ct. 353, 93 L.Ed.2d 216 (1986), so require. We disagree.

In *Midlantic* we held that § 554(a) of the Code, 11 U.S.C. § 554(a), which provides that "the trustee may abandon any property of the estate that is burdensome to the estate," does not give a trustee the authority to violate state health and safety laws by abandoning property containing hazardous wastes. 474 U.S., at 507, 106 S.Ct., at 762. In reaching that conclusion, we noted that according to pre-Code doctrine the trustee's au-

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thority to dispose of property could be limited in order "to protect legitimate state or federal interests." *Id.*, at 500, 106 S.Ct., at 759. But we did not rest solely, or even primarily, on a presumption of continuity with pre-Code practice. Rather, we concluded that a contrary result would render abandonment doctrine inconsistent with other provisions of the Code itself, which embody the principle that "the trustee is not to have *carte blanche* to ignore nonbankruptcy law." *Id.*, at 502, 106 S.Ct., at 760. We also recognized that the outcome sought would be not only a departure from pre-Code practice, but also "an extraordinary exemption from nonbankruptcy law," *id.*, at 501, 106 S.Ct., at 759, requiring some clearer expression of congressional intent. We relied as well on Congress' repeated emphasis in environmental legislation "on its 'goal of protecting the environment against toxic pollution.' " *Id.*, at 505, 106 S.Ct., at 762, quoting *Chemical Manufacturers Assn. v. Natural Resources Defense Council, Inc.*, 470 U.S. 116, 143, 105 S.Ct. 1102, 1117, 84 L.Ed.2d 90 (1985). To put it simply, we looked to pre-Code practice for interpretive assistance, because it appeared that a literal application of the statute would be "demonstrably at odds with the intentions of its drafters." *Griffin v. Oceanic Contractors, Inc.*, 458 U.S., at 571, 102 S.Ct., at 3250.

A similar issue presented itself in *Kelly v. Robinson, supra,* where we held that a restitution obligation, imposed as pa t of a state criminal sentence, was not dischargeable in bankruptcy. We reached this conclusion by interpreting § 523(a)(7) of the Code,[7] 11 U.S.C. § 523(a)(7), as "preserv[ing] from discharge any condition a state criminal court imposes as part of a criminal sentence." 479 U.S., at 50, 107 S.Ct., at 361. We noted that the Code provision was "subject to interpretation," *ibid.*, and considered both legislative history and pre-Code practice in aid of that interpretation. But in determin-

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ing that Congress had not intended to depart from pre-Code practice in this regard, we did not rely on a pale presumption to that effect. We concluded that the pre-Code practice had been animated by "a deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings," *id.*, at 47, 107 S.Ct., at 360, which has its source in the basic principle of our federalism that "the States' interest in administering their criminal justice systems free from federal interference is one of the most powerful of the considerations that should influence a court considering equitable types of relief." *Id.*, at 49, 107 S.Ct., at 361. In *Kelly,* as in *Midlantic,* pre-Code practice was significant because it reflected policy considerations of great longevity and importance.[8]

Kelly and *Midlantic* make clear that, in an appropriate case, a court must determine whether Congress has expressed an intent to change the interpretation of a judicially created concept in enacting the Code. But *Midlantic* and *Kelly* suggest that there are limits to what may constitute an appropriate case. Both decisions concerned statutory language which, at least to some degree, was open to interpretation. Each involved a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance. In the present case, in contrast, the language in question is clearer than the language at issue in *Midlantic* and *Kelly:* as written it directs that postpetition interest be paid on all oversecured claims. In addition, this natural interpretation of the statutory language does not conflict with any significant state or federal interest, nor with any other aspect of the Code. Although the payment of postpetition interest is arguably somewhat in tension with the desirability of paying all creditors as uni-

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formly as practicable, Congress expressly chose to create that alleged tension. There is no reason to suspect that Congress did not mean what the language of the statute says.

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D

But even if we saw the need to turn to pre-Code practice in this case, it would be of little assistance. The practice of denying postpetition interest to the holders of nonconsensual liens, while allowing it to holders of consensual liens, was an exception to an exception, recognized by only a few courts and often dependent on particular circumstances. It was certainly not the type of "rule" that we assume Congress was aware of when enacting the Code; nor was it of such significance that Congress would have taken steps other than enacting statutory language to the contrary.

There was, indeed, a pre-Code rule that the running of interest ceased when a bankruptcy petition was filed. See *Sexton v. Dreyfus,* 219 U.S. 339, 344, 31 S.Ct. 256, 257, 55 L.Ed. 244 (1911). Two exceptions to this rule had been recognized under pre-Code ractice. The first allowed postpetition interest when the debtor ultimately proved to be solvent; the second allowed dividends and interest earned by securities held by the creditor as collateral to be applied to postpetition interest. See *City of New York v. Saper,* 336 U.S. 328, 330, n. 7, 69 S.Ct. 554, 555, n. 7, 93 L.Ed. 710 (1949). Neither of these exceptions would be relevant to this case. A third exception was of more doubtful provenance: an exception for oversecured claims. At least one Court of Appeals refused to apply this exception, *United States v. Harrington,* 269 F.2d 719, 722 (CA4 1959), and there was some uncertainty among courts which did recognize it as to whether this Court ever had done so. *United States v. Bass,* 271 F.2d 129, 131, n. 3 (CA9 1959); but see *Vanston Bondholders Protective Committee v. Green,* 329 U.S. 156, 159, 67 S.Ct. 237, 238, 91 L.Ed. 162 (1946).

What is at issue in this case is not the oversecured claim exception *per se,* but an exception to that exception. Several Courts of Appeals refused to apply the oversecured

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claim exception to an oversecured federal tax claim. See *United States v. Harrington,* 269 F.2d, at 722-723 (holding that even if there were a general exception for oversecured claims, it would not apply to tax liens); *United States v. Bass,* 271 F.2d, at 132; *In re Kerber Packing Co.,* 276 F.2d 245, 247-248 (CA7 1960); see also *In re Boston & Maine Corp.,* 719 F.2d 493, 496 (CA1 1983) (municipal property tax claim), cert. denied *sub nom. City of Cambridge v. Meserve,* 466 U.S. 938, 104 S.Ct. 1913, 80 L.Ed.2d 461 (1984). But see *In re Parchem,* 166 F.Supp. 724, 730 (D.C.Minn.) (allowing postpetition interest on tax claim), appeal dism'd upon stipulation, 261 F.2d 839 (CA8 1958); *In re Ross Nursing Home,* 2 B.R. 496, 499-500 (Bkrtcy.EDNY 1980) (same). It is this refusal to apply the exception that the Court of Appeals thought constituted a well-established judicially created rule.

The fact that this Court never clearly has acknowledged or relied upon this limitation on the oversecured-claim exception counsels against concluding that the limitation was well recognized. Also arguing against considering this limitation a clear rule is the fact that all the cases that limited the third exception were tax-lien cases. Each gave weight to *City of New York v. Saper, supra,* where this Court had ruled that postpetition interest was not available on *unsecured* tax claims, and reasoned that the broad language of that case denied it for all tax claims. See *United States v. Harrington,* 269 F.2d, at 721-722; *United States v. Bass,* 271 F.2d, at 132; *in RE kerbER packinG co.,* 276 F.2d, at 247.[9] the rule

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articulated in these cases never was extended to other forms of nonconsensual liens. Obviously, there is no way to read § 506(b) as allowing postpetition interest on all oversecured claims except claims based on unpaid taxes. For this reason, the statute Congress wrote is simply not subject to a reading that would harmonize it with the supposed pre-Code rule.

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Mor importantly, this "rule," in the few cases where it was recognized, was only a guide to the trustee's exercise of his powers in the particular circumstances of the case. We have noted that "the touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance of equities between creditor and creditor or between creditors and the debtor." *Vanston Bondholders Protective Committee v. Green,* 329 U.S., at 165, 67 S.Ct., at 241. All the exceptions to the denial of postpetition interest "are not rigid doctrinal categories. Rather, they are flexible guidelines which have been developed by the courts in the exercise of their equitable powers in insolvency proceedings." *In re Boston & Maine Corp.,* 719 F.2d, at 496. None of the cases cited by the Court of Appeals states that the doctrine does anything more than provide a bankruptcy court with guidance in the exercise of its equitable powers. As such, there is no reason to think that Congress, in enacting a contrary standard, would have felt the need expressly to repudiate it. The contrary view, which is the view we adopt today, is more consistent with Congress' stated intent, in enacting the Code, to "codif[y] creditors' rights *more clearly than the case law* . . . [b]y defin[ing] the protections to which a secured creditor is entitled, and the means through which the court may grant that protection." Report, at 4-5 (emphasis added). Whether or

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not Congress took notice of the pre-Code standard, it acted with sufficient clarity in enacting the statute.

The judgment of the Court of Appeals is reversed.

It is so ordered.

Justice O'CONNOR, with whom Justice BRENNAN, Justice MARSHALL, and Justice STEVENS join, dissenting.

The Court's decision is based on two distinct lines of argument. First, the Court concludes that the language of § 506(b) of the Bankruptcy Code, 11 U.S.C. § 506(b), is clear and unambiguous. Second, the Court takes a very narrow view of *Midlantic National Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), and its progeny. I disagree with both aspects of the Court's opinion, and with the conclusion to which they lead.

The relevant portion of § 506(b) provides that "there shall be allowed to the holder of [an oversecured] claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." The Court concludes that the only natural reading of § 506(b) is that recovery of postpetition interest is "unqualified." *Ante,* at 241. As Justice Frankfurter remarked some time ago, however: "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification." *United States v. Monia,* 317 U.S. 424, 431, 63 S.Ct. 409, 412, 87 L.Ed. 376 (1943) (dissenting opinion).

Although "the use of the comma is exceedingly arbitrary and indefinite," *United States v. Palmer,* 3 Wheat. 610, 638, 4 L.Ed. 471 (1818) (separate opinion of Johnson, J.), the Court is able to read § 506(b) the way that it does only because of the comma following the phrase "interest on such claim." Without this "capricious" bit of punctuation, *In re Newbury Cafe, Inc.,* 841 F.2d 20, 22 (CA1 1988), cert. pending, No. 87-1784, the relevant portion of § 506(b) would read as follows: "there shall be allowed to the holder of [an oversecured] claim, interest on such claim and any reasonable fees, costs, or charges pro-

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vided for under the agreement under which such claim arose." The phrase "interest on such claim" would be qualified by the phrase "provided for under the agreement under which such claim arose," and nonconsensual liens would not accrue postpetition interest. See *Porto Rico Railway, Light & Power Co. v. Mor,* 253 U.S. 345, 348, 40 S.Ct. 516, 518, 64 L.Ed. 944 (1920) ("When

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several words are followed by a clause which is applicable as much to the first and other words as to the last, the natural construction of the language demands that the clause be read as applicable to all"). This conclusion is not altered by the fact that the words "and any" follow the phrase "interest on such claim." Those words simply indicate that interest accrues only on the amount of the claim, and not on "fees, costs, or charges" that happen to be incurred by the creditor.

The Court's reliance on the comma is misplaced. "[P]unctuation is not decisive of the construction of a statute." *Costanzo v. Tillinghast,* 287 U.S. 341, 344, 53 S.Ct. 152, 153, 77 L.Ed. 350 (1932). See also *Barrett v. Van Pelt,* 268 U.S. 85, 91, 45 S.Ct. 437, 439, 69 L.Ed. 857 (1925) (" 'Punctuation is a minor, and not a controlling, element in interpretation, and courts will disregard the punctuation of a statute, or re-punctuate it, if need be, to give effect to what otherwise appears to be its purpose and true meaning' "); *Ewing v. Burnet,* 11 Pet. 41, 53-54, 9 L.Ed. 624 (1837) ("Punctuation is a most fallible standard by which to interpret a writing; it may be resorted to when all other means fail; but the court will first take the instrument by its four corners, in order to ascertain its true meaning: if that is not apparent, on judicially inspecting the whole, the punctuation will not be suffered to change it"). Under this rule of construction, the Court has not hesitated in the past to change or ignore the punctuation in legislation in order to effectuate congressional intent. See, *e.g., Simpson v. United States,* 435 U.S. 6, 11-12, n. 6, 98 S.Ct. 909, 912-913, n. 6, 55 L.Ed.2d 70 (1978) (ignoring punctuation and conjunction so that qualifying phrase would modify antecedent followed by comma and the word "or"); *Stephens v. Cherokee Nation,* 174 U.S. 445, 479-480, 19 S.Ct. 722, 734-735, 43 L.Ed. 1041 (1899) (ignoring

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punctuation so that qualifying phrase would restrict antecedent set off by commas and followed by the word "and").

Although punctuation is not controlling, it can provide useful confirmation of conclusions drawn from the words of a statute. *United States v. Naftalin,* 441 U.S. 768, 774, n. 5, 99 S.Ct. 2077, 2082, n. 5, 60 L.Ed.2d 624 (1979). The Court attempts to buttress its interpretation of § 506(b) by suggesting that any other reading would be inconsistent with the remaining portions of § 506, which "make no distinction between consensual and nonconsensual liens." *Ante,* at 242, n. 5. But § 506(b), regardless of how it is read, does distinguish between types of liens. The phrase "provided for under the agreement under which such claim arose" certainly refers to consensual liens, and must qualify some preceding language. Even under the Court's interpretation, "reasonable fees, costs, or charges" can only be awarded if provided for in a consensual lien. Thus, limiting postpetition interest to consensual liens simply reinforces a distinction that already exists in § 506(b). For the same reason, I find unavailing the Court's assertion, *ibid.,* that Congress would have used the phrase "security interest" if it wanted to limit postpetition interest to consensual liens.

Even if I believed that the language of § 506(b) were clearer than it is, I would disagree with the Court's conclusion, for *Midlantic* counsels against inferring congressional intent to change pre-Code bankruptcy law. At issue in *Midlantic* was § 554(a) of the Code, 11 U.S.C. § 554(a), which provided that "[a]fter notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate." Despite this unequivocal language, the Court held that § 554(a) does not authorize a trustee to abandon hazardous property in contravention of a state statute or regulation reasonably designed to protect the public health or safety. Relying on only three pre-Code cases (one did not deal with state laws and in another the relevant language was arguably icta), the Court concluded that under pre-Code bankruptcy law there

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were restrictions on a trustee's power to abandon property. 474 U.S., at 500-501, 106 S.Ct., at 759-760. The Court stated that the "normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific," and noted that it had "followed this rule with particular care in construing the scope of bankruptcy codifications." *Id.,* at 501, 106 S.Ct., at 759 (citations omitted). Given the pre-Code law and Congress' goal of protecting the environment, the Court was "unwilling to assume that by enactment of § 554(a), Congress implicitly overturned longstanding restrictions on the common law abandonment power." *Id.,* at 506, 106 S.Ct., at 762.

The Court characterizes *Midlantic* as involving "a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance." *Ante,* at 245. Though I agree with that characterization, I think there is more to *Midlantic* than conflict with state or federal laws. Contrary to the Court's intimation, *Midlantic* did not "concer[n] statutory language which . . . was open to interpretation." *Ante,* at 245. The language of § 554(a) is "absolute in its terms," 474 U.S., at 509, 106 S.Ct., at 763 (REHNQUIST, J., dissenting), and the Court in *Midlantic* did not attempt to argue otherwise. Nonetheless, the Court concluded that such clear language was insufficient to demonstrate specific congressional intent to change pre-Code law. The rule of *Midlantic* is that bankruptcy statutes will not be deemed to have changed pre-Code law unless there is some indication that Congress thought that it was effecting such a change. See *Kelly v. Robinson,* 479 U.S. 36, 50-51, 107 S.Ct. 353, 361-362, 93 L.Ed.2d 216 (1986) ("Nowhere in the House and Senate Reports is there any indication that this language should be read so intrusively. . . . If Congress had intended, by § 523(a)(7) [of the Code] or by any other provision, to discharge state criminal sentences, 'we can be certain that there would have been hearings, testimony, and debate concerning consequences so wasteful, so inimical to purposes previously deemed important, and so

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likely to arouse public outrage' ") (quoting *TVA v. Hill,* 437 U.S. 153, 209, 98 S.Ct. 2279, 2309, 57 L.Ed.2d 117 (1978) (Powell, J., dissenting)).

The first step under *Midlantic* is to ascertain whether there was an established pre-Code bankruptcy practice. See 474 U.S., at 500-501, 106 S.Ct., at 759. That question is easily answered here. Prior to the 1978 enactment of the Code, this Court, as well as every Court of Appeals to address the question, had refused to allow postpetition interest on nonconsensual liens such as the tax lien involved in this case. See *City of New York v. Saper,* 336 U.S. 328, 329-341, 69 S.Ct. 554, 555-561, 93 L.Ed. 710 (1949); *In re Kerber Packing Co.,* 276 F.2d 245, 246-248 (CA7 1960); *United States v. Mighell,* 273 F.2d 682, 684 (CA10 1959); *United States v. Bass,* 271 F.2d 129, 130-132 (CA9 1959); *United States v. Harrington,* 269 F.2d 719, 723 (CA4 1959). See also *In re Boston & Maine Corp.,* 719 F.2d 493, 495-498 (CA1 1983) (post-Code case not allowing postpetition interest on municipal tax lien), cert. denied *sub nom. City of Cambridge v. Meserve,* 466 U.S. 938, 104 S.Ct. 1913, 80 L.Ed.2d 461 (1984). In order to deflect this line of cases, the Court refers to the practice "of denying postpetition interest to the holders of nonconsensual liens, while allowing it to holders of consensual liens," as "an exception to an exception." *Ante,* at 246. Regardless of how it is labeled, cf. *Henneford v. Silas Mason Co.,* 300 U.S. 577, 586, 57 S.Ct. 524, 528, 81 L.Ed. 814 (1937) ("Catchwords and labels . . . are subject to the dangers that lurk in metaphors and symbols, a d must be watched with circumspection lest they put us off our guard"), the practice was more widespread and more well established than the practice in *Midlantic,* and was certainly one that Congress "[would have been] aware of when enacting the Code." *Ante,* at 246.

The denial of postpetition interest on nonconsensual liens was based on the distinction between types of liens as well as equitable considerations. Unlike consensual liens, to which the parties voluntarily agree, nonconsensual liens

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depend for their existence only on legislative fiat. Thus, the justification for the allowance of postpetition interest on consensual

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liens—"that when the creditor extended credit, he relied upon the particular security given as collateral to secure both the principal of the debt and interest until payment and, if the collateral is sufficient to pay him, the contract between the parties ought not be abrogated by bankruptcy," *United States v. Harrington,* 269 F.2d, at 724—has no application to nonconsensual liens. The allowance of interest on nonconsensual liens is akin to a penalty on the debtor for the nonpayment of taxes or other monetary obligations imposed by law. Permitting postpetition interest on nonconsensual liens drains the pool of assets to the detriment of lower priority creditors who are not responsible for the debtor's inability to pay and who cannot avoid the imposition of post-petition interest. See *In re Boston & Maine Corp.,* 719 F.2d, at 497. Indeed, the Court acknowledges that "the payment of postpetition interest is arguably somewhat in tension with the desirability of paying all creditors as uniformly as practicable." *Ante,* at 245-246.

The second step under *Midlantic* is to look for some indicia that Congress knew it was changing pre-Code law. See 474 U.S., at 502-505, 106 S.Ct., at 760-762. As the Court said only last Term, "[I]t is most improbable that [a change in the existing bankruptcy rules] would have been made without even any mention in the legislative history." *United Savings Ass'n. of Texas v. Timbers of Inwood Forest Associates, Ltd.,* 484 U.S. 365, 380, 108 S.Ct. 626, 635, 98 L.Ed.2d 740 (1988). The legislative history of § 506(b) is "wholly inconclusive," *Best Repair Co., Inc. v. United States,* 789 F.2d 1080, 1082 (CA4 1986), and there is no statement in that history acknowledging that § 506(b) was to work a major change in pre-Code law. Because there is no evidence whatsoever that § 506(b) was meant to allow postpetition interest on nonconsensual liens, it should not be assumed that Congress "silently abrogated" the pre-Code law. *Kelly v. Robinson,* 479 U.S., at 47, 107 S.Ct., at 359.

For the reasons set forth above, I respectfully dissent.

1. Most bankruptcy courts interpreting § 506(b) have permitted the holder of an oversecured claim to recover postpetition interest. These courts have considered both state and federal tax liens, see, *e.g., In re Brandenburg,* 71 B.R. 719 (SD 1987); *In re Busone,* 71 B.R. 201 (ED NY 1987); *In re Gilliland,* 67 B.R. 410 (ND Tex.1986); *In re Hoffman,* 28 B.R. 503 (Md.1983), and private nonconsensual liens, such as judicial and mechanic's liens, see, *e.g., In re Charter Co.,* 63 B.R. 568 (MD Fla.1986); *In re Romano,* 51 B.R. 813 (MD Fla.1985); *In re Morrissey,* 37 B.R. 571 (ED Va.1984). One other Court of Appeals and a leading commentator have taken the position that § 506(b) codifies pre-Code law and distinguishes between consensual and nonconsensual liens in determining the allowance of postpetition interest. See *In re Newbury Cafe, Inc.,* 841 F.2d 20 (CA1 1988), cert. pending, No. 87-1784; 3 Collier on Bankruptcy ¶ 506.05, p. 506-41, and n. 5b (15th ed. 1988).

2. Section 506, as amended, reads:

"(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount f such allowed claim. Such value should be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

"(b) To the extent that an allowed secured claim is secured by property the value of which, after any

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recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

"(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

"(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

"(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

"(2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." 11 U.S.C. § 506 (1982 ed. and Supp.IV).

3. Thus, a $100,000 claim, secured by a lien on property of a value of $60,000, is considered to be a secured claim to the extent of $60,000, and to be an unsecured claim for $40,000. See 3 Collier on Bankruptcy ¶ 506.04, p. 506-15 (15th ed. 1988) ("[S]ection 506(a) requires a bifurcation of a 'partially secured' or 'undersecured' claim into separate and independent secured claim and unsecured claim components").

4. The United States Court of Appeals for the Fourth Circuit pointed out in *Best Repair Co.* that, had Congress intended to limit postpetition interest to consensual liens, § 506(b) could have said: "there shall be allowed to the holder of such claim, as provided for under the agreement under which such claim arose, interest on such claim and any reasonable fees, costs or charges." 789 F.2d, at 1082, n. 2. A less clear way of stating this, closer to the actual language, would be: "there shall be allowed to the holder of such claim, interest on such claim and reasonable fees, costs, and charges provided for under the agreement under which such claim arose." *Ibid.*

5. It seems to us that the interpretation adopted by the Court of Appeals in this case not only requires that the statutory language be read in an unnatural way, but that it is inconsistent with the remainder of § 506 and with terminology used throughout the Code. Adopting the Court of Appeals' view would mean that § 506(b) is operative only in regard to consensual liens, *i.e.*, that only a holder of an oversecured claim arising from an agreement is entitled to any added recovery. But the other portions of § 506 make no distinction between consensual and nonconsensual liens. Moreover, had Congress intended § 506(b) to apply only to consensual liens, it would have clarified its intent by using the specific phrase, "security interest," which the Code employs to refer to liens created by agreement. 11 U.S.C. § 101(45) (1982 ed., Supp.IV). When Congress wanted to restrict the application of a particular provision of the Code to such liens, it used the term "security interest." See, *e.g.*, 11 U.S.C. §§ 362(b)(12) and (13), 363(a), 547(c)(3)-(5), 552, 752(c), 1110(a), 1168(a), 1322(b)(2) (1982 ed. and Supp.IV).

6. See H.R. 6, 95th Cong., 1st Sess. (1977); H.R. 8200, 95th Cong., 1st Sess. (1977); S. 2266, 95th Cong., 1st Sess. (1977). Because the final version of the statute contained the same language as that initially introduced, there was no change during the legislative process that could shed light on the meaning of the allowance of interest. See generally 3 Collier on Bankruptcy ¶ 506.03, pp. 506-7 to 506-12. Neither the Committee Reports nor the statements by the managers of the legislation discuss the question of postpetition interest at all. See Report, at 356; S.Rep. No. 95-989, p. 68 (1978); 124 Cong.Rec. 32398 (1978) (statement of Rep. Edwards); *id.*, at 33997 (statement of Sen. DeConcini).

7. Section 523(a)(7) provides that a discharge in bankruptcy does not affect any debt that "is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss. . . ."

8. The rule preventing discharge of criminal fines was articulated promptly after the Bankruptcy Act

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of 1898 was passed, see *In re Moore,* 111 F. 145, 148-149 (WD Ky.1901), and was uniformly accepted at the time Congress was considering the Code. See *Kelly v. Robinson,* 479 U.S., at 45-46, 107 S.Ct., at 358-359.

9. Some pre-Code courts also distinguished between the two types of liens because nonconsensual liens were often fixed to the entirety of a debtor's property, while consensual liens usually were fixed to a particular item of property. Whatever the merit of the distinction, modern commercial lending practices have changed, and it is not unusual for commercial lenders to obtain a lien on almost all of the debtor's property. Congress, in enacting the Code, was aware of this, see Report, at 127, and in fact took specific steps to deal with such blanket liens on household goods, see 11 U.S.C. § 522(f)(2). On the other hand, not all nonconsensual liens attach broadly to a debtor's property. A typical mechanic's or construction lien is limited to the property on which the improvement is made. See T. Crandall, R. Hagedorn, & F. Smith, Jr., Debtor-Creditor Law Manual ¶ 9.02[2] (1985).

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511 U.S. 531

114 S. Ct. 1757

128 L. Ed. 2d 556

BFP, PETITIONER

v.

RESOLUTION TRUST CORPORATION, AS RECEIVER OF IMPERIAL FEDERAL SAVINGS ASSOCIATION, ET AL.

No. 92-1370

SUPREME COURT OF THE UNITED STATES

December 7, 1993, Argued

May 23, 1994, Decided

Syllabus.

Petitioner BFP took title to a California home subject to, inter alia, a deed of trust in favor of Imperial Savings Association. After Imperial entered a notice of default because its loan was not being serviced, the home was purchased by respondent Osborne for $ 433,000 at a properly noticed foreclosure sale. BFP soon petitioned for bankruptcy and, acting as a debtor in possession, filed a complaint to set aside the sale to Osborne as a fraudulent transfer, claiming that the home was worth over $ 725,000 when sold and thus was not exchanged for a "reasonably equivalent value" under 11 U.S.C. § 548(a)(2). The Bankruptcy Court granted summary judgment to Imperial. The District Court affirmed the dismissal, and a bankruptcy appellate panel affirmed the judgment, holding that consideration received in a noncollusive and regularly conducted nonjudicial foreclosure sale establishes "reasonably equivalent value" as a matter of law. The Court of Appeals affirmed.

Held:

A "reasonably equivalent value" for foreclosed real property is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with. Pp. 535-549.

(a) Contrary to the positions taken by some Courts of Appeals, fair market value is not necessarily the benchmark against which determination of reasonably equivalent value is to be measured. It may be presumed that Congress acted intentionally when it used the term "fair market value" elsewhere in the Bankruptcy Code but not in § 548, particularly when the omission entails replacing standard legal terminology with a neologism. Moreover, fair market value presumes market conditions that, by definition, do not obtain in the forced-sale context, since property sold within the time and manner strictures of state-prescribed foreclosure is simply worth less than property sold without such restrictions. "Reasonably equivalent value" also cannot be read to mean a "reasonable" or "fair" forced-sale price, such as a percentage of fair market value. To specify a federal minimum sale price beyond what state foreclosure law requires would extend bankruptcy law well beyond the traditional field of fraudulent transfers and upset the coexistence that fraudulent transfer law and foreclosure law have enjoyed for over 400 years. While, under fraudulent transfer law, a "grossly inadequate price" raises a rebuttable presumption of actual fraudulent intent, it is black letter foreclosure law that, when a State's procedures are followed, the mere inadequacy of a foreclosure sale price is no basis for setting the sale aside. Absent clearer textual guidance than the phrase "reasonably equivalent value" -- a phrase entirely compatible with preexisting practice -- the Court will not presume that Congress intended to displace traditional state regulation with an interpretation that would profoundly affect the important state interest in the security and stability of title to real property. Pp. 535-545.

(b) The conclusion reached here does not render § 548(a)(2) superfluous. The "reasonably equivalent value" criterion will continue to have independent meaning outside the foreclosure context, and § 548(a)(2) will continue to be an exclusive means of invalidating foreclosure sales

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that, while not intentionally fraudulent, nevertheless fail to comply with all governing state laws. Pp. 545-546.

Roy B. Woolsey argued the cause for petitioner. With him on the briefs was Ronald B. Coulombe.

Ronald J. Mann argued the cause for respondent Resolution Trust Corporation. With him on the brief were Solicitor General Days, Assistant Attorney General Hunger, Jeffrey P. Minear, Joseph Patchan, Jeffrey Ehrlich, and Janice Lynn Green.

Michael R. Sment argued the cause and filed a brief for respondent Osborne et al. *

* Marian C. Nowell, Henry J. Sommer, Gary Klein, Neil Fogarty, and Philip Shuchman filed a brief for Frank Allen et al. as amici curiae urging reversal.

Briefs of amici curiae urging affirmance were filed for the American Council of Life Insurance et al. by Christopher F. Graham, James L. Cunningham, and Richard E. Barnsback; for the California Trustee's Association et al. by Phillip M. Adleson, Patric J. Kelly, and Duane W. Shewaga; for the Council of State Governments et al. by Richard Ruda; for the Federal Home Loan Mortgage Corporation et al. by Dean S. Cooper, Roger M. Whelan, David F. B. Smith, and William E. Cumberland; and for Jim Walter Homes, Inc., by Lawrence A. G. Johnson.

SCALIA, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and O'CONNOR, KENNEDY, and THOMAS, JJ., joined. SOUTER, J., filed a dissenting opinion, in which BLACKMUN, STEVENS, and GINSBURG, JJ., joined, post, p. 549.

[511 U.S. 533] [128 L. Ed. 2d 561] [114 S. Ct. 1759] JUSTICE SCALIA delivered the opinion of the Court.

This case presents the question whether the consideration received from a noncollusive, real estate mortgage foreclosure sale conducted in conformance with applicable state law conclusively satisfies the Bankruptcy Code's requirement that transfers of property by insolvent debtors within one year prior to the filing of a bankruptcy petition be in exchange for "a reasonably equivalent value." 11 U.S.C. § 548(a)(2).

I

Petitioner BFP is a partnership, formed by Wayne and Marlene Pedersen and Russell Barton in 1987, for the purpose of buying a home in Newport Beach, California, from Sheldon and Ann Foreman. Petitioner took title subject to a first deed of trust in favor of Imperial Savings Association (Imperial) 1 to secure payment of a loan of $ 356,250 [128 L. Ed. 2d 562] made to the Pedersens in connection with petitioner's acquisition of the home. Petitioner granted a second deed of trust to the Foremans as security for a $ 200,000 promissory note. Subsequently, Imperial, whose loan was not being serviced, entered a notice of default under the first deed of trust and scheduled a properly noticed foreclosure sale. The foreclosure proceedings were temporarily delayed by the filing of an involuntary bankruptcy petition on behalf of petitioner. After the dismissal of that petition in June 1989, Imperial's [511 U.S. 534] foreclosure proceeding was completed at a foreclosure sale on July 12, 1989. The home was purchased by respondent Paul Osborne for $ 433,000.

In October 1989, petitioner filed for bankruptcy under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1174. Acting as a debtor in possession, petitioner filed a complaint in Bankruptcy Court seeking to set aside the conveyance of the home to respondent Osborne on the grounds that the foreclosure sale constituted a fraudulent transfer under § 548 of the Code, 11 U.S.C. § 548. Petitioner alleged that the home was actually worth over $ 725,000 at the time of the sale to Osborne. Acting on separate motions, the Bankruptcy Court dismissed the complaint as to the private respondents and granted summary judgment in favor of Imperial. The Bankruptcy Court found,

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inter alia, that the foreclosure sale had been conducted in compliance with California law and was neither collusive nor fraudulent. In an unpublished opinion, the District Court affirmed the Bankruptcy Court's granting of the private respondents' motion to dismiss. A divided bankruptcy appellate panel affirmed the Bankruptcy Court's entry of summary judgment forImperial. 132 B.R. 748 (1991). Applying the analysis set forth in In re Madrid, 21 B.R. 424 (Bkrtcy. App. Pan. CA9 1982), affirmed on other grounds, 725 F.2d 1197 (CA9), cert. denied, 469 U.S. 833, [114 S. Ct. 1760] 83 L. Ed. 2d 66, 105 S. Ct. 125 (1984), the panel majority held that a "non-collusive and regularly conducted nonjudicial foreclosure sale . . . cannot be challenged as a fraudulent conveyance because the consideration received in such a sale establishes 'reasonably equivalent value' as a matter of law." 132 B.R. at 750.

Petitioner sought review of both decisions in the Court of Appeals for the Ninth Circuit, which consolidated the appeals. The Court of Appeals affirmed. In re BFP, 974 F.2d 1144 (1992). BFP filed a petition for certiorari, which we granted. 508 U.S. 938 (1993).

[511 U.S. 535]

II

Section 548 of the Bankruptcy Code, 11 U.S.C. § 548, sets forth the powers of a trustee in bankruptcy (or, in a Chapter 11 case, a debtor in possession) to avoid fraudulent transfers. 2 It permits to be set aside not only transfers infected by actual fraud but certain other transfers [128 L. Ed. 2d 563] as well -- so-called constructively fraudulent transfers. The constructive fraud provision at issue in this case applies to transfers by insolvent debtors. It permits avoidance if the trustee can establish (1) that the debtor had an interest in property; (2) that a transfer of that interest occurred within one year of the filing of the bankruptcy petition; (3) that the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and (4) that the debtor received "less than a reasonably equivalent value in exchange for such transfer." 11 U.S.C. § 548(a)(2)(A). It is the last of these four elements that presents the issue in the case before us.

Section 548 applies to any "transfer," which includes "foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(54) (1988 ed., Supp. IV). Of the three critical terms "reasonably equivalent value," only the last is defined: "value" means, for purposes of § 548, "property, or satisfaction or securing of a . . . debt of the debtor," 11 U.S.C. [511 U.S. 536] § 548(d)(2)(A). The question presented here, therefore, is whether the amount of debt (to the first and second lienholders) satisfied at the foreclosure sale (viz., a total of $ 433,000) is "reasonably equivalent" to the worth of the real estate conveyed. The Courts of Appeals have divided on the meaning of those undefined terms. In *Durrett v. Washington Nat. Ins. Co.,*, 621 F.2d 201 (1980), the Fifth Circuit, interpreting a provision of the old Bankruptcy Act analogous to § 548(a)(2), held that a foreclosure sale that yielded 57% of the property's fair market value could be set aside, and indicated in dicta that any such sale for less than 70% of fair market value should be invalidated. Id., at 203-204. This "*Durrett* rule" has continued to be applied by some courts under § 548 of the new Bankruptcy Code. See *In re Littleton*, 888 F.2d 90, 92, n. 5 (CA11 1989). In *In re Bundles*, 856 F.2d 815, 820 (1988), the Seventh Circuit rejected the *Durrett* rule in favor of a case-by-case, "all facts and circumstances" approach to the question of reasonably equivalent value, with a *rebuttable* presumption that the foreclosure sale price is sufficient to withstand attack under § 548(a)(2). 856 F.2d at 824-825; see also *In re Grissom*, 955 F.2d 1440, 1445-1446 (CA11 1992). In this case the Ninth Circuit, agreeing with the Sixth Circuit, see *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1139 (CA6 1985), adopted the position first put forward in *In re Madrid*, 21 B.R. 424 (Bkrtcy. App. Pan. CA9 1982), affirmed on other grounds, 725 F.2d 1197 (CA9), cert. denied, 469 U.S. 833, 83 L. Ed. 2d 66, 105 S. Ct. 125 (1984), that the consideration received at a noncollusive, regularly conducted real estate foreclosure sale constitutes a reasonably equivalent value under § 548(a)(2)(A).

The Court of Appeals acknowledged that it "necessarily parted from the positions taken by the Fifth Circuit in *Durrett* . . . and the Seventh Circuit in *Bundle* s." 974 F.2dat 1148.

[128 L. Ed. 2d 564] In contrast to the approach adopted by the Ninth Circuit in the present case, both *Durrett* and *Bundles* refer to fair market value as the benchmark against which determination [511 U.S. 537] of reasonably equivalent value is to be measured. In the context of an otherwise lawful mortgage foreclosure sale of real estate, 3 such reference is in our opinion not consistent with the text of the Bankruptcy Code. The term "fair market value," though it is a well-established concept, does not appear in § 548. In contrast, § 522, dealing with a debtor's exemptions, specifically provides that, for purposes of that section, "'value' means fair market value as of the date of the filing of the petition." 11 U.S.C. § 522(a)(2). "Fair market value" also appears in the Code provision that defines the extent to which indebtedness with respect to an equity security is not forgiven for the purpose of determining whether the debtor's estate has realized taxable income. § 346(j)(7)(B). Section 548, on the other hand, seemingly goes out of its way to avoid that standard term. It might readily have said "received less than fair market value in exchange for such transfer or obligation," or perhaps "less than a reasonable equivalent of fair market value." Instead, it used the (as far as we are aware) entirely novel phrase "reasonably equivalent value." "It is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another," *Chicago v. Environmental Defense Fund, ante*, at 338 (internal quotation marks omitted), and that presumption is even stronger when the omission entails the replacement of standard legal terminology with a neologism. One must suspect the language means that fair market value cannot -- or at least cannot *always* -- be the benchmark.

That suspicion becomes a certitude when one considers that market value, as it is commonly understood, has no applicability in the forced-sale context; indeed, it is the very *antithesis* of forced-sale value. "The market value of . . . a [511 U.S. 538] piece of property is the price which it might be expected to bring if offered for sale in a fair market; not the price which might be obtained on a sale at public auction or a sale forced by the necessities of the owner, but such a price as would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing (but not compelled) to sell and a purchaser who desires to buy but is not compelled to take the particular . . . piece of property." Black's Law Dictionary 971 (6th ed. 1990). In short, "fair market value" presumes market conditions that, by definition, simply do not obtain in the context of a forced sale. See, *e. g., East Bay Municipal Utility District v. Kieffer*, 99 Cal. App. 240, 255, 278 P. 476, 482 (1929), overruled on other grounds by *County of San Diego v. Miller*, 13 Cal. 3d 684, 532 P.2d 139, 119 Cal. Rptr. 491 (1975) (in bank); *Nevada Nat. Leasing Co. v. Hereford*, 36 Cal. 3d 146, 152, 680 P.2d 1077, 1080, 203 Cal. Rptr. 118 (1984) (in bank); *Guardian* [128 L. Ed. 2d 565] *Loan Co. v. Early* , 47 N.Y.2d 515, 521, 392 N.E.2d 1240, 1244, 419 N.Y.S.2d 56 (1979).

Neither petitioner, petitioner's *amici*, nor any federal court adopting the *Durrett* or the Bundles analysis has come to grips with this glaring discrepancy between the factors relevant to an appraisal of a property's market value, on the one hand, and the strictures of the foreclosure process on the other. Market value cannot be the criterion of equivalence [114 S. Ct. 1762] in the foreclosure-sale context. 4 The language of § 548(a)(2)(A) ("received less than a reasonably equivalent [511 U.S. 539] value in exchange") requires judicial inquiry into whether the foreclosed property was sold for a price that approximated its worth at the time of sale. An appraiser's reconstruction of "fair market value" could show what similar property would be worth if it did not have to be sold within the time and manner strictures of state-prescribed foreclosure. But property that *must*be sold within those strictures is simply *worth less.* No one would pay as much to own such property as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques. And it is no more realistic to ignore

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that characteristic of the property (the fact that state foreclosure law permits the mortgagee to sell it at forced sale) than it is to ignore other price-affecting characteristics (such as the fact that state zoning law permits the owner of the neighboring lot to open a gas station). 5 Absent a clear statutory requirement to the contrary, we must assume the validity of this state-law regulatory background and take due account of its effect. "The existence and force and function of established [511 U.S. 540] institutions of local government are always in the consciousness of lawmakers and, while their weight may vary, they may never be completely overlooked in the task of interpretation. [128 L. Ed. 2d 566] "*Davies Warehouse Co. v. Bowles*, 321 U.S. 144, 154, 88 L. Ed. 635, 64 S. Ct. 474 (1944). Cf. *Gregory v. Ashcroft*, 501 U.S. 452, 460-462, 115 L. Ed. 2d 410, 111 S. Ct. 2395 (1991).

There is another artificially constructed criterion we might look to instead of "fair market price." One might judge there to be such a thing as a "reasonable" or "fair" forced-sale price. Such a conviction must lie behind the *Bundles* inquiry into whether the state foreclosure proceedings "were calculated . . . to return to the debtor-mortgagor his equity in the property." 856 F.2d at 824. And perhaps that is what the courts that follow the Durrett rule have in mind when they select 70% of fair market value as the outer limit of "reasonably equivalent value" for forecloseable property (we have no idea where else such an arbitrary percentage could have come from). The problem is that such judgments represent policy determinations that the Bankruptcy Code gives us no apparent authority to make. How closely the price received in a forced sale is likely to [114 S. Ct. 1763] approximate fair market value depends upon the terms of the forced sale -- how quickly it may be made, what sort of public notice must be given, etc. But the terms for foreclosure sale are not *standard*. They vary considerably from State to State, depending upon, among other things, how the particular State values the divergent interests of debtor and creditor. To specify a federal "reasonable" foreclosure-sale price is to extend federal bankruptcy law well beyond the traditional field of fraudulent transfers, into realms of policy where it has not ventured before. Some sense of history is needed to appreciate this.

The modern law of fraudulent transfers had its origin in the Statute of 13 Elizabeth, which invalidated "covinous and fraudulent" transfers designed "to delay, hinder or defraud creditors and others." 13 Eliz., ch. 5 (1570). English courts [511 U.S. 541] soon developed the doctrine of "badges of fraud": proof by a creditor of certain objective facts (for example, a transfer to a close relative, a secret transfer, a transfer of title without transfer of possession, or grossly inadequate consideration) would raise a rebuttable presumption of actual fraudulent intent. See *Twyne's Case*, 3 Coke Rep. 80b, 76 Eng. Rep. 809 (K. B. 1601); O. Bump, Fraudulent Conveyances: A Treatise upon Conveyances Made by Debtors to Defraud Creditors 31-60 (3d ed. 1882). Every American bankruptcy law has incorporated a fraudulent transfer provision; the 1898 Act specifically adopted the language of the Statute of 13 Elizabeth. Bankruptcy Act of July 1, 1898, ch. 541, § 67(e), 30 Stat. 564-565.

The history of foreclosure law also begins in England, where courts of chancery developed the "equity of redemption" -- the equitable right of a borrower to buy back, or redeem, property conveyed as security by paying the secured debt on a later date than "law day," the original due date. The courts' continued expansion of the period of redemption left lenders in a quandary, since title to forfeited property could remain clouded for years after law day. To meet this problem, courts created the equitable remedy of foreclosure: after a certain date the borrower would be forever foreclosed from exercising his equity of redemption. This remedy [128 L. Ed. 2d 567] was called strict foreclosure because the borrower's entire interest in the property was forfeited, regardless of any accumulated equity. See G. Glenn, 1 Mortgages 3-18, 358-362, 395-406 (1943); G. Osborne, Mortgages 144 (2d ed. 1970). The next major change took place in 19th-century America, with the development of foreclosure by sale (with the surplus over the debt refunded to the debtor) as a means of avoiding the draconian consequences of strict foreclosure.

Id., at 661-663; Glenn, *supra*, at 460-462, 622. Since then, the States have created diverse networks of judicially and legislatively crafted rules governing the foreclosure process, to achieve what each of them considers the proper balance between the [511 U.S. 542] needs of lenders and borrowers. All States permit judicial foreclosure, conducted under direct judicial oversight; about half of the States also permit foreclosure by exercising a private power of sale provided in the mortgage documents. See Zinman, Houle, & Weiss, Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977, 1004-1005 (1984). Foreclosure laws typically require notice to the defaulting borrower, a substantial lead time before the commencement of foreclosure proceedings, publication of a notice of sale, and strict adherence to prescribed bidding rules and auction procedures. Many States require that the auction be conducted by a government official, and some forbid the property to be sold for less than a specified fraction of a mandatory presale fair-market-value appraisal. See *id.*, at 1002, 1004-1005; Osborne, *supra*, 511 U.S. at 683, 733-735; G. Osborne, G. Nelson, & D. Whitman, Real Estate Finance Law 9, 446-447, 475-477 (1979). When these procedures have been followed, however, it is "black letter" law that mere inadequacy of the foreclosure sale price is no basis for setting the sale aside, though it may be set aside (*under state foreclosure law*, rather than fraudulent transfer law) if the price is so low as to "shock the conscience or [114 S. Ct. 1764] raise a presumption of fraud or unfairness." Osborne, Nelson, & Whitman, supra, 511 U.S. at 469; see also *Gelfert v. National City Bank of N. Y.*, 313 U.S. 221, 232, 85 L. Ed. 1299, 61 S. Ct. 898 (1941);*Ballentyne v. Smith*, 205 U.S. 285, 290, 51 L. Ed. 803, 27 S. Ct. 527 (1907).

Fraudulent transfer law and foreclosure law enjoyed over 400 years of peaceful coexistence in Anglo-American jurisprudence until the Fifth Circuit's unprecedented 1980 decision in *Durrett*. To our knowledge no prior decision had ever applied the "grossly inadequate price" badge of fraud under fraudulent transfer law to set aside a foreclosure sale. 6 To say that the "reasonably equivalent value" language in [511 U.S. 543] the fraudulent transfer provision of the Bankruptcy Code requires a foreclosure sale to yield a certain minimum price beyond what state foreclosure law requires, is to say, in essence, that the Code has adopted *Durrett or Bundles*. Surely Congress has the power pursuant to its constitutional grant of authority over bankruptcy, U.S. Const., Art. I, § 8, cl. 4, to disrupt the ancient harmony that foreclosure law and fraudulent conveyance law, those two pillars of debtor-creditor jurisprudence, have [128 L. Ed. 2d 568] heretofore enjoyed. But absent clearer textual guidance than the phrase "reasonably equivalent value" -- a phrase entirely compatible with preexisting practice -- we will not presume such a radical departure. See *United Sav. Assn. of Tex. v.Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 380, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988); *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501, 88 L. Ed. 2d 859, 106 S. Ct. 755 (1986); cf. *United States v. Texas*, 507 U.S. 529, 534, 123 L. Ed. 2d 245, 113 S. Ct. 1631 (1993) (statutes that invade common law must be read with presumption favoring retention of long-established principles absent evident statutory purpose to the contrary). 7

[511 U.S. 544] Federal statutes impinging upon important state interests "cannot . . . be construed without regard to the implications of our dual system of government. . . . When the Federal Government takes over . . . local radiations in the vast network of our national economic enterprise and thereby radically readjusts the balance of state and national authority, those charged with the duty of legislating [must be] reasonably explicit." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 539-540 (1947), quoted in *Kelly v. Robinson*, 479 U.S. 36, 49-50, n. 11, 93 L. Ed. 2d 216, 107 S. Ct. 353 (1986). It is beyond question that an essential state interest is at issue here: We have said that "the general welfare of society is involved in the security of the titles to real estate" and the power to ensure that security "inheres in the very [114 S. Ct. 1765] nature of [state] government." *American Land Co. v. Zeiss*, 219 U.S. 47, 60, 55 L. Ed. 82, 31 S. Ct. 200 (1911).Nor is there any doubt that the

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interpretation urged by petitioner would have a profound effect upon that interest: The title of every piece of realty purchased at foreclosure would be under a federally created cloud. (Already, title insurers have reacted to the *Durrett* rule by including specially crafted exceptions from coverage in many policies issued for properties purchased at foreclosure sales. See, *e. g.*, L. Cherkis & L. King, Collier Real Estate Transactions and the Bankruptcy Code, pp. 5-18 to 5-19 [128 L. Ed. 2d 569] (1992).) To displace traditional state regulation in such a manner, the federal statutory purpose must be "clear and manifest," *English v. General Elec. Co.*, 496 U.S. 72, 79, 110 L. Ed. 2d 65, 110 S. Ct. 2270 (1990). Cf. *Gregory v. Ashcroft*, 501 U.S. at 460-461. 8 Otherwise, the Bankruptcy [511 U.S. 545] Code will be construed to adopt, rather than to displace, pre-existing state law. See *Kelly, supra*, at 49; *Butner v. United States*, 440 U.S. 48, 54-55, 59 L. Ed. 2d 136, 99 S. Ct. 914 (1979); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 171, 91 L. Ed. 162, 67 S. Ct. 237 (1946) (Frankfurter, J., concurring).

For the reasons described, we decline to read the phrase "reasonably equivalent value" in § 548(a)(2) to mean, in its application to mortgage foreclosure sales, either "fair market value" or "fair foreclosure price" (whether calculated as a percentage of fair market value or otherwise). We deem, as the law has always deemed, that a fair and proper price, or a "reasonably equivalent value," for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with.

This conclusion does not render § 548(a)(2) superfluous, since the "reasonably equivalent value" criterion will continue to have independent meaning (ordinarily a meaning similar to fair market value) outside the foreclosure context. Indeed, § 548(a)(2) will even continue to be an exclusive means of invalidating some foreclosure sales. Although *collusive*foreclosure sales are likely subject to attack under § 548(a)(1), which authorizes the trustee to avoid transfers "made . . . with actual intent to hinder, delay, or defraud" creditors, that provision may not reach foreclosure sales that, while not intentionally fraudulent, nevertheless fail to comply with all governing state laws. Cf. 4 L. King, Collier on Bankruptcy P548.02, p. 548-35 (15th ed. 1993) (contrasting subsections (a)(1) and (a)(2)(A) of § 548). Any irregularity in the conduct of the sale that would permit judicial invalidation of the sale under applicable state law deprives the sale [511 U.S. 546] price of its conclusive force under § 548(a)(2)(A), and the transfer may be avoided if the price received was not reasonably equivalent to the property's actual value at the time of the sale (which we think would be the price that would have been received if the foreclosure sale had proceeded according to law).

III

A few words may be added in general response to the dissent. We have no quarrel with the dissent's assertion that where the "meaning of the Bankruptcy Code's text is itself clear," post, at 566, its operation is unimpeded by contrary state law or prior practice. Nor do we contend that Congress must override historical [128 L. Ed. 2d 570] state practice "expressly or not at all." *Post*, at 565. The Bankruptcy Code can of course override by implication when the implication is unambiguous. But where the intent to override is doubtful, our federal system demands deference [114 S. Ct. 1766] to long-established traditions of state regulation.

The dissent's insistence that here no doubt exists -- that our reading of the statute is "in derogation of the *straight-forward language* used by Congress,"*post*, at 549 (emphasis added) -- does not withstand scrutiny. The problem is not that we disagree with the dissent's proffered "plain meaning" of § 548(a)(2)(A) ("The bankruptcy court must compare the price received by the insolvent debtor and the worth of the item when sold and set aside the transfer if the former was substantially ('[un]reasonably') 'less than' the latter," post, at 552) -- which indeed echoes our own framing of the question presented ("whether the amount of debt . . . satisfied at the foreclosure sale . . . is 'reasonably equivalent' to the worth of

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the real estate conveyed," *supra*, 511 U.S. at 536). There is no doubt that this provision directs an inquiry into the relationship of the value received by the debtor to the worth of the property transferred. The problem, however, as any "ordinary speaker of English would have no difficulty grasping," *post*, at 552, is that this highly generalized reformulation [511 U.S. 547] of the "plain meaning" of "reasonably equivalent value" continues to leave unanswered the one question central to this case, wherein the ambiguity lies: *What is a foreclosed property worth?* Obviously, until that is determined, we cannot know whether the value received in exchange for foreclosed property is "reasonably equivalent." We have considered three (not, as the dissent insists, only two, see post, at 549) possible answers to this question -- fair market value, *supra*, 511 U.S. at 536-540, reasonable forced-sale price, *supra*, 511 U.S. at 540, and the foreclosure-sale price itself -- and have settled on the last. We would have expected the dissent to opt for one of the other two, or perhaps even to concoct a fourth; but one searches JUSTICE SOUTER's opinion in vain for any alternative response to the question of the transferred property's worth. Instead, the dissent simply reiterates the "single meaning" of "reasonably equivalent value" (with which we entirely agree): "[A] court should discern the 'value' of the property transferred and determine whether the price paid was, under the circumstances, 'less than reasonable.'"*Post*, at 559. Well and good. But what is the "value"? The dissent has no response, evidently thinking that, in order to establish that the law is clear, it suffices to show that "the eminent sense of the natural reading," *post*, at 565, provides an unanswered question.

Instead of answering the question, the dissent gives us hope that someone else will answer it, exhorting us "to believe that [bankruptcy courts], familiar with these cases (and with local conditions) as we are not, will give ["reasonably equivalent value"] sensible content in evaluating particular transfers on foreclosure." *Post*, at 560. While we share the dissent's [128 L. Ed. 2d 571] confidence in the capabilities of the United States Bankruptcy Courts, it is the proper function of *this* Court to give "sensible content" to the provisions of the United States Code. It is surely the case that bankruptcy "courts regularly make . . . determinations about the 'reasonably equivalent value' of assets transferred through other [511 U.S. 548] means than foreclosure sales." *Post*, at 560. But in the vast majority of those cases, they can refer to the traditional common-law notion of fair market value as the benchmark. As we have demonstrated, this generally useful concept simply has no application in the foreclosure-sale context, *supra*, 511 U.S. at 536-540.

Although the dissent's conception of what constitutes a property's "value" is unclear, it does *seem* to take account of the fact that the property is subject to forced sale. The dissent refers, for example, to a reasonable price "under the circumstances," *post*, at 559, and to the "worth of the item *when sold*," *post*, at 552 (emphasis added). But just as we are never told how the broader question of a property's "worth" is to be answered, neither are we informed how the lesser included inquiry into the impact of forced sale is to be conducted. Once again, we are called upon to have faith that bankruptcy courts will be able to determine whether a property's foreclosure-sale price falls unreasonably short of its "optimal value," *post*, at 559, whatever that may be. [114 S. Ct. 1767] This, the dissent tells us, is the statute's plain meaning.

We take issue with the dissent's characterization of our interpretation as carving out an "exception" for foreclosure sales, *post*, at 549, or as giving "two different and inconsistent meanings," *post*, at 557, to "reasonably equivalent value." As we have emphasized, the inquiry under § 548(a)(2)(A) -- whether the debtor has received value that is substantially comparable to the worth of the transferred property -- is the same for all transfers. But as we have also explained, the fact that a piece of property is legally subject to forced sale, like any other fact bearing upon the property's use or alienability, necessarily affects its worth. *Unlike* most other legal restrictions, however, foreclosure has the effect of completely redefining the market in which the property is offered for sale; normal free-market rules of

exchange are replaced by the far more restrictive rules governing forced sales. Given this altered reality, and the concomitant inutility [511 U.S. 549] of the normal tool for determining what property is worth (fair market value), the only legitimate evidence of the property's value at the time it is sold is the foreclosure-sale price itself.

* * *

For the foregoing reasons, the judgment of the Court of Appeals for the Ninth Circuit is Affirmed.

FOOTNOTES

1 Respondent Resolution Trust Corporation (RTC) acts in this case as receiver of Imperial Federal Savings Association (Imperial Federal), which was organized pursuant to a June 22, 1990, order of the Director of the Office of Thrift Supervision, and into which RTC transferred certain assets and liabilities of Imperial. The Director previously had appointed RTC as receiver of Imperial. For convenience we refer to all respondents other than RTC and Imperial as the private respondents.

2 Title 11 U.S.C. § 548 provides in relevant part:

"(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily --

"(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

"(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

"(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation . . . ."

3 We emphasize that our opinion today covers only mortgage foreclosures of real estate. The considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different.

4 Our discussion assumes that the phrase "reasonably equivalent" means "approximately equivalent," or "roughly equivalent." One could, we suppose, torture it into meaning "as close to equivalent as can reasonably be expected" -- in which event even a vast divergence from equivalent value would be permissible so long as there is good reason for it. On such an analysis, fair market value *could*be the criterion of equivalence, even in a forced-sale context; the forced sale would be the reason why gross inequivalence is nonetheless reasonable equivalence. Such word-gaming would deprive the criterion of all meaning. If "reasonably equivalent value" means only "as close to equivalent value as is reasonable," the statute might as well have said "reasonably infinite value."

5 We are baffled by the dissent's perception of a "patent" difference between zoning and foreclosure laws insofar as impact upon property value is concerned, *post*, at 557-558, n. 10. The only distinction we perceive is that the former constitute permanent restrictions upon use of the subject property, while the latter apply for a brief period of time and restrict only the manner of its sale. This difference says nothing about how significantly the respective regimes affect the property's value when they are operative. The dissent characterizes foreclosure rules as "merely procedural," and asserts that this renders them, unlike "substantive" zoning regulations, irrelevant in bankruptcy. We are not sure we agree with the characterization. But in any event, the cases relied on for this distinction all address creditors' attempts to claim the benefit of state rules of law (whether procedural or substantive) as property rights, in a bankruptcy proceeding. See *United Sav. Assn. of Tex. v. Timbers of Inwood Forest*

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Associates, Ltd., 484 U.S. 365, 370-371, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988); *Owen v. Owen*, 500 U.S. 305, 313, 114 L. Ed. 2d 350, 111 S. Ct. 1833 (1991); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 206-207, 76 L. Ed. 2d 515, 103 S. Ct. 2309, and nn. 14, 15 (1983). None of them declares or even intimates that state laws, procedural or otherwise, are irrelevant to prebankruptcy valuation questions such as that presented by § 548(a)(2)(A).

6 The only case cited by *Durrett* in support of its extension of fraudulent transfer doctrine, *Schafer v. Hammond*, 456 F.2d 15 (CA10 1972), involved a direct sale, not a foreclosure.

7 We are unpersuaded by petitioner's argument that the 1984 amendments to the Bankruptcy Code codified the *Durrett* rule. Those amendments expanded the definition of "transfer" to include "foreclosure of the debtor's equity of redemption," 11 U.S.C. § 101(54) (1988 ed., Supp. IV), and added the words "voluntarily or involuntarily" as modifiers of the term "transfer" in § 548(a). The first of these provisions establishes that foreclosure sales fall within the general definition of "transfers" that may be avoided under several statutory provisions, including (but not limited to) § 548. See § 522(h) (transfers of exempt property), § 544 (transfers voidable under state law), § 547 (preferential transfers), § 549 (postpetition transfers). The second of them establishes that a transfer may be avoided as fraudulent even if it was against the debtor's will. See *In re Madrid*, 725 F.2d 1197, 1199 (CA9 1984) (preamendment decision holding that a foreclosure sale is not a "transfer" under § 548). Neither of these consequences has any bearing upon the meaning of "reasonably equivalent value" in the context of a foreclosure sale.

Nor does our reading render these amendments "superfluous," as the dissent contends, *post*, at 555. Prior to 1984, it was at least open to question whether § 548 could be used to invalidate even a *collusive* foreclosure sale, see *Madrid, supra*, at 1204 (Farris, J., concurring). It is no superfluity for Congress to clarify what had been at best unclear, which is what it did here by making the provision apply to involuntary as well as voluntary transfers and by including foreclosures within the definition of "transfer." See *infra*, at 545-546.

8 The dissent criticizes our partial reliance on *Gregory* because the States' authority to "define and adjust the relations between debtors and creditors . . . [cannot] fairly be called essential to their independence." *Post*, at 565, n. 17 (internal quotation marks omitted). This ignores the fact that it is not state authority over debtor-creditor law *in general* that is at stake in this case, but the essential sovereign interest in the security and stability of title to land. See *American Land Co. v. Zeiss*, 219 U.S. 47, 60, 55 L. Ed. 82, 31 S. Ct. 200 (1911).

JUSTICE SOUTER, with whom JUSTICE BLACKMUN, JUSTICE STEVENS, and JUSTICE GINSBURG join, dissenting.

The Court today holds that by the terms of the Bankruptcy Code Congress intended a peppercorn paid at a non-collusive and procedurally regular foreclosure sale to be treated as [128 L. Ed. 2d 572] the "reasonable equivalent" of the value of a California beachfront estate. Because the Court's reasoning fails both to overcome the implausibility of that proposition and to justify engrafting a foreclosure-sale exception onto 11 U.S.C. § 548(a)(2)(A), in derogation of the straightforward language used by Congress, I respectfully dissent.

I

A

The majority presents our task of giving meaning to § 548(a)(2)(A) in this case as essentially entailing a choice between two provisions that Congress might have enacted, but did not. One would allow a bankruptcy trustee to avoid a recent foreclosure-sale transfer from an insolvent debtor whenever anything less than fair market value was obtained, while the second would limit the avoidance power to cases where the

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foreclosure sale was collusive or had failed to comply with state-prescribed procedures. The Court then argues that, given the unexceptionable proposition that forced sales rarely yield as high a price as sales held under ideal, "market" conditions, Congress's "omission" from [511 U.S. 550] § 548(a)(2)(A) of the phrase "fair market value" means that the latter, narrowly procedural reading of § 548(a)(2)(A) is the preferable one.

If those in fact were the interpretive alternatives, the majority's choice might be a defensible one. 1 The first, equating "reasonably [114 S. Ct. 1768] equivalent value" at a foreclosure sale with "fair market value" has little to recommend it. Forced-sale prices may not be (as the majority calls them) the "very *antithesis*" of market value, see *ante*, at 537, but they fail to bring in what voluntary sales realize, and rejecting such a [511 U.S. 551] reading of the statute is as easy as statutory interpretation [128 L. Ed. 2d 573] is likely to get. On the majority's view, laying waste to this straw man necessitates accepting as adequate value whatever results from noncollusive adherence to state foreclosure requirements. Because properties are "simply worth less," *ante*, at 539, on foreclosure sale, the Court posits, they must have been "worth" whatever price was paid. That, however, is neither a plausible interpretation of the statute, nor its only remaining alternative reading. 2

[511 U.S. 552] The question before the Court is whether the price received at a foreclosure sale after compliance with state procedural rules in a noncollusive sale must be treated conclusively as the "reasonably equivalent value" of the mortaged property and in answering that question, the words and meaning of § 548(a)(2)(A) are plain. See *Patterson v.Shumate*, 504 U.S. 753, 760, 119 L. Ed. 2d 519, 112 S. Ct. 2242 (1992) (party seeking to defeat plain meaning of Bankruptcy Code text bears an "exceptionally heavy burden") (internal quotation marks omitted); *Perrin v. United States*, 444 U.S. 37, 42, 62 L. Ed. 2d 199, 100 S. Ct. 311 (1979) (statutory words should be given their ordinary meaning). A trustee is authorized to avoid certain recent prebankruptcy transfers, including those on foreclosure sales, that a bankruptcy court determines were not made in exchange for "a reasonably equivalent value." Although this formulation makes no pretense to mathematical precision, an ordinary speaker of English would have no difficulty grasping its basic [114 S. Ct. 1769] thrust: the bankruptcy court must compare the price received by the insolvent debtor and the worth of the item when sold and set aside the transfer if the former was substantially ("[un]reasonably") " [128 L. Ed. 2d 574] less than" the latter. 3 Nor would any ordinary English speaker, concerned to determine whether a foreclosure sale was collusive or procedurally irregular (an enquiry going exclusively to the process by which a transaction was consummated), direct an adjudicator, as the Court now holds Congress did, to ascertain whether the sale had realized "less than a reasonably equivalent value" (an enquiry described in quintessentially substantive terms). 4

[511 U.S. 553] Closer familiarity with the text, structure, and history of the disputed provision (and relevant amendments) confirms the soundness of the plain reading. Before 1984, the question whether foreclosure sales fell within bankruptcy courts' power to set aside transfers for "too little in return" was, potentially, a difficult one. Then, it might plausibly have been contended that § 548 was most concerned with "fraudulent" conduct by debtors on the brink of bankruptcy, misbehavior unlikely to be afoot when an insolvent debtor's property is sold, against his wishes, at foreclosure. 5 Indeed, it could further have been argued, again consonantly with the text of the earlier version of the Bankruptcy Code, that Congress had not understood foreclosure to involve a "transfer" within the ambit of § 548, see, *e. g., Abramson v. Lakewood Bank & Trust Co.*, 647 F.2d 547, 549 (CA5 1981) (Clark, J., [511 U.S. 554] dissenting) (Bankruptcy Act case), cert. [114 S. Ct. 1761] denied, 454 U.S. 1164, 71 L. Ed. 2d 320, 102 S. Ct. 1038 (1982), on the theory that the "transfer" from mortgagor to mortgagee occurs, once and for all, when the security interest is first created. See generally *In re Madrid*, 725 F.2d 1197 (CA9), cert. denied, 469 U.S. 833, 83 L. Ed. 2d 66, 105 S. Ct. 125 (1984).

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In 1984, however, Congress pulled the rug out from under these previously serious arguments, by amending the Code in two relevant respects. See Bankruptcy Amendments and Federal Judgeship Act of [128 L. Ed. 2d 575] 1984, §§ 401(1), 463(a), 98 Stat. 366, 378. One amendment provided expressly that "involuntary" transfers are no less within the trustee's§ 548 avoidance powers than "voluntary" ones, and another provided that the "foreclosure of the debtor's equity of redemption" itself is a "transfer" for purposes of bankruptcy law. See 11 U.S.C. § 101(54) (1988 ed., Supp. IV). 6 Thus, whether or not [114 S. Ct. 1770] one believes (as the majority seemingly does not) that foreclosure sales rightfully belong within the historic domain of "fraudulent conveyance" law, that is exactly where Congress has now put them, cf. *In re Ehring*, 900 F.2d 184, 187 (CA9 1990), and our duty is to give effect to these new amendments, along with every other clause of the Bankruptcy Code. See, *e. g., United States v. Nordic Village, Inc.*, 503 U.S. 30, 36, 117 L. Ed. 2d 181, 112 S. Ct. 1011 (1992); *United Sav. Assn. of Tex. v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 374-375, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988); see also *Dewsnup v. Timm*, 502 U.S. 410, 426, 116 L. Ed. 2d 903, 112 S. Ct. 773 (1992) (SCALIA, J., dissenting). The Court's attempt to escape the [511 U.S. 555] plain effect of § 548(a)(2)(A) opens it to some equally plain objections.

The first and most obvious of these objections is the very enigma of the Court's reading. If a property's "value" is conclusively presumed to be whatever it sold for, the "less than reasonable equivalen[ce]" question will never be worth asking, and the bankruptcy avoidance power will apparently be a dead letter in reviewing real estate foreclosures. Cf. 11 U.S.C. § 361(3) ("indubitable equivalent"). 7 The Court answers that the section is not totally moribund: it still furnishes a way to attack collusive or procedurally deficient real property foreclosures, and it enjoys a vital role in authorizing challenges to other transfers than those occurring on real estate foreclosure. The first answer, however, just runs up against a new objection. If indeed the statute fails to reach noncollusive, procedurally correct real estate foreclosures, then the recent amendments discussed above were probably superfluous. There is a persuasive [128 L. Ed. 2d 576] case that collusive or seriously irregular real estate sales were already subject to avoidance in bankruptcy, see, *e. g., In re Worcester*, 811 F.2d 1224, 1228, 1232 (CA9 1987) (interpreting § 541(a)), and neither the Court nor the respondents and their *amici* identify any specific case in which a court pronounced itself powerless to avoid a collusive foreclosure sale. But cf. *Madrid, supra*, 725 F.2d at 1204 (Farris, J., concurring). It would seem peculiar, [511 U.S. 556] then, that for no sound reason, Congress would have tinkered with these closely watched sections of the Bankruptcy Code, for the sole purpose of endowing bankruptcy courts with authority that had not been found wanting in the first place. 8

[114 S. Ct. 1771] The Court's second answer to the objection that it renders the statute a dead letter is to remind us that the statute applies to all sorts of transfers, not just to real estate foreclosures, and as to all the others, the provision enjoys great vitality, calling for true comparison between value received for the property and its "reasonably equivalent value." (Indeed, the Court has no trouble acknowledging that something "similar to" fair market value may supply the benchmark of reasonable equivalence when such a sale is not initiated by a mortgagee, ante, at 545.) This answer, however, is less tenable than the first. A common rule of construction [511 U.S. 557] calls for a single definition of a common term occurring in several places within a statute, see *Bray v. Alexandria Women's Health Clinic*, 506 U.S. 263, 283, 122 L. Ed. 2d 34, 113 S. Ct. 753 (1993); *Dewsnupv. Timm*, 502 U.S. at 422 (SCALIA, J., dissenting) ("'Normal rule[s] of statutory construction'" require that "identical words *[used] in the same section of the same enactment*" must be given the same effect) (emphasis in original), and the case for different definitions within a single text is difficult to make, cf. *Bray, supra*, at 292 (SOUTER, J., concurring in part). But to give a single term two different and inconsistent meanings (one procedural, one substantive) for a single occurrence is an offense

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so unlikely that no common prohibition has ever [128 L. Ed. 2d 577] been thought necessary to guard against it. 9 Cf. *Owen v. Owen*, 500 U.S. 305, 313, 114 L. Ed. 2d 350, 111 S. Ct. 1833 (1991)(declining to "create a distinction [between state and federal exemptions] that the words of the statute do not contain"); *Union Bank v. Wolas*, 502 U.S. 151, 162, 116 L. Ed. 2d 514, 112 S. Ct. 527 (1991) (the "statutory text . . . makes no distinction between short-term debt and long-term debt"). Unless whimsy is attributed to Congress, the term in question cannot be exclusively procedural in one class of cases and entirely substantive in all others. To be sure, there are real differences between sales on mortgage foreclosures and other transfers, as Congress no doubt understood, but these differences may be addressed simply and consistently with the statute's plain meaning. 10

[511 U.S. 558] [114 S. Ct. 1772] The "neologism," *ante*, at 537, " [128 L. Ed. 2d 578] reasonably equivalent value" (read in light of the amendments confirming that foreclosures are to be judged under the same standard as are [511 U.S. 559] other transfers) has a single meaning in the one provision in which it figures: a court should discern the "value" of the property transferred and determine whether the price paid was, under the circumstances, "less than reasonable." There is thus no reason to rebuke the Courts of Appeals for having failed to "come to grips," *ante*, at 538, with the implications of the fact that foreclosure sales cannot be expected to yield fair market value. The statute has done so for them. As courts considering nonforeclosure transfers often acknowledge, the qualification "reasonably equivalent" itself embodies both an awareness that the assets of insolvent debtors are commonly transferred under conditions that will yield less than their optimal value and a judgment that avoidance in bankruptcy (unsettling as it does the expectations of parties who may have dealt with the debtor in good faith) should only occur when it is clear that the bankruptcy estate will be substantially augmented. See, *e. g.*, *In re Southmark Corp.*, 138 B.R. 820, 829-830 (Bkrtcy. Ct. ND Tex. 1992) (court must compare "the value of what went out with the value of what came in," but the equivalence need not be "dollar for dollar") (citation omitted); *In re Countdown of Conn., Inc.*, 115 B.R. 18, 21 (Bkrtcy. Ct. Conn. 1990) ("Some disparity between the value of the collateral and the value of debt does not necessarily lead to a finding of lack of reasonably equivalent value"). 11

[511 U.S. 560]

B

I do not share in my colleagues' apparently extreme discomfort at the prospect of vesting bankruptcy courts with responsibility for determining whether "reasonably equivalent value" was received in cases like this one, nor is the suggestion well taken that doing so is an improper abdication. Those courts regularly make comparably difficult (and contestable) determinations about the "reasonably equivalent value" of assets transferred through other means than foreclosure sales, see, *e. g.*, *Covey v. Commercial Nat. Bank*, 960 F.2d 657, 661-662 (CA7 1992) (rejecting creditor's claim that resale price may be presumed to be "reasonably equivalent value" when that creditor "seiz[es] an asset and sell[s] it for just enough to cover its loan (even if it would have been worth substantially [114 S. Ct. 1773] more as part of an ongoing enterprise)"); *In re Morris Communications NC, Inc.*, 914 F.2d 458 (CA4 1990) (for "reasonably equivalent value" purposes, worth of entry in cellular phone license "lottery" should be discounted to reflect probability of winning); cf. *In re Royal Coach Country, Inc.*, 125 B.R. 668, 673-674 (Bkrtcy. Ct. MD Fla. 1991) (avoiding exchange of 1984 truck valued at $ 2,800 for 1981 car valued [128 L. Ed. 2d 579] at $ 500), and there is every reason to believe that they, familiar with these cases (and with local conditions) as we are not, will give the term sensible content in evaluating particular transfers on foreclosure, cf. *United States v. Energy Resources Co.*, 495 U.S. 545, 549, 109 L. Ed. 2d 580, 110 S. Ct. 2139 (1990); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527, 79 L. Ed. 2d 482, 104 S. Ct. 1188 (1984); *Rosen v. Barclays Bank of N. Y.*, 115 B.R. 433 (EDNY 1990). 12 As in other § 548(a)(2) cases, a

trustee seeking [511 U.S. 561] avoidance of a foreclosure-sale transfer must persuade the bankruptcy court that the price obtained on prebankruptcy transfer was "unreasonably" low, and as in other cases under the provision, the gravamen of such a claim will be that the challenged transfer significantly and needlessly diminished the bankruptcy estate, i. e., that it extinguished a substantial equity interest of the debtor and that the foreclosing mortgagee failed to take measures which (consistently with state law, if not required by it) would have augmented the price realized. 13

[511 U.S. 562] Whether that enquiry is described as a search for a benchmark "'fair' forced-sale price," *ante*, at 540, or for the price that was reasonable under the circumstances, cf. *ante*, at 538, n. 4, is ultimately, as the Court itself seems to acknowledge, see *ante*, at 540, of no greater moment than whether the rule the Court [128 L. Ed. 2d 580] discerns in the provision is styled an "exception," an "irrebuttable presumption," or a rule of *per se* validity. The majority seems to invoke these largely synonymous terms in service of its thesis that the provision's text is "ambiguous" (and therefore ripe for application of policy-based construction rules), but the question presented here, [114 S. Ct. 1774] whether the term "less than reasonably equivalent value" may be read to forestall all enquiry beyond whether state-law foreclosure procedures were adhered to, admits only two answers, and only one of these, in the negative, is within the "apparent authority," *ibid.*, conferred on courts by the text of the Bankruptcy Code. 14

C

What plain meaning requires and courts can provide, indeed, the policies underlying a national bankruptcy law fully [511 U.S. 563] support. This case is a far cry from the rare one where the effect of implementing the ordinary meaning of the statutory text would be "patent absurdity," see *INS v. Cardoza-Fonseca*, 480 U.S. 421, 452, 94 L. Ed. 2d 434, 107 S. Ct. 1207 (1987) (SCALIA, J., concurring in judgment), or "demonstrably at odds with the intentions of its drafters," *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 244, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989) (internal quotation marks omitted). 15 Permitting avoidance of procedurally regular foreclosure sales for low prices (and thereby returning a valuable asset to the bankruptcy estate) is plainly consistent with those policies of obtaining a maximum and equitable distribution for creditors and ensuring a "fresh start" for individual debtors, which the Court has often said are at the core of federal bankruptcy law. See *Stellwagen v. Clum*, 245 U.S. 605, 617, 62 L. Ed. 507, 38 S. Ct. 215 (1918); *Williams v. United States Fidelity & Guaranty Co.*, 236 U.S. 549, 554-555, 59 L. Ed. 713, 35 S. Ct. 289 (1915). They are not, of course, any less the policies of federal bankruptcy law simply because state courts will not, for a mortgagor's benefit, set aside a foreclosure sale for "price inadequacy" alone. 16 The [128 L. Ed. 2d 581] unwillingness [511 U.S. 564] of the state courts to upset a foreclosure sale for that reason does not address the question of what "reasonably equivalent value" means in bankruptcy law, any more than the refusal of those same courts to set aside a contract for "mere inadequacy of consideration," see Restatement (Second) of Contracts § 79 (1981), would define the scope of the trustee's power to reject executory contracts. See 11 U.S.C. § 365 (1988 ed. and Supp. IV). On the contrary, a central premise of the bankruptcy avoidance powers is that what state law plainly allows [114 S. Ct. 1775] as acceptable or "fair," as between a debtor and a particular creditor, may be set aside because of its impact on other creditors or on the debtor's chances for a fresh start.

When the prospect of such avoidance is absent, indeed, the economic interests of a foreclosing mortgagee often stand in stark opposition to those of the debtor himself and of his other creditors. At a typical foreclosure sale, a mortgagee has no incentive to bid any more than the amount of the indebtedness, since any "surplus" would be turned over to the debtor (or junior lienholder), and, in some States, it can even be advantageous for the creditor to bid less and seek a deficiency judgment. See generally Washburn, The Judicial and Legislative Response

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to Price Inadequacy in Mortgage Foreclosure Sales, 53 S. Cal. L. Rev. 843, 847-851 (1980); Ehrlich, Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives, 71 Va. L. Rev. 933, 959-962 (1985); G. Osborne, G. Nelson, & D. Whitman, Real Estate Finance Law § 8.3, p. 528 (1979). And where a property is obviously worth more than the amount of the indebtedness, the lending mortgagee's interests are served best if the foreclosure sale is poorly attended; then, the lender is more likely to take the property by bidding the amount of indebtedness, retaining for itself any profits from resale. While state foreclosure procedures may somewhat mitigate the potential for this sort of opportunism (by requiring for publication of notice, for example), it surely [511 U.S. 565] is plausible that Congress, in drafting the Bankruptcy Code, would find it intolerable that a debtor's assets be wasted and the bankruptcy estate diminished, solely to speed a mortgagee's recovery.

II

Confronted with the eminent sense of the natural reading, the Court seeks finally to place this case in a line of decisions, *e. g., Gregory v. Ashcroft*, 501 U.S. 452, 115 L. Ed. 2d 410, 111 S. Ct. 2395 (1991), in which we have held that something more than mere plain language is required. 17 Because the stability of title in real [128 L. Ed. 2d 582] property may be said to be an "important" state interest, the Court suggests, see *ante*, at 544, the statute must be presumed to contain an implicit foreclosure-sale exception, which Congress must override expressly or not at all. Our cases impose no such burden on Congress, however. To be sure, they do offer support for the proposition that when the Bankruptcy Code is truly silent or ambiguous, it should not be [511 U.S. 566] read as departing from previous practice, see, *e. g., Dewsnup v. Timm*, 502 U.S. 410, 116 L. Ed. 2d 903, 112 S. Ct. 773 (1992); *Butner v. United States*, 440 U.S. 48, 54, 59 L. Ed. 2d 136, 99 S. Ct. 914 (1979). But we have never required Congress to supply "clearer textual guidance" when the apparent meaning of the Bankruptcy Code's text is itself clear, as it is here. See *Ron Pair*, 489 U.S. at 240 ("It is not appropriate or realistic to expect Congress to have explained with particularity each step it [114 S. Ct. 1776] took. Rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute"); cf. *Dewsnup, supra*, at 434 (SCALIA, J., dissenting) (Court should not "venerate 'pre-Code law'" at the expense of plain statutory meaning). 18

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We have, on many prior occasions, refused to depart from plain Code meaning in spite of arguments that doing that would vindicate similar, and presumably equally "important," state interests. In *Owen v. Owen*, 500 U.S. 305, 114 L. Ed. 2d 350, 111 S. Ct. 1833 (1991), for example, the Court refused to hold that the state "opt-out" policy embodied in § 522(b)(1) required immunity from avoidance under § 522(f) for a lien binding under Florida's exemption rules. We emphasized that "nothing in the text of § 522(f) remotely justifies treating the [state and federal] exemptions differently." 500 U.S. at 313. And in *Johnson v. Home State Bank*, 501 U.S. 78, 115 L. Ed. 2d 66, 111 S. Ct. 2150 (1991), we relied on plain Code language to allow a debtor who had "stripped" himself of personal mortgage liability under Chapter 7 to reschedule the remaining indebtedness under Chapter 13, notwithstanding a plausible contrary argument based on Code structure and a complete dearth of precedent for the [128 L. Ed. 2d 583] manoeuver under state law and prior bankruptcy practice.

[511 U.S. 567] The Court has indeed given full effect to Bankruptcy Code terms even in cases where the Code would appear to have cut closer to the heart of state power than it does here. No "clearer textual guidance" than a general definitional provision was required, for example, to hold that criminal restitution could be a "debt" dischargeable under Chapter 13, see *Davenport*, 495 U.S. at 563-564 (declining to "carve out a broad judicial exception" from statutory term, even to avoid "hampering the flexibility of state criminal judges"). Nor, in *Perez v. Campbell*, 402

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U.S. 637, 29 L. Ed. 2d 233, 91 S. Ct. 1704 (1971), did we require an express reference to state highway safety laws before construing the generally worded discharge provision of the Bankruptcy Act to bar application of a state statute suspending the driver's licenses of uninsured tortfeasors. 19

Rather than allow state practice to trump the plain meaning of federal statutes, cf. *Adams Fruit Co. v. Barrett*, 494 U.S. 638, 648, 108 L. Ed. 2d 585, 110 S. Ct. 1384 (1990), our cases describe a contrary rule: whether or not Congress has used any special "pre-emptive" language, state regulation must yield to the extent it actually conflicts with federal law. This is no less true of laws enacted under Congress's power to "establish . . . uniform Laws on the subject of Bankruptcies," U.S. Const., Art. I, § 8, cl. 4, than of those passed under its Commerce Clause power. See generally *Perez v. Campbell, supra*; cf. *id.*, at [511 U.S. 568] 651-652 (rejecting the "aberrational doctrine . . . that state law may frustrate the operation of federal law as long as the state legislature in passing its law had some purpose in mind other than one of frustration"); *Cipollone* v. [114 S. Ct. 1777] *Liggett Group, Inc.*, 505 U.S. 504, 545, 546, 120 L. Ed. 2d 407, 112 S. Ct. 2608 (1992) (SCALIA, J., concurring in judgment in part and dissenting in part) (arguing against a "presumption against . . . pre-emption" of "historic police powers") (internal quotation marks omitted).

Nor, finally, is it appropriate for the Court to look to "field pre-emption" cases, see *ante*, at 544, to support the higher duty of clarity it seeks to impose on Congress. As written and as applied by the majority of Courts of Appeals to construe it, the disputed Code provision comes nowhere near working the fundamental displacement of the state law of foreclosure procedure that the majority's rhetoric conjures. 20 [511 U.S. 569] To the contrary, construing § 548(a)(2)(A) as authorizing [128 L. Ed. 2d 584] avoidance of an insolvent's recent foreclosure-sale transfer in which "less than a reasonably equivalent value" was obtained is no more pre-emptive of state foreclosure procedures than the trustee's power to set aside transfers by marital dissolution decree, see *Britt v. Damson*, 334 F.2d 896 (CA9 1964), cert. denied, 379 U.S. 966, 13 L. Ed. 2d 560, 85 S. Ct. 661 (1965); *In re Lange*, 35 B.R. 579 (Bkrtcy. Ct. ED Mo. 1983), "pre-empts" state domestic relations law, 21 or the power to reject executory contracts, see 11 U.S.C. § 365, "displaces" the state law of voluntary obligation. While it is surely true that if the provision were accorded its plain meaning, some States (and many mortgagees) would take steps to diminish the risk that particular transactions would be set aside, such voluntary action should not be cause for dismay: it would advance core Bankruptcy Code purposes of augmenting the bankruptcy estate and improving the debtor's prospects for a "fresh start," without compromising lenders' state-law rights to move expeditiously against the property for the money owed. To the extent, in any event, that the respondents and their numerous *amici* are correct that the "important" policy favoring security of title should count more and the "important" bankruptcy policies should count less, Congress, and not this Court, is the appropriate body to provide a foreclosure-sale exception. See *Wolas*, 502 U.S. at 162. See also S. 1358, 100th Cong., 1st Sess. (1987) (proposed amendment creating foreclosure-sale exception).

III

Like the Court, I understand this case to involve a choice between two possible statutory provisions: one authorizing [511 U.S. 570] the trustee to avoid "involuntary . . . transfers [including foreclosure sales] . . . [for] less than a reasonably equivalent value," see 11 U.S.C. § 548(a), and another precluding such avoidance when "[a] secured party or third party purchaser . . . obtains title to an interest of the debtor in property pursuant to a good faith prepetition foreclosure . . . proceeding . . . [114 S. Ct. 1778] permitting . . . the realization of security upon default of the borrower, [128 L. Ed. 2d 585] " see S. 445, 98th Cong., 1st Sess., § 360 (1983). But that choice is not ours to make, for Congress made it in 1984, by enacting the former alternative into law and not the latter. Without some indication that doing so would frustrate Congress's clear intention or yield patent

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absurdity, our obligation is to apply the statute as Congress wrote it. Doing that in this case would produce no frustration or absurdity, but quite the opposite.

FOOTNOTES

1 I note, however, two preliminary embarrassments: first, the gloss on § 548(a)(2)(A) the Court embraces is less than entirely hypothetical. In the course of amending the Bankruptcy Code in 1984, see *infra*, at 554, Congress considered, but did not enact, an amendment that said precisely what the majority now says the current provision means, i. e., that the avoidance power is confined to foreclosures involving collusion or procedural irregularity. See S. 445, 98th Cong., 1st Sess., § 360 (1983). Even if one is careful not to attach too much significance to such a legislative nonoccurrence, it surely cautions against undue reliance on a different, entirely speculative congressional "omission." See *ante*, at 537 (the statute "seemingly goes out of its way to avoid" using "fair market value"); but cf. *ante*, at 545 (reasonably equivalent value will "continue" to have a meaning "similar to fair market value" outside the foreclosure-sale context).

In this case, such caution would be rewarded. While the assertedly "standard," *ante*, at 537, phrase "fair market value" appears in more than 150 distinct provisions of the Tax Code, it figures in only two Bankruptcy Code provisions, one of which is entitled, suggestively, "Special tax provisions." See 11 U.S.C. § 346. The term of choice in the bankruptcy setting seems to be "value," unadorned and undefined, which appears in more than 30 sections of the Bankruptcy Code, but which is, with respect to many of them, read to mean "fair market value." See also § 549(c) ("present fair equivalent value"); § 506(a) ("value [is to] be determined in light of the purpose of the valuation and of the proposed disposition or use of such property"); S. Rep. No. 95-989, p. 54 (1978) ("Matters [of valuation under § 361] are left to case-by-case interpretation and development. . . . Value [does not] mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes . . ."). To the extent, therefore, that this negative implication supplies ground to "suspect," see ante, at 537, that Congress could not have meant what the statute says, such suspicion is misplaced.

2 The majority's statutory argument depends similarly heavily on the success of its effort to relegate "fair market value" to complete pariah status. But it is no short leap from the (entirely correct) observation that a property's fair market value will not be dispositive of whether "less than a reasonably equivalent value" was obtained on foreclosure to the assertion that market value has "no applicability," *ante*, at 537, or *is not "legitimate evidence," ante*, at 549 (emphasis added), of whether the statutory standard was met. As is explored more fully *infra*, the assessed value of a parcel of real estate at the time of foreclosure sale is not to be ignored. On the contrary, that figure plainly is relevant to the Bankruptcy Code determination, both because it provides a proper measure of the rights received by the transferee and because it is indicative of the extent of the debtor's equity in the property, an asset which, but for the prebankruptcy transfer under review, would have been available to the bankruptcy estate, see *infra*, at 562-565.

It is also somewhat misleading, similarly, to suggest that "no one would pay as much," *ante*, at 539, for a foreclosed property as he would for the same real estate purchased under leisurely, market conditions. Buyers no doubt hope for bargains at foreclosure sales, but an investor with a million dollars cash in his pocket might be ready to pay "as much" for a desired parcel of property on forced sale, at least if a rival, equally determined millionaire were to appear at the same auction. The principal reason such sales yield low prices is not so much that the properties become momentarily *"worth less," ibid.* (on the contrary, foreclosure-sale purchasers receive a bundle of rights essentially similar to what they get when they buy on the market) or that foreclosing mortgagees are under the compulsion of state law to make no more than the most desultory efforts to encourage higher bidding, but

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rather that such free-spending millionaires are in short supply, and those who do exist are unlikely to read the fine print which fills the "legal notice" columns of their morning newspaper. Nor, similarly, is market value justly known as the "antithesis" of foreclosure-sale price, for the important (if intuitive) reason that properties with higher market values can be expected to sell for more on foreclosure.

3 Indeed, it is striking that this is what the Court says the statute (probably) does mean, with respect to almost every transfer other than a sale of property upon foreclosure. See *ante*, at 545.

4 The Court protests, *ante*, at 546, that its formulation, see *ante*, at 536, deviates only subtly from the reading advanced here and purports not to disagree that the statute compels an enquiry "into the relationship of the value received and the worth of the property transferred," *ante*, at 546. Reassuring as such carefully chosen words may sound, they cannot obscure the fact that the "comparison" the majority envisions is an empty ritual. See n. 10, *infra*.

5 The Court notes correctly that fraudulent conveyance laws were directed first against insolvent debtors' passing assets to friends or relatives, in order to keep them beyond their creditors' reach (the proverbial "Elizabethan deadbeat who sells his sheep to his brother for a pittance," see Baird & Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829, 852 (1985)), and then later against conduct said to carry the "badges" of such misconduct, but bankruptcy law had, well before 1984, turned decisively away from the notion that the debtor's state of mind, and not the objective effects on creditors, should determine the scope of the avoidance power. Thus, the 1938 Chandler Act, Bankruptcy Revision, provided that a transfer could be set aside without proving any intent to "hinder, delay, or defraud," provided that the insolvent debtor obtained less than "fair consideration" in return, see 11 U.S.C. § 107(d)(2) (1976), and the 1978 Bankruptcy Code eliminated scrutiny of the transacting parties' "good faith." Cf. 11 U.S.C. § 107(d)(1)(e) (1976). At the time when bankruptcy law was more narrowly concerned with debtors' turpitude, moreover, the available "remedies" were strikingly different, as well. See, *e. g.*, 21 Jac. I., ch. 19, § 6 (1623), 4 Statutes of the Realm 1228 (insolvent debtor who fraudulently conceals assets is subject to have his ear nailed to pillory and cut off).

6 As noted at n. 1, *supra*, an earlier version of the Senate bill contained a provision that would have added to § 548 the conclusive presumption the Court implies here. See S. 445, 98th Cong., 1st Sess., § 360 (1983) ("A secured party or third party purchaser who obtains title to an interest of the debtor in property pursuant to a good faith prepetition foreclosure, power of sale, or other proceeding or provision of nonbankruptcy law permitting or providing for the realization of security upon default of the borrower under a mortgage, deed of trust, or other security agreement takes for reasonably equivalent value within the meaning of this section"). The provision was deleted from the legislation enacted by Congress.

7 Evidently, many States take a less Panglossian view than does the majority about the prices paid at sales conducted in accordance with their prescribed procedures. If foreclosure-sale prices truly represented what properties are "worth," *ante*, at 539, or their "fair and proper price," *ante*, at 545, it would stand to reason that deficiency judgments would be awarded simply by calculating the difference between the debt owed and the "value," as established by the sale. Instead, in those jurisdictions permitting creditors to seek deficiency judgments it is quite common to require them to show that the foreclosure price roughly approximated the property's (appraised) value. See, *e. g.*, Tex. Prop. Code Ann. §§ 51.003-51.005 (Supp. 1992); see generally *Gelfert v. National City Bank of N. Y.*, 313 U.S. 221, 85 L. Ed. 1299, 61 S. Ct. 898 (1941); cf. *id.*, at 233 ("The price which property commands at a forced sale may be hardly even a rough measure of its value").

8 That is not the only aspect of the majority's approach that is hard to square with the amended

text. By redefining "transfer" in § 101, Congress authorized the trustee to avoid any "foreclosure of the equity of redemption" for "less than a reasonably equivalent value." In light of the fact, see, e. g., Lifton, Real Estate in Trouble: Lender's Remedies Need an Overhaul, 31 Bus. Law 1927, 1937 (1976), that most foreclosure properties are sold (at noncollusive and procedurally unassailable sales, we may presume) for the precise amount of the outstanding indebtedness, when some (but by no means all) are worth more, see generally Wechsler, Through the Looking Glass: Foreclosure by Sale as *De Facto* Strict Foreclosure -- An Empirical Study of Mortgage Foreclosure and Subsequent Resale, 70 Cornell L. Rev. 850 (1985), it seems particularly curious that Congress would amend a statute to recognize that a debtor "transfers" an "interest in property," when the equity of redemption is foreclosed, fully intending that the "reasonably equivalent value" of that interest would, in the majority of cases, be presumed conclusively to be zero.

To the extent that the Court believes the amended § 548(a)(2)(A) to be addressed to "collusive" sales, meanwhile, a surprisingly indirect means was chosen. Cf. 11 U.S.C. § 363(n) (authorizing trustee avoidance of postpetition sale, or, in the alternative, recovery of the difference between the "value" of the property and the "sale price," when the "sale price was controlled by an agreement"). Cf. *ante*, at 537 (citing *Chicago v. Environmental Defense Fund, ante*, at 338).

9 Indeed, the Court candidly acknowledges that the proliferation of meanings may not stop at two: not only does "reasonably equivalent value" mean one thing for foreclosure sales and another for other transfers, but tax sales and other transactions may require still other, unspecified "benchmark[s]." See *ante*, at 537, and n. 3.

10 The Court's somewhat mischievous efforts to dress its narrowly procedural gloss in respectable, substantive garb, see *ante*, at 537-538, 546-547, make little sense. The majority suggests that even if the statute must be read to require a comparison, the one it compels dooms the trustee always to come up short. A property's "value," the Court would have us believe, should be determined with reference to a State's rules governing creditors' enforcement of their rights, in the same fashion that it might encompass a zoning rule governing (as a matter of state law) a neighboring landowner's entitlement to build a gas station. But the analogy proposed ignores the patent difference between these two aspects of the "regulatory background," *ante*, at 539: while the zoning ordinance would reduce the value of the property "to the world," foreclosure rules affect not the price any purchaser "would pay," *ibid.*, but rather the means by which the mortgagee is permitted to extract its entitlement from the entire "value" of the property.

Such distinctions are a mainstay of bankruptcy law, where it is commonly said that creditors' "substantive" state-law rights "survive" in bankruptcy, while their "procedural" or "remedial" rights under state debtor-creditor law give way, see, *e. g., United Sav. Assn. of Tex. v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 370-371, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988) (refusing to treat "right to immediate foreclosure" as an "interest in property" under applicable nonbankruptcy law); *Owen v. Owen*, 500 U.S. 305, 114 L. Ed. 2d 350, 111 S. Ct. 1833 (1991) (bankruptcy exemption does not incorporate state law with respect to liens); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 206-207, 76 L. Ed. 2d 515, 103 S. Ct. 2309 (1983); see also *Gelfert v. National City Bank of N. Y.*, 313 U.S. at 234 ("The advantages of a forced sale" are not "a . . . property right" under the Constitution). And while state foreclosure rules reflect, *inter alia*, an understandable judgment that creditors should not be forced to wait indefinitely as their defaulting debtors waste the value of loan collateral, bankruptcy law affords mortgagees distinct and presumably adequate protections for their interest, see 11 U.S.C. §§ 548(c), 550(d)(1), 362(d); *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278-279, 85 L. Ed. 184, 61 S. Ct. 196 (1940), along with the general promise that the debtor's estate will, effectively, be maximized in the interest of creditors.

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The majority professes to be "baffled," *ante*, at 539, n. 5, by this commonsense distinction between state zoning laws and state foreclosure procedures. But a zoning rule is not merely "price-affecting," ante, at 539: it affects the property's value (i. e., the price for which any transferee can expect to resell). State-mandated foreclosure procedures, by contrast, might be called "price-affecting," in the sense that adherence solely to their minimal requirements will no doubt keep sale prices low. But state rules hardly forbid mortgagees to make efforts to encourage more robust bidding at foreclosure sales; they simply fail to furnish sellers any reason to do so, see *infra*.

*11 Indeed, it is not clear from its opinio*n that the Court has "come to grips," *ante*, at 538, with the reality that "involuntary" transfers occur outside the real property setting, that legally voluntary transfers can be involuntary in fact, and that, where insolvent debtors on the threshold of bankruptcy are concerned, transfers for full, "fair market" price are more likely the exception than the rule. On the Court's reading, for example, nothing would prevent a debtor who deeded property to a mortgagee "in lieu of foreclosure" prior to bankruptcy from having the transaction set aside, under the "ordinary," *ante*, at 545, substantive standard.

12 It is only by renewing, see *ante*, at 548, its extreme claim, but see n. 2, *supra*, that market value is wholly irrelevant to the analysis of foreclosure-sale transfer (and that bankruptcy courts are debarred from even "referring" to it) that the Court is able to support its assertion that evaluations of such transactions are somehow uniquely beyond their ken.

The majority, as part of its last-ditch effort to salvage some vitality for the provision, itself would require bankruptcy judges to speculate as to the price "that would have been received if the foreclosure sale had proceeded according to [state] law." *Ante*, at 546; cf. *ante*, at 540 (expressing skepticism about judicial competence to determine "such a thing" as a "fair" forced-sale price).

13 In this regard and in its professions of deference to the processes of local self-government, the Court wrongly elides any distinction between what state law commands and what the States permit. While foreclosure sales "under state law" may typically be sparsely attended and yield low prices, see *infra*, at 564, these are perhaps less the result of state law "strictures," *ante*, at 538, than of what state law fails to supply, incentives for foreclosing lenders to seek higher prices (by availing themselves of advertising or brokerage services, for example). Thus, in judging the reasonableness of an apparently low price, it will surely make sense to take into account (as the Court holds a bankruptcy court is forbidden to) whether a mortgagee who promptly resold the property at a large profit answers, "I did the most that could be expected of me" or "I did the least I was allowed to."

I also do not join my colleagues in their special scorn for the "70% rule" associated with *Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201 (CA5 1980), which they decry, *ante*, at 540, as less an exercise in statutory interpretation than one of "policy determination." Such, of course, it may be, in the limited sense that the statute's text no more mentions the 70% figure than it singles out procedurally regular foreclosure sales for the special treatment the Court accords them. But the *Durrett*"rule," as its expositor has long made clear, claims only to be a description of what foreclosure prices have, in practice, been found "reasonable," and as such, it is consistent (as the majority's "policy determination" is not), with the textual directive that one value be compared to another, the transfer being set aside when one is unreasonably "less than" the other. To the extent, moreover, that *Durrett* is said to have announced a "rule," it is better understood as recognizing a "safe harbor" or affirmative defense for bidding mortgagees or other transferees who paid 70% or more of a property's appraised value at the time of sale.

14 The Court's criticism, *ante*, at 546-548, deftly conflates two distinct questions: is the price on procedurally correct and noncollusive sale

presumed irrebuttably to be reasonably equivalent value (the question before us) and, if not, what are the criteria (a question not raised here but explored by courts that have rejected the irrebuttable presumption)? What is "plain" is the answer to the first question, thanks to the plain language, whose meaning is confirmed by policy and statutory history. The answer to the second may not be plain in the sense that the criteria might be self-evident, see n. 13, *supra*, but want of self-evidence hardly justifies retreat from the obvious answer to the first question. Courts routinely derive criteria, unexpressed in a statute, to implement standards that are statutorily expressed, and in a proper case this Court could (but for the majority's decision) weigh the relative merits of the subtly different approaches taken by courts that have rejected the irrebuttable presumption.

15 Tellingly, while the Court's opinion celebrates fraudulent conveyance law and state foreclosure law as the "twin pillars" of creditor-debtor regulation, it evinces no special appreciation of the fact that this case arises under the Bankruptcy Code, which, in maintaining the national system of credit and commerce, embodies policies distinct from those of state debtor-creditor law, see generally *Stellwagen v. Clum*, 245 U.S. 605, 617, 62 L. Ed. 507, 38 S. Ct. 215 (1918), and which accordingly endows trustees with avoidance power beyond what state law provides, see *Board of Trade of Chicago v. Johnson*, 264 U.S. 1, 10, 68 L. Ed. 533, 44 S. Ct. 232 (1924); *Stellwagen, supra*, at 617; 11 U.S.C. §§ 541(a), 544(a).

16 Although the majority accurately states this "'black letter'" law, it also acknowledges that courts will avoid a foreclosure sale for a price that "shock[s] the conscience," see *ante*, at 542 (internal quotation marks omitted), a standard that has been invoked to justify setting aside sales yielding as much as 87% of appraised value. See generally Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 S. Cal. L. Rev. 843, 862-870 (1980). Moreover, while price inadequacy "alone" may not be enough to set aside a sale, such inadequacy will often induce a court to undertake a sort of "strict scrutiny" of a sale's compliance with state procedures. See, *e. g.*, *id.*, at 861.

17 The Court dangles the possibility that *Gregory* itself is somehow pertinent to this case, but that cannot be so. There, invoking principles of constitutional avoidance, we recognized a "plain statement" rule, whereby Congress could supplant state powers "reserved under the Tenth Amendment" and "at the heart of representative government," only by making its intent to do so unmistakably clear. Unlike the States' authority to "determine the qualifications of their most important government officials," 501 U.S. at 463 (*e. g.*, to enforce a retirement age for state judges mandated by the State Constitution, at issue in *Gregory*), the authority of the States in defining and adjusting the relations between debtors and creditors has never been plenary, nor could it fairly be called "essential to their independence." In making the improbable contrary assertion, the Court converts a stray phrase in *American Land Co. v. Zeiss*, 219 U.S. 47, 55 L. Ed. 82, 31 S. Ct. 200 (1911), which upheld against substantive due process challenge the power of a State to legislate with respect to land titles (California's effort to restore order after title records had been destroyed in the calamitous 1906 San Francisco earthquake) into a pronouncement about the allocation of responsibility between the National Government and the States. Cf. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 546, 120 L. Ed. 2d 407, 112 S. Ct. 2608 (1992) (SCALIA, J., concurring in judgment in part and dissenting in part) (emphasizing the inapplicability of "clear-statement" rules to ordinary pre-emption cases).

18 Even if plain language is insufficiently "clear guidance" for the Court, further guidance is at hand here. The provision at hand was amended in the face of judicial decisions driven by the same policy concerns that animate the Court, to make plain that foreclosure sales and other "involuntary" transfers are within the sweep of the avoidance power.

19 Only over vigorous dissent did the Court read the trustee's generally worded abandonment power, 11 U.S.C. § 554, as not authorizing

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abandonment "in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards." *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 505, 88 L. Ed. 2d 859, 106 S. Ct. 755 (1986); cf. *id.*, at 513 (REHNQUIST, J., dissenting) ("Congress knew how to draft an exception covering the exercise of 'certain' police powers when it wanted to"); cf. also L. Cherkis & L. King, Collier Real Estate Transactions and the Bankruptcy Code, p. 6-24 (1992) (post-*Midlantic* cases suggest that "if the hazardous substances on the property do not pose immediate danger to the public, and if the trustee has promptly notified local environmental authorities of the contamination and cooperated with them, abandonment may be permitted").

20 Talk of "'radical adjust[ments to] the balance of state and national authority,'" ante, at 544, notwithstanding, the Court's submission with respect to "displacement" consists solely of the fact that some private companies in *Durrett* jurisdictions have required purchasers of title insurance to accept policies with "specially crafted exceptions from coverage in many policies issued for properties purchased at foreclosure sales." *Ante*, at 544 (citing Cherkis & King, *supra*, at 5-18 to 5-19). The source cited by the Court reports that these exceptions have been demanded when mortgagees are the purchasers, but have not been required in policies issued to third-party purchasers or their transferees, Cherkis & King, *supra*, 505 U.S. 504 at 5-18 to 5-19, and that such clauses have neither been limited to *Durrett* jurisdictions, nor confined to avoidance under federal bankruptcy law. See Cherkis & King, *supra*, 505 U.S. 504 at 5-10 (noting one standard exclusion from coverage for "any claim, which arises . . . by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws"). Nothing in the Bankruptcy Code, moreover, deprives the States of their broad powers to regulate directly the terms and conditions of title insurance policies.

The "federally created cloud" on title seems hardly to be the Damoclean specter that the Court makes it out to be. In the nearly 14 years since the *Durrett* decision, the bankruptcy reports have included a relative handful of decisions actually setting aside foreclosure sales, nor do the States, either inside or outside *Durrett* jurisdictions, seem to have ventured major changes in the "diverse networks of . . . rules governing the foreclosure process." See *ante*, at 541.

21 But cf. *Wetmore v. Markoe*, 196 U.S. 68, 49 L. Ed. 390, 25 S. Ct. 172 (1904) (alimony is not a "debt" subject to discharge under the Bankruptcy Act).

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484 U.S. 365
108 S.Ct. 626
98 L.Ed.2d 740
UNITED SAVINGS ASSOCIATION OF TEXAS, Petitioner

v.

TIMBERS OF INWOOD FOREST ASSOCIATES, LTD.

No. 86-1602.

Argued Dec. 1, 1987.
Decided Jan. 20, 1988.
Syllabus

When a bankruptcy petition is filed, § 362(a) of the Bankruptcy Code provides an automatic stay of actions taken to realize the value of collateral given by the debtor. Section 362(d) authorizes the bankruptcy court to grant relief from the stay "(1) for cause, including the lack of adequate protection of an interest in property of . . . [a] party in interest," or "(2) with respect to a stay of an act against property," if the debtor does not have an equity in such property (*i.e.*, the creditor is undersecured) and the property is "not necessary to an effective reorganization." Section 361 provides that adequate protection of an entity's interest in property may be provided by granting such relief "as will result in the realization by such entity of the indubitable equivalent of its interest." After respondent filed a petition for reorganization under Chapter 11 of the Code, petitioner, an undersecured creditor, moved the Bankruptcy Court for relief from the § 362(a) stay on the ground that there was a lack of "adequate protection" of its interest within the meaning of § 362(d)(1). The court granted relief, conditioning continuance of the stay on monthly payments by respondent on the estimated amount realizable on the foreclosure that the stay prevented. The District Court affirmed, but the Court of Appeals reversed.

Held: Undersecured creditors are not entitled to compensation under § 362(d)(1) for the delay caused by the automatic stay in foreclosing on their collateral. Pp. 370-380.

(a) The language of other Code provisions that deal with the rights of secured creditors, and the substantive dispositions that those provisions effect, establish that the "interest in property" protected by § 362(d)(1) does not include a secured party's right to immediate foreclosure. First, petitioner's contrary interpretation contradicts the carefully drawn substantive disposition effected by § 506(b), which codifies the pre-Code rule denying undersecured creditors postpetition interest on their *claims*. Had Congress nevertheless meant to give undersecured creditors interest on the value of their *collateral*, it would have said so plainly in § 506(b). Moreover, the meaning of § 362(d)(1)'s "interest in property" phrase is clarified by the use of similar terminology in § 506(a), where it must be interpreted to mean only the creditor's security inter-

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est in the property without regard to his right to immediate possession on default. Second, § 552(b), which makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfy the secured creditor's claim ahead of the claims of unsecured creditors, is inconsistent with petitioner's interpretation of § 362(d)(1), under which the undersecured creditor who lacks such a perfected security interest in effect could achieve the same result by demanding the "use value" of his collateral. Third, petitioner's interpretation of § 362(d)(1) makes a practical nullity of § 362(d)(2), which on petitioner's theory would be of use only to a secured creditor who was fully protected both as to the value of, and interest on, its collateral, but nonetheless wanted to foreclose. Petitioner's contention that undersecured creditors will face inordinate and extortionate delay if they are denied compensation under § 362(d)(1) is also belied by § 362(d)(2), which requires relief from the stay unless the *debtor* establishes a reasonable possibility of a successful reorganization within a reasonable time, and under which numerous cases have provided relief within less than a year from the filing of the bankruptcy petition. Pp. 370-376.

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(b) Denying petitioner compensation under § 362(d)(1) is not inconsistent with § 361(3)'s use of the phrase "indubitable equivalent." Although the same phrase appears in § 1129(b), under which section, as a condition for confirmation of a reorganization plan, a secured claimant has a right to receive the present value of his collateral (including interest if the claim is to be paid over time), the source of the right in § 1129 is not the "indubitable equivalent" language but the provision guaranteeing payments of a value, "*as of the effective date of the plan,*" equal to the value of the collateral. Similarly, petitioner's contention that, since general administrative expenses do not have priority over secured claims, see §§ 506(c), 507(a), the Code embodies a principle prohibiting secured creditors from bearing any of the costs of reorganization, is without merit. Congress could not have intended that its readoption of the pre-Code administrative expenses rule would work a change in the also readopted pre-Code rule denying undersecured creditors post-petition interest. Finally, although failure to interpret § 362(d)(1) to require compensation for undersecured creditors appears inconsistent with § 726(a)(5), which allows postpetition interest on unsecured claims when the debtor proves solvent, this anomaly pertains to such a rare occurrence that it is likely the product of congressional inadvertence, and, in any case, its inequitable effects are entirely avoidable. Pp. 377-379.

(c) General statements in the legislative history of §§ 361 and 362(d)(1) that "[s]ecured creditors should not be deprived of the benefit of their bargain" are inadequate to overcome the plain textual indication in

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§§ 506 and 362(d)(2) of Congress' intent, as discussed above. It is most improbable that Congress would have made a major change entitling undersecured creditors to postpetition interest without specifically mentioning it in the legislative history. Petitioner's argument that pre-Code Chapter XI gave undersecured creditors the absolute right to foreclose, and that the silence of the Code's legislative history as to the withdrawal of that right indicates a congressional intent to provide interest on the collateral during the stay as a substitute, is flawed. The authorities are far from clear that there was a distinctive Chapter XI rule of absolute entitlement to foreclose, but, even assuming there was, § 362(d)(2) indicates that, in enacting Chapter 11 of the current Code, Congress adopted the approach of pre-Code Chapters X and XII, under which the undersecured creditor did not have such an absolute right. Pp. 379-382.

808 F.2d 363, affirmed.

H. Miles Cohn, Houston, Tex., for petitioner.

Leonard H. Simon, Daphne Levey, Timothy J. Henderson, Houston, Tex., for respondent.

Justice SCALIA delivered the opinion of the Court.

Petitioner United Savings Association of Texas seeks review of an en banc decision of the United States Court of Appeals for the Fifth Circuit, holding that petitioner was not entitled to receive from respondent debtor, which is under-

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going reorganization in bankruptcy, monthly payments for the use value of the loan collateral which the bankruptcy stay prevented it from possessing. *In re Timbers of Inwood Forest Associates, Ltd.*, 808 F.2d 363 (1987). We granted certiorari, 481 U.S. 1068, 107 S.Ct. 2459, 95 L.Ed.2d 868 (1987), to resolve a conflict in the Courts of Appeals regarding application of §§ 361 and 362(d)(1) of the Bankruptcy Code, 11 U.S.C. §§ 361 and 362(d)(1) (1982 ed. and Supp. IV). Compare *Grundy Nat. Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1440-1441 (CA4 1985); *In re American Mariner Industries, Inc.*, 734 F.2d 426, 432-435 (CA9 1984); see also *In re Briggs Transp. Co.*, 780 F.2d 1339, 1348-1351 (CA8 1985).

I

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On June 29, 1982, respondent Timbers of Inwood Forest Associates, Ltd., executed a note in the principal amount of $4,100,000. Petitioner is the holder of the note as well as of a security interest created the same day in an apartment project owned by respondent in Houston, Texas. The security interest included an assignment of rents from the project. On March 4, 1985, respondent filed a voluntary petition under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (1982 ed. and Supp. IV), in the United States Bankruptcy Court for the Southern District of Texas.

On March 18, 1985, petitioner moved for relief from the automatic stay of enforcement of liens triggered by the petition, see 11 U.S.C. § 362(a), on the ground that there was lack of "adequate protection" of its interest within the meaning of 11 U.S.C. § 362(d)(1). At a hearing before the Bankruptcy Court, it was established that respondent owed petitioner $4,366,388.77, and evidence was presented that the value of the collateral was somewhere between $2,650,000 and $4,250,000. The collateral was appreciating in value, but only very slightly. It was therefore undisputed that petitioner was an undersecured creditor. Respondent had agreed to pay petitioner the postpetition rents from the

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apartment project (covered by the after-acquired property clause in the security agreement), minus operating expenses. Petitioner contended, however, that it was entitled to additional compensation. The Bankruptcy Court agreed and on April 19, 1985, it conditioned continuance of the stay on monthly payments by respondent, at the market rate of 12% per annum, on the estimated amount realizable on foreclosure, $4,250,000—commencing six months after the filing of the bankruptcy petition, to reflect the normal foreclosure delays. *In re Bear Creek Ministorage, Inc.,* 49 B.R. 454 (1985) (editorial revision of earlier decision). The court held that the postpetition rents could be applied to these payments. See *id.,* at 460. Respondent appealed to the District Court and petitioner cross-appealed on the amount of the adequate protection payments. The District Court affirmed but the Fifth Circuit en banc reversed.

We granted certiorari to determine whether undersecured creditors are entitled to compensation under 11 U.S.C. § 362(d)(1) for the delay caused by the automatic stay in foreclosing on their collateral.

II

When a bankruptcy petition is filed, § 362(a) of the Bankruptcy Code provides an automatic stay of, among other things, actions taken to realize the value of collateral given by the debtor. The provision of the Code central to the decision of this case is § 362(d), which reads as follows:

"On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

"(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

"(2) with respect to a stay of an act against property under subsection (a) of this section, if—

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"(A) the debtor does not have an equity in such property; and

"(B) such property is not necessary to an effective reorganization."

The phrase "adequate protection" in paragraph (1) of the foregoing provision is given further content by § 361 of the Code, which reads in relevant part as follows:

"When adequate protection is required under section 362 . . . of this title of an interest of an entity in property, such adequate protection may be provided by—

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"(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title . . . results in a decrease in the value of such entity's interest in such property;

"(2) providing to such entity an additional or replacement lien to the extent that such stay . . . results in a decrease in the value of such entity's interest in such property; or

"(3) granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."

It is common ground that the "interest in property" referred to by § 362(d)(1) includes the right of a secured creditor to have the security applied in payment of the debt upon completion of the reorganization; and that that interest is not adequately protected if the security is depreciating during the term of the stay. Thus, it is agreed that if the apartment project in this case had been declining in value petitioner would have been entitled, under § 362(d)(1), to cash payments or additional security in the amount of the decline, as § 361 describes. The crux of the present dispute is that petitioner asserts, and respondent denies, that the phrase "interest in property" also includes the secured party's right (suspended by the stay) to take immediate possession of the defaulted

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security, and apply it in payment of the debt. If that right is embraced by the term, it is obviously not adequately protected unless the secured party is reimbursed for the use of the proceeds he is deprived of during the term of the stay.

The term "interest in property" certainly summons up such concepts as "fee ownership," "life estate," "co-ownership," and "security interest" more readily than it does the notion of "right to immediate foreclosure." Nonetheless, viewed in the isolated context of § 362(d)(1), the phrase could reasonably be given the meaning petitioner asserts. Statutory construction, however, is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, see, *e.g., Sorenson v. Secretary of Treasury*, 475 U.S. 851, 860, 106 S.Ct. 1600, 1606, 89 L.Ed.2d 855 (1986), or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law, see, *e.g., Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 54, 107 S.Ct. 1549, 1556, 95 L.Ed.2d 39 (1987); *Weinberger v. Hynson, Westcott & Dunning, Inc.*, 412 U.S. 609, 631-632, 93 S.Ct. 2469, 2484, 37 L.Ed.2d 207 (1973); *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307-308, 81 S.Ct. 1579, 1582-83, 6 L.Ed.2d 859 (1961). That is the case here. Section 362(d)(1) is only one of a series of provisions in the Bankruptcy Code dealing with the rights of secured creditors. The language in those other provisions, and the substantive dispositions that they effect, persuade us that the "interest in property" protected by § 362(d)(1) does not include a secured party's right to immediate foreclosure.

Section 506 of the Code defines the amount of the secured creditor's allowed secured claim and the conditions of his receiving postpetition interest. In relevant part it reads as follows:

"(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and

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is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. . . .

"(b) To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable

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fees, costs, or charges provided for under the agreement under which such claim arose."

In subsection (a) of this provision the creditor's "interest in property" obviously means his security interest without taking account of his right to immediate possession of the collateral on default. If the latter were included, the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended. The phrase "value of such creditor's interest" in § 506(a) means "the value of the collateral." H.R.Rep. No. 95-595, pp. 181, 356 (1977); see also S.Rep. No. 95-989, p. 68 (1978), U.S. Code Cong. & Admin. News 1978, pp. 5787, 5854, 6141, 6312. We think the phrase "value of such entity's interest" in § 361(1) and (2), when applied to secured creditors, means the same.

Even more important for our purposes than § 506's use of terminology is its substantive effect of denying undersecured creditors postpetition interest on their claims—just as it denies *over* secured creditors postpetition interest to the extent that such interest, when added to the principal amount of the claim, will exceed the value of the collateral. Section 506(b) provides that "*[t]o the extent that* an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim." (Emphasis added.) Since this provision permits postpetition interest to be paid only out of the "security cushion," the undersecured creditor,

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who has no such cushion, falls within the general rule disallowing postpetition interest. See 11 U.S.C. § 502(b)(2). If the Code had meant to give the undersecured creditor, who is thus denied interest on his *claim,* interest on the value of his *collateral,* surely this is where that disposition would have been set forth, and not obscured within the "adequate protection" provision of § 362(d)(1). Instead of the intricate phraseology set forth above, § 506(b) would simply have said that the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser." Petitioner's interpretation of § 362(d)(1) must be regarded as contradicting the carefully drawn disposition of § 506(b).

Petitioner seeks to avoid this conclusion by characterizing § 506(b) as merely an alternative method for compensating oversecured creditors, which does not imply that no compensation is available to undersecured creditors. This theory of duplicate protection for oversecured creditors is implausible even in the abstract, but even more so in light of the historical principles of bankruptcy law. Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors. "To allow a secured creditor interest where his security was worth less than the value of his debt was thought to be inequitable to unsecured creditors." *Vanston Bondholders Protective Committee v. Green,* 329 U.S. 156, 164, 67 S.Ct. 237, 240, 91 L.Ed. 162 (1946). It was considered unfair to allow an undersecured creditor to recover interest from the estate's unencumbered assets before unsecured creditors had recovered any principal. See *id.,* at 164, 166, 67 S.Ct. at 240, 241; *Ticonic Nat. Bank v. Sprague,* 303 U.S. 406, 412, 58 S.Ct. 612, 615, 82 L.Ed. 926 (1938). We think it unlikely that § 506(b) codified the pre-Code rule with the intent, not of achieving the principal purpose and function of that rule, but of providing over-secured creditors an alternative method of compensation.

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Moreover, it is incomprehensible why Congress would want to favor undersecured creditors with interest if they move for it under § 362(d)(1) at the inception of the reorganization process—thereby probably pushing the estate into

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liquidation—but not if they forbear and seek it only at the completion of the reorganization.

Second, petitioner's interpretation of § 362(d)(1) is structurally inconsistent with 11 U.S.C. § 552. Section 552(a) states the general rule that a prepetition security interest does not reach property acquired by the estate or debtor postpetition. Section 552(b) sets forth an exception, allowing postpetition "proceeds, product, offspring, rents, or profits" of the collateral to be covered only if the security agreement expressly provides for an interest in such property, and the interest has been perfected under "applicable nonbankruptcy law." See, *e.g., In re Casbeer,* 793 F.2d 1436, 1442-1444 (CA5 1986); *In re Johnson,* 62 B.R. 24, 28-30 (CA9 Bkrtcy.App. Panel 1986); cf. *Butner v. United States,* 440 U.S. 48, 54-56, 99 S.Ct. 914, 917-18, 59 L.Ed.2d 136 (1979) (same rule under former Bankruptcy Act). Section 552(b) therefore makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors. Under petitioner's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under § 362. It is true that § 506(b) gives the *over* secured creditor, despite lack of compliance with the conditions of § 552, a similar priority over unsecured creditors; but that does not compromise the principle of § 552, since the interest payments come only out of the "cushion" in which the oversecured creditor *does have* a perfected security interest.

Third, petitioner's interpretation of § 362(d)(1) makes nonsense of § 362(d)(2). On petitioner's theory, the undersecured creditor's inability to take immediate possession of

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his collateral is always "cause" for conditioning the stay (upon the payment of market rate interest) under § 362(d)(1), since there is, within the meaning of that paragraph, "lack of adequate protection of an interest in property." But § 362(d)(2) expressly provides a different standard for relief from a stay "of an act against property," which of course includes taking possession of collateral. It provides that the court shall grant relief "if . . . (A) the debtor does not have an equity in such property [*i.e.,* the creditor is undersecured]; *and* (B) such property is not necessary to an effective reorganization." (Emphasis added.) By applying the "adequate protection of an interest in property" provision of § 362(d)(1) to the alleged "interest" in the earning power of collateral, petitioner creates the strange consequence that § 362 entitles the secured creditor to relief from the stay (1) if he is undersecured (and thus not eligible for interest under § 506(b)), *or* (2) if he is undersecured *and* his collateral "is not necessary to an effective reorganization." This renders § 362(d)(2) a practical nullity and a theoretical absurdity. If § 362(d)(1) is interpreted in this fashion, an undersecured creditor would seek relief under § 362(d)(2) only if his collateral was not depreciating (or he was being compensated for depreciation) and it was receiving market rate interest on his collateral, but nonetheless wanted to foreclose. Petitioner offers no reason why Congress would want to provide relief for such an obstreperous and thoroughly unharmed creditor.

Section 362(d)(2) also belies petitioner's contention that undersecured creditors will face inordinate and extortionate delay if they are denied compensation for interest lost during the stay as part of "adequate protection" under § 362(d)(1). Once the movant under § 362(d)(2) establishes that he is an undersecured creditor, it is the burden of the *debtor* to establish that the collateral at issue is "necessary to an effective reorganization." See § 362(g). 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

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that the property is essential for an effective reorganization *that is in prospect.* This means, as

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many lower courts, including the en banc court in this case, have properly said, that there must be "a reasonable possibility of a successful reorganization within a reasonable time." 808 F.2d, at 370-371, and nn. 12-13, and cases cited therein. The cases are numerous in which § 362(d)(2) relief has been provided within less than a year from the filing of the bankruptcy petition.[1] And while the bankruptcy courts demand less detailed showings during the four months in which the debtor is given the exclusive right to put together a plan, see 11 U.S.C. §§ 1121(b), (c)(2), even within that period lack of any realistic prospect of effective reorganization will require § 362(d)(2) relief.[2]

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III

A.

Petitioner contends that denying it compensation under § 362(d)(1) is inconsistent with sections of the Code other than those just discussed. Petitioner principally relies on the phrase "indubitable equivalent" in § 361(3), which also appears in 11 U.S.C. § 1129(b)(2)(A)(iii). Petitioner contends that in the latter context, which sets forth the standards for confirming a reorganization plan, the phrase has developed a well-settled meaning connoting the right of a secured creditor to receive present value of his security—thus requiring interest if the claim is to be paid over time. It is true that under § 1129(b) a secured claimant has a right to receive under a plan the present value of his collateral. This entitlement arises, however, not from the phrase "indubitable equivalent" in § 1129(b)(2)(A)(iii), but from the provision of § 1129(b)(2)(A)(i)(II) that guarantees the secured creditor "deferred cash payments . . . of a value, *as of the effective date of the plan,* of at least the value of such [secured claimant's] interest in the estate's interest in such property." (Emphasis added.) Under this formulation, even though the undersecured creditor's "interest" is regarded (properly) as solely the value of the collateral, he must be rendered payments that assure him that value *as of the effective date of the plan.* In § 361(3), by contrast, the relief pending the stay need only be such "*as will result in the realization* . . . of the indubitable equivalent" of the collateral. (Emphasis added.) It is obvious (since §§ 361 and 362(d)(1) do not entitle the secured creditor to immediate payment of the principal of his collateral) that this "realization" is to "result" not at once, but only upon completion of the reorganization. It is *then* that he must be assured "realization . . . of the indubitable equivalent" of his collateral. To put the point differently: similarity of outcome between § 361(3) and § 1129 would be demanded only if the former read "such other relief . . . as

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will give such entity, *as of the date of the relief,* the indubitable equivalent of such entity's interest in such property."

Nor is there merit in petitioner's suggestion that "indubitable equivalent" in § 361(3) connotes reimbursement for the use value of collateral because the phrase is derived from *In re Murel Holding Corp.,* 75 F.2d 941 (CA2 1935), where it bore that meaning. *Murel* involved a proposed reorganization plan that gave the secured creditor interest on his collateral for 10 years, with full payment of the secured principal due at the end of that term; the plan made no provision, however, for amortization of principal or maintenance of the collateral's value during the term. In rejecting the plan, *Murel* used the words "indubitable equivalence" with specific reference not to interest (which was assured), but to the jeopardized principal of the loan:

"Interest is indeed the common measure of the difference [between payment now and payment 10 years hence], but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence." *Id.,* at 942.

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Of course *Murel,* like § 1129, proceeds from the premise that in the confirmation context the secured creditor is entitled to present value. But no more from *Murel* than from § 1129 can it be inferred that a similar requirement exists as of the time of the bankruptcy stay. The reorganized debtor is supposed to stand on his own two feet. The debtor in process of reorganization, by contrast, is given many temporary protections against the normal operation of the law.

Petitioner also contends that the Code embodies a principle that secured creditors do not bear the costs of reorganization. It derives this from the rule that general administrative expenses do not have priority over secured claims. See §§ 506(c), 507(a). But the general principle does not follow

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from the particular rule. That secured creditors do not bear one kind of reorganization cost hardly means that they bear none of them. The Code rule on administrative expenses merely continues pre-Code law. But it was also pre-Code law that undersecured creditors were not entitled to postpetition interest as compensation for the delay of reorganization. See *supra,* at 737; see also *infra,* at 381. Congress could hardly have understood that the readoption of the rule on administrative expenses would work a change in the rule on postpetition interest, which it also readopted.

Finally, petitioner contends that failure to interpret § 362(d)(1) to require compensation of undersecured creditors for delay will create an inconsistency in the Code in the (admittedly rare) case when the debtor proves solvent. When that occurs, 11 U.S.C. § 726(a)(5) provides that postpetition interest is allowed on unsecured claims. Petitioner contends it would be absurd to allow postpetition interest on unsecured claims but not on the secured portion of undersecured creditors' claims. It would be disingenuous to deny that this is an apparent anomaly, but it will occur so rarely that it is more likely the product of inadvertence than are the blatant inconsistencies petitioner's interpretation would produce. Its inequitable effects, moreover, are entirely avoidable, since an undersecured creditor is entitled to "surrender or waive his security and prove his entire claim as an unsecured one." *United States Nat. Bank v. Chase Nat. Bank,* 331 U.S. 28, 34, 67 S.Ct. 1041, 1044, 91 L.Ed. 1320 (1947). Section 726(a)(5) therefore requires no more than that undersecured creditors receive postpetition interest from a solvent debtor on equal terms with unsecured creditors rather than ahead of them which, where the debtor is solvent, involves no hardship.

B

Petitioner contends that its interpretation is supported by the legislative history of §§ 361 and 362(d)(1), relying almost entirely on statements that "[s]ecured creditors should not

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be deprived of the benefit of their bargain." H.R.Rep. No. 95-595, at 339; S.Rep. No. 95-989, at 53, U.S. Code Cong. & Admin. News 1978, pp. 5839, 6295. Such generalizations are inadequate to overcome the plain textual indication in §§ 506 and 362(d)(2) of the Code that Congress did not wish the undersecured creditor to receive interest on his collateral during the term of the stay. If it is at all relevant, the legislative history tends to subvert rather than support petitioner's thesis, since it contains not a hint that § 362(d)(1) entitles the undersecured creditor to postpetition interest. Such a major change in the existing rules would not likely have been made without specific provision in the text of the statute, cf. *Kelly v. Robinson,* 479 U.S. 36, 47, 107 S.Ct. 353, 359-360, 93 L.Ed.2d 216 (1986); it is most improbable that it would have been made without even any mention in the legislative history.

Petitioner makes another argument based upon what the legislative history does *not* contain. It contends that the pre-Code law gave the undersecured creditor relief from the automatic stay by permitting him to foreclose; and that Congress would not have withdrawn this

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entitlement to relief without any indication of intent to do so in the legislative history, unless it was providing an adequate substitute, to wit, interest on the collateral during the stay.

The premise of this argument is flawed. As petitioner itself concedes, Brief for Petitioner 20, the undersecured creditor had no absolute entitlement to foreclosure in a Chapter X or XII case; he could not foreclose if there was a reasonable prospect for a successful rehabilitation within a reasonable time. See, *e.g., In re Yale Express System, Inc.,* 384 F.2d 990, 991-992 (CA2 1967) (Chapter X); *In re Nevada Towers Associates,* 14 Collier Bankr. Cas. (MB) 146, 151-156 (Bkrtcy.Ct.SDNY 1977) (Chapter XII); *In re Consolidated Motor Inns,* 6 Collier Bankr. Cas. (MB) 18, 31-32 (Bkrtcy.Ct.ND Ga.1975) (same). Thus, even assuming petitioner is correct that the undersecured creditor had an absolute entitlement to relief under Chapter XI, Congress would have been faced with the choice between adopting the rule from

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Chapters X and XII or the asserted alternative rule from Chapter XI, because Chapter 11 of the current Code "replaces chapters X, XI and XII of the Bankruptcy Act" with a "single chapter for all business reorganizations." S.Rep. No. 95-989, at 9; see also H.R.Rep. No. 95-595, at 223-224, U.S. Code Cong. & Admin. News 1978, pp. 5795, 6182, 6183. We think § 362(d)(2) indicates that Congress adopted the approach of Chapters X and XII. In any event, as far as the silence of the legislative history on the point is concerned, that would be no more strange with respect to alteration of the asserted Chapter XI rule than it would be with respect to alteration of the Chapters X and XII rule.

Petitioner's argument is further weakened by the fact that it is far from clear that there was a distinctive Chapter XI rule of absolute entitlement to foreclosure. At least one leading commentator concluded that "a Chapter XI court's power to stay lien enforcement is as broad as that of a Chapter X or XII court and that the automatic stay rules properly make no distinctions between the Chapters." Countryman, Real Estate Liens in Business Rehabilitation Cases, 50 Am.Bankr.L.J. 303, 315 (1976). Petitioner cites dicta in some Chapter XI cases suggesting that the undersecured creditor was automatically entitled to relief from the stay, but the courts in those cases uniformly found in addition that reorganization was not sufficiently likely or was being unduly delayed. See, *e.g., In re Bric of America, Inc.,* 4 Collier Bankr. Cas. (MB) 34, 39-40 (Bkrtcy.Ct.MD Fla.1975); *In re O.K. Motels,* 1 Collier Bankr. Cas. (MB) 416, 419-420 (Bkrtcy.Ct.MD Fla.1974). Moreover, other Chapter XI cases held undersecured creditors not entitled to foreclosure under reasoning very similar to that used in Chapters X and XII cases. See *In re Coolspring Estates, Inc.,* 12 Collier Bankr. Cas. (MB) 55, 60-61 (Bkrtcy.Ct.ND Ind.1977); *In re The Royal Scot, Ltd.,* 2 Bankr.Ct. Dec. (CRR) 374, 376-377 (Bkrtcy.Ct.WD Mich.1976); *In re Mesker Steel, Inc.,* 1 Bankr.Ct. Dec. (CRR) 235, 236-237 (Bkrtcy.Ct.SD Ind.1974). The at best divided authority under Chapter XI re-

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moves all cause for wonder that the alleged departure from it should not have been commented upon in the legislative history.

The Fifth Circuit correctly held that the undersecured petitioner is not entitled to interest on its collateral during the stay to assure adequate protection under 11 U.S.C. § 362(d)(1). Petitioner has never sought relief from the stay under § 362(d)(2) or on any ground other than lack of adequate protection. Accordingly, the judgment of the Fifth Circuit is

Affirmed.

1. See, *e.g., In re Findley,* 76 B.R. 547, 555 (Bkrtcy.Ct.N.D.Miss.1987) (61/2 months); *In re Efcor, Inc.,* 74 B.R. 837, 843-845 (Bkrtcy.Ct.M.D.Pa.1987) (41/2 months); *In re Belton Inns, Inc.,* 71 B.R. 811, 818 (Bkrtcy.Ct.SD Iowa 1987) (1 year); *In re Louden,* 69 B.R. 723,

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725-726 (Bkrtcy.Ct.ED Mo.1987) (10 months); *In re Playa Development Corp.*, 68 B.R. 549, 556 (Bkrtcy.Ct.WD Tex.1986) (71/2 months); *In re Cablehouse, Ltd.*, 68 B.R. 309, 313 (Bkrtcy.Ct.SD Ohio 1986) (111/2 months); *In re Pacific Tuna Corp.*, 48 B.R. 74, 78 (Bkrtcy.Ct.WD Tex.1985) (9 months); *In re Development, Inc.*, 36 B.R. 998, 1005-1006 (Bkrtcy.Ct.Haw.1984) (6 months); *In re Boca Development Associates, Ltd.*, 21 B.R. 624, 630 (Bkrtcy.Ct.SDNY 1982) (71/2 months); *In re Sundale Associates*, 11 B.R. 978, 980-981 (Bkrtcy.Ct.SD Fla.1981) (5 months); *In re Clark Technical Associates, Ltd.*, 9 B.R. 738, 740-741 (Bkrtcy.Ct.Conn.1981) (9 months).

2. See, *e.g.*, *In re Anderson Oaks (Phase I) Limited Partnership*, 77 B.R. 108, 109, 110-113 (Bkrtcy.Ct.WD Tex.1987) ("immediately after the bankruptcy filings"); *In re New American Food Concepts, Inc.*, 70 B.R. 254, 262 (Bkrtcy.Ct.ND Ohio 1987) (3 months); *In re 6200 Ridge, Inc.*, 69 B.R. 837, 843-844 (Bkrtcy.Ct.ED Pa.1987) (3 months); *In re Park Timbers, Inc.*, 58 B.R. 647, 651 (Bkrtcy.Ct.Del.1985) (2 months); *In re Bellina's Restaurants II, Inc.*, 52 B.R. 509, 512 (Bkrtcy.Ct.SD Fla.1985) (1 month); *In re Anchorage Boat Sales, Inc.*, 4 B.R. 635, 641 (Bkrtcy.Ct. EDNY 1980) (4 months); *In re Terra Mar Associates*, 3 B.R. 462, 466 (Bkrtcy.Ct.Conn.1980) (2 months).

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NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

OFFICE OF THE UNITED STATES TRUSTEE *v.* JOHN Q. HAMMONS FALL 2006, LLC, ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 22–1238. Argued January 9, 2024—Decided June 14, 2024

Two Terms ago, in *Siegel* v. *Fitzgerald*, 596 U. S. 464, the Court held that a statute violated the Bankruptcy Clause's uniformity requirement because it permitted different fees for Chapter 11 debtors depending on the district where their case was filed. In this case, the Court is asked to determine the appropriate remedy for that constitutional violation. As noted in *Siegel*, there are three options: (1) refund fees for the thousands of debtors charged higher fees in districts administered by the U. S. Trustee Program, (2) retroactively extract higher fees from the small number of debtors charged lower fees in districts administered by the Bankruptcy Administrator Program, or (3) require only prospective fee parity. See *id.*, at 480.

As in *Siegel*, this case arises from a case filed in a U. S. Trustee district. In 2016, 76 legal entities filed for Chapter 11 bankruptcy in the District of Kansas. In 2018, under the amended fee statute the Court later found unconstitutional in *Siegel*, the debtors began paying higher fees than they would have if their case had been filed in a Bankruptcy Administrator district. In 2020, the debtors challenged the constitutionality of those fees. The Bankruptcy Court found no constitutional violation, but the Tenth Circuit, anticipating *Siegel*, reversed. To remedy the constitutional violation, the Tenth Circuit ordered a refund of the debtors' quarterly fees to the extent they exceeded the lower fees paid in the Bankruptcy Administrator districts. This Court vacated that judgment and remanded the case in light of *Siegel*, and the Tenth Circuit reinstated its original opinion without alteration.

Held: Prospective parity is the appropriate remedy for the short-lived and small disparity created by the fee statute held unconstitutional in *Siegel*. Pp. 5–16.

(a) Across remedial contexts, "the nature of the violation determines the scope of the remedy." *Swann* v. *Charlotte-Mecklenburg Bd. of Ed.*, 402 U. S. 1, 16. Three aspects of the Court's holding in *Siegel* are relevant here. First, the violation identified was nonuniformity, not high fees. Second, the fee disparity was short lived, lasting only from 2018 to 2021. Third, the disparity was small: 98% of the relevant class of debtors still paid uniform fees. Pp. 5–7.

(b) To determine the appropriate remedy for this short-lived and small disparity, the Court asks "what the legislature would have willed had it been apprised of the constitutional infirmity." *Sessions* v. *Morales-Santana*, 582 U. S. 47, 74. In cases involving unequal treatment, the Court focuses on two considerations: Congress's "intensity of commitment" to the more broadly applicable rule, and "the degree of potential disruption to the statutory scheme that would occur" if the Court were to extend the exception. *Id.,* at 75. Here, faced with the short-lived and small fee disparity created by the constitutional violation identified in *Siegel,* Congress would have wanted prospective parity, not a refund or retrospective raising of fees.

To start, Congress has demonstrated intense commitment to the more broadly applicable rule, higher fees in U. S. Trustee districts. That commitment stems from Congress's desire for the U. S. Trustee program to "be funded in its entirety by user fees." *Siegel,* 596 U. S., at 469. In light of this desire, it is not surprising that, in the 2017 fee statute at issue in *Siegel,* Congress chose to address a funding shortfall for the U. S. Trustee program by raising fees on the largest Chapter 11 debtors. In 2021, when Congress amended the fee statute to require uniform fees, it kept fees at an elevated level "to further the long-standing goal of Congress of ensuring that the bankruptcy system is self-funded." §2(b), 134 Stat. 5086.

Now consider the disruption that would follow from extending the exception, lower fees in Bankruptcy Administrator districts. Retrospectively lowering fees for all relevant debtors in U. S. Trustee districts would cost approximately $326 million. Thus, in mandating a refund, this Court would transform a program Congress designed to be self-funding into an enormous bill for taxpayers. On top of that, respondents' proposed refund would almost certainly exacerbate the existing fee disparity.

The only remaining question, then, is whether Congress would have wanted to retrospectively impose higher fees on debtors in Bankruptcy Administrator districts. The best evidence that Congress would not want such a remedy is that Congress itself chose not to pursue that course when amending the fee statute in 2021. Congress's choice makes sense. Retrospectively raising fees in Bankruptcy Administrator districts would do nothing to achieve Congress's goal of keeping the

U. S. Trustee program self-funding. What is more, there are serious practical challenges to a retrospective imposition of higher fees, including the logistical problems with locating all the former debtors or their successors who would owe the higher fees. Pp. 7–14.

(c) Relying on a series of cases involving unconstitutional state taxes, respondents and the dissent claim that due process requires overriding Congress's clear intent. See, *e.g., McKesson Corp.* v. *Division of Alcoholic Beverages and Tobacco, Fla. Dept. of Business Regulation*, 496 U. S. 18; *Harper* v. *Virginia Dept. of Taxation*, 509 U. S. 86. These cases, respondents contend, stand for the proposition that unless an "exclusive" predeprivation remedy is both "clear and certain," *Newsweek, Inc.* v. *Florida Dept. of Revenue*, 522 U. S. 442, 443–444 (*per curiam*), due process requires "meaningful backward-looking relief," *McKesson*, 496 U. S., at 31. And, they claim, the predeprivation remedy here was neither exclusive nor clear and certain.

The tax cases, assuming that they are even applicable here, do not entitle respondents to relief. In those cases, the Court held that the existence of a predeprivation hearing would be enough to satisfy the Due Process Clause. See *Harper*, 509 U. S., at 101. Respondents acknowledge that they had the opportunity to challenge their fees before they paid them, so due process is satisfied. Respondents misread this Court's later decisions on bait-and-switch schemes as displacing that basic holding. To be sure, due process may sometimes constrain the Court's remedial options. In this case, though, due process does not mandate any particular remedy. Thus, as the tax cases themselves advise, the Court must "implement what the legislature would have willed." *Levin* v. *Commerce Energy, Inc.*, 560 U. S. 413, 427. Pp. 13–16.

15 F. 4th 1011, reversed and remanded.

JACKSON, J., delivered the opinion of the Court, in which ROBERTS, C. J., and ALITO, SOTOMAYOR, KAGAN, and KAVANAUGH, JJ., joined. GORSUCH, J., filed a dissenting opinion, in which THOMAS and BARRETT, JJ., joined.

NOTICE: This opinion is subject to formal revision before publication in the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D. C. 20543, pio@supremecourt.gov, of any typographical or other formal errors.

SUPREME COURT OF THE UNITED STATES

No. 22–1238

OFFICE OF THE UNITED STATES TRUSTEE, PETITIONER *v.* JOHN Q. HAMMONS FALL 2006, LLC, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

[June 14, 2024]

JUSTICE JACKSON delivered the opinion of the Court.

Two Terms ago, in *Siegel* v. *Fitzgerald*, 596 U. S. 464 (2022), we held that a statute violated the Bankruptcy Clause's uniformity requirement because it permitted different fees for Chapter 11 debtors depending on the district where their case was filed. See *id.*, at 479–480, and n. 2. Today, we are asked to determine the remedy for that constitutional violation. We agree with the Government that the appropriate remedy is prospective parity. Requiring equal fees for otherwise identical Chapter 11 debtors going forward comports with congressional intent, corrects the constitutional wrong, and complies with due process.

Resisting this conclusion, respondents, a group of Chapter 11 debtors, argue that they are entitled to a refund. But, as respondents forthrightly concede, adopting their preferred remedy would require us to undercut congressional intent and transform, by judicial fiat, a program that Congress designed to be self-funding into an estimated $326 million bill for taxpayers. Neither remedial principles nor due process requires that incongruous result. We reverse.

BANKRUPTCY

IN A NUTSHELL®

TENTH EDITION

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PART I

WHAT YOU NEED TO KNOW ABOUT CREDITORS RIGHTS LAWS OTHER THAN BANKRUPTCY

The nonbankruptcy part of debtor-creditor law is primarily state statutes governing judicial collection law. Much of this state law is codification of early English common law doctrine.

To a large extent, the states' laws share a common design. They agree on the kind of rights available to individual debtors and the kinds of remedies available to creditors, but they disagree widely on the details.

This book focuses on the general design of rights and remedies that are common throughout the country and considers some of the significant state collection law questions that arise throughout the country. That is what you need to know for law school. When, later in practice, you encounter these questions, you will find that each state has one or more "how to" texts for lawyers that fill in the needed details.

CHAPTER II

AN OVERVIEW OF JUDICIAL COLLECTION LAW

A. WHAT CAN CREDITORS DO OUTSIDE OF BANKRUPTCY?

Creditors are generally happy to do nothing. More specifically, creditors are happy to do nothing so long as their debtors are paying them.

When debtors default in paying, creditors will first attempt through "persuasion" to get the debtor to pay "voluntarily." The creditor may even hire a collection agency or attorney to help persuade the debtor. If these nonjudicial collection efforts are unsuccessful, the creditor can resort to the debt collection remedies provided by either (i) creditors' judicial remedies or (ii) the creditor's contract to seize and sell the debtor's assets to satisfy the debt.

1. FORMS OF CREDITORS' JUDICIAL REMEDIES

Let's consider the law of creditors' judicial remedies first. At the broadest level, the law of creditors' judicial remedies involves only three questions: (1) when and how does a creditor gets a lien on property of the debtor, (2) how does a creditor with a lien enforce the lien so as to collect its debt and (3) what is the lien's priority in. relation to third parties' rights to the property, including other creditors' liens and the claims of transferees. These

three issues are common to every kind of creditors' remedy.

Why the focus on "liens"? A creditor cannot seize and sell its debtor's property unless it has some property interest in the debtor's property, and the principal way to obtain such an interest is to obtain a "lien" on that property.

Say for example that *C* claims that *D* owes $1,000. *C* can't simply come over to *D*'s apartment and take *D*'s stuff. *C* needs to establish a legal right to be paid $1,000. *C* needs to establish a legal right to *D's* property. *C* needs to obtain a judgment and an execution lien.

This example illustrates the two most important general rules of the law of creditors' remedies: (1) generally a creditor is not able to obtain a lien in the debtor's property until the creditor reduces its claim to judgment[1] and (2) a creditor enforces this judgment through the appropriate postjudgment judicial process.

You should now be asking the questions why is action beyond a judgment necessary. The answer is that a judgment is no more than another form of debt.

A judgment does, however, differ from the original debt in that a judgment is the State's recognition of

[1] There is a very narrow exception to the general rule that a creditor cannot obtain a judicial lien until it has obtained a judgment. In a narrow group of situations, a creditor can obtain a prejudgment "attachment lien." Because of due process concerns, attachment liens do not often occur in practice (and will not occur on your exam.)

the legitimacy of the creditor's claim against the debtor. Along with this recognition a willingness by the state to use its coercive power to enforce this lien and otherwise collect the amount of the judgment forcibly from the debtor's property (both real and personal) if the judgment debtor does not pay "voluntarily."

a. Judgment Liens

But first the judgment creditor must obtain a lien. A judgment creditor can obtain a lien on the debtor's real property by "docketing" (i.e., recording) the judgment in the real property record system in the county in which the real property is located. Such a lien is called a "judgment lien."

A "judgment lien" is one form of a "judicial lien." A "judicial lien" is a lien obtained through litigation—through the creditor's use of the judicial process. A "judgment lien" is thus a judicial lien on the debtor's real property.

b. Execution Liens

A judicial lien on a debtor's personal property is called an "execution lien." Obtaining an execution lien on a debtor's personal property is a bit more complicated than obtaining a judgment lien on a debtor's real property.

A creditor with a judgment initiates the execution process by applying to the court that rendered the judgment (or sometimes a different court depending on where the debtor's property is located) for a *writ*

of execution, sometimes referred to as a writ of *Fieri Facias* ("FiFa" because lawyers like to use words that most people don't understand). The writ of execution is typically directed to the sheriff of the county where the property is located. The writ orders the sheriff to seize specified property of the debtor located within the county, sell it, and apply the proceeds in satisfaction of the judgment, after payment of the sheriff's costs. The process varies a bit from state to state,[2] but this is the general pattern.

With a judgment lien on real property or execution lien on personal property, an attorney for a judgment creditor can cause state officials to seize and sell a judgment debtor's property that is encumbered by the judicial lien.

c. Garnishment Liens

To reach a debtor's tangible property held by third persons, and to collect from third parties amounts owed the debtor, there is a special proceeding at law in the nature of an adversary suit against the person who holds the debtor's property or who owes the debtor money. This process is called *garnishment*.

Garnishment is in essence a special form of execution designed for reaching property of the debtor held by a third party. The court orders the third party (called the garnishee) to turn over the property, or pay the judgment creditor the amount that the garnishee owed to the debtor.

[2] For example, in a few states a lien against personal property arises simply by a central filing of the judgment.

The most common example of garnishment is garnishment of bank accounts. When a creditor tries to collect its judgment against the debtor from funds in the debtor's bank account, it seeks to obtain property of the debtor held by a third person, in this case the bank. In this context, the proper terminology regarding what occurs when, for example, the IRS tries to seize a bank account of delinquent taxpayer, is that the IRS is garnishing the bank account and the bank is the "garnishee."

In addition to bank accounts, a judgment creditor might also seek to garnish the debtor's wages by bringing a garnishment action against the debtor's employer or the cash surrender value of an insurance policy by garnishing the insurer.

2. CREDITORS' JUDICIAL REMEDIES SHORTCOMINGS

If you understood what you just read (and more especially if you did not understand what you just read), then you will understand why

- Most lawyers do not like to do debt collection work.
- Most creditors do not like to pay for this kind of legal work.
- Most law professors do not like to teach judicial collection law.

Happily, judicial collection law has become less important in practice and less important in law school. There are three reasons for this change:

(1) The most important reason for the diminished role of judicial collection law in practice and in law school is the increased role of bankruptcy in practice and in the classroom. Businesses and individuals are more willing to file for bankruptcy. And, as we will see, the filing of a bankruptcy petition not only bars a creditor from continuing its efforts to collect its debt using judicial collection remedies but also can require a creditor who has successfully collected its debt using judicial collection remedies to return what it has collected.

(2) Obtaining a judgment and getting a sheriff to seize and sell property of a debtor can be difficult, time consuming and expensive.

(3) Obtaining a judgment and getting a sheriff to seize and sell property of a debtor is often unsuccessful as a way of collecting a debt. There is no guarantee that the judgment debtor will have property that can be seized and sold, or that the property will be in the place that the judgment creditor told the sheriff to go look.

And, even if the judgment debtor has property, that property may be encumbered by other creditors' liens that have priority. These other liens may have been created because of (i) a prior judicial collection effort, or (ii) statute, or (iii) agreement.

3. STATUTORY LIENS AND LIENS CREATED BY AGREEMENT

Tax liens, mechanics' liens and landlords' liens are examples of statutory liens. These are liens that arise by operation of law-arise if the debtor fails to pay a debt protected by the statute.

While statutory liens are important, consensual liens are the most common liens. Most debt deals which are large enough to involve lawyers also involve consensual liens.

A big part of bankruptcy practice and a big part of law school bankruptcy courses deals with consensual liens and so a big part of this book deals with consensual liens, For now, you need to understand that: (1) by contract, a creditor can obtain property rights in addition to the rights available to a creditor under generally available state creditors' remedies law; (2) these rights, i.e., these consensual liens, have the effect of limiting the rights of other creditors under creditors' remedies law; and (3) these consensual liens are property rights and so enjoy the constitutional protection afforded to property rights (you know, due process, no takings, and all that Fifth Amendment stuff on your Con Law test). In essence, a creditor with a consensual lien (or any lien for that matter) really has two claims: (1) an *in personam* (or contract) claim against the debtor based on the promise or obligation to pay, and (2) an *in rem* (or property) claim against the collateral.

State law controls the creation and effect of consensual liens. State law tends to categorize the

types of consensual liens by the type of property involved. The two basic types of property in this regard are real property (that is, dirt and things built on and attached to the dirt) and personal property (that is, things that are not dirt or attached to dirt, both tangible (goods) and intangible (like accounts receivable)).

There are various devices for creating consensual liens on real property; i.e., the mortgage, the deed of trust, and the installment land-sale contract. When properly recorded in the local real estate records, these instruments establish the lender's *priority* in the property over other parties, such as other creditors and purchasers, that might claim an interest in the land.

When the creditor and debtor create a consensual lien on personal property or fixtures, the governing law is Uniform Commercial Code, Article 9. All 50 states have adopted Article 9 (yes, *even* Louisiana). Article 9 provides for only one kind of consensual lien on personal property, the "Article 9 security interest."

"Security interest" is Article 9's term for a consensual lien on personal property. Other Article 9 terms that you will encounter in this book are "secured party" and "perfection." A "secured party" under Article 9 is a creditor with a security interest. Perfection refers to action taken by the secured party to establish the priority of its security interest over other parties with an interest in the same property, including creditors with judgment liens. Perfection is usually, but not always, accomplished by filing

what's known as a UCC financing statement in the appropriate state government office.

B. WHAT CAN A DEBTOR DO OUTSIDE OF BANKRUPTCY?

There is not much that debtor can do outside of bankruptcy to fix its debt problems. At least not much that a debtor can do without the help and support of its creditors.

1. EXEMPT PROPERTY

If the debtor is an individual (that is, a flesh and blood human), state and some nonbankruptcy federal laws exempt certain property of the debtor from the collection efforts by judgment creditors. At most, these exemption statutes enable a debtor to protect some of their property, or at least part of the value of their property, from execution by their creditors.

State exemption laws vary significantly from state to state. In most states, the amount of property that a debtor can designate as exempt, and retain free from execution, is very limited—enough to assure only a subsistence level of living for the debtor and her dependents. And, in all states, creditors with a mortgage or other lien on property that is designated as exempt are not covered by exemption law; they are themselves "exempt" from it, and therefore can still seize and sell that property free from the exemption law claim. If, for example, Bank has a mortgage on *D*'s house and *D* defaults, First Bank can seize and sell *D*'s house even if *D* has designated the house as *D*'s exempt homestead.

All exemption statutes do is leave an individual debtor with some property. Exemption statutes do not enable a person with debt problems to "fix" the problems.

2. WORKOUT AGREEMENTS

A debtor can try to work out some sort of debt repayment agreement with its creditors. Professors who teach first year contracts courses call these agreements "compositions" and "extensions." Real lawyers call these agreements "workout agreements." Their creditor clients call these agreements "haircuts" (or worse).

Whatever you call these agreements, they are "agreements" and only bind the creditors who agree. If even one creditor refuses to participate in the workout agreement, that dissenting creditor, can in essence, "blow up" any deal by suing on its debt and using the execution process to seize and sell assets of the debtor that are essential to the debtor's performing its workout obligations to the assenting creditors.

C. WHY BANKRUPTCY?

If you understand the material in this Chapter of the book, then you know the answer to the question "Why bankruptcy."

To summarize:

First, judicial collection law focuses on each individual creditor's collection effort against the

debtor; it is not concerned with the rights of creditors as a group.[3]

Second, judicial collection law is "grab law," meaning that the creditor that reaches the debtor's property first gets all the value of that property, at least until its judgment is satisfied, before later creditors get anything. (If you come from a big family, think about mealtime and you probably get the idea.)

Third, because the race goes to the swiftest, once creditors get the idea that the debtor may be experiencing financial difficulties, the feeding frenzy begins and any hope the debtor might have had of reversing its fortunes are out the door, literally and figuratively.

Fourth, because the judicial collection process calls for the forced sale of the debtor's property at auction, judicial collection law produces notoriously low

[3] There is an infrequently used exception to this statement known as an "assignment for the benefits of creditors" or "ABC." An ABC is a state law, usually statutory, procedure that allows a debtor to voluntarily liquidate its assets in order to pay creditors. Specifically, the debtor will transfer title to all of its nonexempt assets to an assignee that acts as a representative for the debtor's creditors. While creditors will often cooperate with debtor's seeking to use an ABC, there is no way of making them do so. Also, and perhaps most importantly, the debtor cannot obtain a general discharge of debts remaining unpaid after its assets are liquidated and distributed in an ABC, because of the "Impairment of Contracts" clause of the Constitution. In addition to ABC's, there are a variety of both state and federal statutes that call for appointment of a "receiver" under various circumstances, including insolvency of the debtor, to take possession of the debtor's assets with the intent to sell them and disburse the proceeds to creditors according to the priority of their interests. While not unimportant in certain specialized situations, there is not a well-developed body of "receivership law."

values for the debtor's property; *i.e.*, much lower than what would be attained if the property could be sold in an orderly, market transaction.

And so, the rest of the book is about bankruptcy.

PART II

WHAT YOU NEED TO KNOW ABOUT BANKRUPTCY[1]

In general, a law student or practicing lawyer needs to be able to answer four questions about bankruptcy:

(1) How does a bankruptcy case begin?

(2) What happens during a bankruptcy case?

(3) How does a bankruptcy case end?

(4) How can a later bankruptcy affect transactions?

The bankruptcy law answers to these questions turn on the form of bankruptcy involved.

[1] I understand that the title of this part of the book is somewhat misleading. "MORE THAN WHAT YOU NEED TO KNOW ABOUT BANKRUPTCY" is probably more accurate for law students. Many law school profs will not cover all of this stuff.

3 The Nature, Source, and Policies of Bankruptcy Law

§3.1 WHAT IS BANKRUPTCY?

When a debtor becomes bankrupt, the debt collection procedures that are otherwise applicable in the jurisdiction are replaced by a powerful and wide-ranging system of laws and procedures. Bankruptcy has a profound impact on the debtor, creditors, and most other parties that have an interest in the debtor's affairs.

Bankruptcy takes different forms and is flexible enough to provide different goals. It is therefore difficult to devise a general definition of bankruptcy that is both precise and meaningful. However, one can begin to define bankruptcy by identifying some of the distinctive characteristics (expanded upon in the rest of this chapter) that make it so different from collection remedies under state law:

1. Bankruptcy is a remedial system provided for by federal law — more specifically, by Title 11 of the U.S. Code. (From now on, Title 11 is referred to as "the Code." When a Code section is cited, only the section symbol and number are used.)
2. It is a collective proceeding that draws in all the debtor's creditors and, with a few exceptions, encompasses all of the debtor's assets.
3. It is designed to fulfill two functions that are often in tension with each other: It affords relief to the debtor by resolving and settling current debts while at the same time protecting creditors and

guarding their interests. As part of this function, it is aimed at preserving and maximizing the value of the debtor's estate.

4. It is administered by a "system" consisting of specialized courts, government officials, and private persons.

§3.2 THE FEDERAL NATURE OF BANKRUPTCY LAW

§3.2.1 The Federal Power over Bankruptcy

Outside of bankruptcy, the creation, performance, and enforcement of obligations are governed by state law, or in the case of some obligations, by generally applicable federal nonbankruptcy law.[1] (For example, an obligation arising out of contract or tort is enforced in a state court under state law, while an obligation, say, to pay federal tax is enforced in a federal court under the Internal Revenue Code.). However, as soon as bankruptcy relief is sought, federal bankruptcy law is brought into effect. A new regime is established over the debtor's affairs that largely displaces the enforcement mechanisms that would normally be used outside of bankruptcy.

Bankruptcy law is federal because the Constitution grants to Congress the power "[t]o establish . . . uniform laws on the subject of bankruptcies throughout the United States." Art. I, §8. In addition, the supremacy clause states that the laws of the United States made pursuant to the Constitution shall be the supreme law of the land and take precedence over state laws. Art. VI, cl. 2.

Although the records of the Constitutional Convention say very little about the bankruptcy power, contemporaneous writings indicate that a centralized bankruptcy law was regarded as one of the economic reforms essential to a viable union. The frustrating diversity of the debtor/creditor laws of the Confederated States was a barrier to interstate commerce. By establishing a uniform bankruptcy law, the drafters hoped to promote commercial order and efficiency and to lessen the disruptive influence of local interests and rivalries. The need for uniformity and the nationwide enforcement of the bankruptcy remedy remain an important justification of federal bankruptcy power.

1. The term "nonbankruptcy law" is explained in section 3.2.2.

§3.2.2 Bankruptcy Law and Nonbankruptcy Law

The Code uses the rather inelegant term "nonbankruptcy law" to describe the generally prevailing law, both state and federal, that would be applicable to the debtor's property, rights, obligations, and transactions in the absence of bankruptcy. "Nonbankruptcy law" is therefore not a synonym for state law because it also includes federal law other than the Code. However, because state law governs most property, rights, obligations, and transactions that will be handled in the bankruptcy case, it is the predominant component of nonbankruptcy law.

In the absence of bankruptcy, nonbankruptcy law is the only law applicable to the debtor/creditor relationship. When bankruptcy occurs, bankruptcy law interacts with this body of prevailing nonbankruptcy law in a complex and multifaceted way. Under the Supremacy Clause, bankruptcy law preempts state law[2] to the extent that they are inconsistent. However, because bankruptcy law is primarily focused on the treatment of rights that arise under state law, the field of federal preemption is quite narrow: It relates to the way in which rights are handled and enforced, and is not usually concerned with their creation and validity. These questions are generally still resolved under state law, even in the context of bankruptcy. You will therefore see that many matters in a bankruptcy case are resolved by a complex interaction between bankruptcy and nonbankruptcy law. In the discussion of bankruptcy in the following chapters, there will be many examples of the interaction between nonbankruptcy and bankruptcy law. For the present, simply note that bankruptcy brings into effect a whole legal structure that may alter or affirm rights and procedures provided by the underlying network of state common and statute law and federal law. The extent to which nonbankruptcy law is overridden is usually expressed in the particular provisions of the Code. Sometimes, where congressional intent is less clear, questions of statutory interpretation may be presented.

§3.3 UNIFORMITY IN BANKRUPTCY LAW

As stated in section 3.2.1, national uniformity in bankruptcy law is mandated by the Constitution. However, this does not mean that the exact same body of law applies to every bankruptcy case across the nation. The reason for this, as stated above, is that rights in bankruptcy are frequently

2. In addition to preempting inconsistent state law, bankruptcy law may alter the effect of otherwise applicable federal nonbankruptcy law. This is not a matter of preemption. Rather, when provisions of bankruptcy law cannot be reconciled with other federal statutes, the court must interpret congressional intent to decide which is to prevail. See Example 2.

determined with reference to nonbankruptcy law, which consists predominantly of state law. Diversity in state law inevitably produces a different resolution of many identical issues in bankruptcy cases from state to state. However, over a century ago, the U.S. Supreme court made it clear that absolute and literal uniformity is not required. In *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902), the Court established the fundamental principle governing uniformity: The requirement of uniformity is met when "the trustee takes in each state whatever would have been awardable to the creditors if the bankrupt law had not been passed." Therefore, while a uniform bankruptcy law is required, in the sense that the same rules and principles of bankruptcy law must apply nationwide, the impact of applicable local laws on that uniform bankruptcy law does not render the law nonuniform.

Quite apart from variations in nonbankruptcy law, the requirement of uniformity in bankruptcy law must be understood in light of the structure of the federal court system and the operation of judicial precedent. There are many diverse (and sometimes dramatically diverse) judicial interpretations of provisions of the Code. Because the decisions of bankruptcy and district courts do not create binding precedent, and because the courts of one circuit are not bound by decisions in another, it is common to find that sections of the Code are interpreted differently by different courts. The U.S. Supreme Court occasionally resolves divergent interpretations of bankruptcy law, but there are always numerous areas in which there is disagreement on bankruptcy law among the courts of different circuits.

§3.4 THE STATUTORY SOURCE OF BANKRUPTCY LAW

§3.4.1 Federal Bankruptcy Legislation

The current code, 11 U.S.C. §§101 *et seq.*, was enacted as the Bankruptcy Reform Act in 1978, and has been amended several times since then, as detailed below. It is the fifth bankruptcy statute enacted by Congress. The first three were passed at various times in the nineteenth century, but none of them lasted very long, and for much of that century there was no federal bankruptcy law, leaving debtor/creditor relations to be governed only by state law. In 1898, Congress passed the Bankruptcy Act, which turned out to be the first durable bankruptcy statute. It lasted, with much amendment and judicial embellishments, until it was replaced in 1978 by the current Code. By the end of the 1960s, it had become clear that the old Act was outdated and had been patched up too much by amendments, judicial decisions, and procedural rules promulgated by the courts. Congress

therefore appointed a commission in 1970 to study the bankruptcy law and to recommend a new comprehensive statute. The commission's report and proposed statute, released in 1973, drew on the traditions established under the old Act, and preserved many of its rules and principles. However, it also made many significant changes to substantive law and procedure. The report was controversial, leading to much debate and the passage of different bills in each house of Congress. Ultimately, differences were resolved in compromise, and the 1978 Code was enacted. Some of the compromises were uneasy, and never finally settled the differences that underlay them. As a result, some of these questions continue to generate debate and calls for reform.

Since its enactment in 1978, the Code has been amended several times. In addition to occasional piecemeal changes to individual sections, it has been subjected to four wide-ranging amending statutes. The first, passed in 1984, was principally concerned with trying to overcome constitutional problems relating to bankruptcy court jurisdiction. (*See* section 4.2.1 for an overview of these constitutional problems.) The second, passed in 1986, made a number of small amendments, introduced a new form of debt adjustment for family farmers, and established a nationwide U.S. Trustee system.

The third, the Bankruptcy Reform Act of 1994, began its progress through Congress in 1992. It originated as a fairly comprehensive and extensive revision of the Code, but it was pared down to a less ambitious undertaking when it became apparent that its more controversial aspects would not pass. A compromise bill, with the controversial elements abandoned, was enacted in 1994 to deal with a variety of discrete problems that had arisen in the application and interpretation of the Code. These various changes affect both consumer and business bankruptcies, and they are noted in later chapters where pertinent to the topic under discussion.

The more complex and contentious issues were left for further consideration by a National Bankruptcy Review Commission established under the 1994 Act, whose charge was to evaluate and propose reforms to the Code. After extensive hearings and study, the Commission submitted its report in 1997. In some areas, the commissioners made unanimous recommendations for reform, but they disagreed on others, on which they submitted a majority and dissenting report. The most explosive issue that divided the commissioners was whether the bankruptcy system was too lenient on individual debtors. Some commissioners felt that it was, and that the Code should impose more rigorous payment requirements on individual debtors. Others concluded that the bankruptcy of most individual debtors resulted from economic factors beyond their control, such as job loss, the lack of medical insurance, and an inadequate social safety net. They therefore felt that more rigorous standards would simply increase the hardship of

debtors without addressing the root problem of a high rate of individual bankruptcies.

The report engendered fierce reaction from the public and in Congress, and formed the backdrop to the fourth significant amendment to the Code, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Congress was very selective in picking which of the Commission's recommendations to adopt. It disregarded some of them and even passed some provisions that conflicted with what was recommended. Because some aspects of the statute were so controversial, it took Congress several attempts between 1998 and 2005 to pass it. The various amendments to the Code enacted in BAPCPA are discussed in the appropriate places throughout this book. For now it is enough to make two general observations about BAPCPA. First, it adopted a more rigorous approach to individual debtors, imposing tougher demands on debtors who are deemed to be capable of making greater payments to creditors in a bankruptcy case. Second, many provisions of BAPCPA were poorly drafted, leading to interpretational puzzles and divergent judicial resolutions of unclear language.

§3.4.2 The Structure and Organization of the Code and Ancillary Statutes

It is useful to take note of the structure of the Code and other laws pertaining to bankruptcy. An understanding of this structure can help you to find Code provisions and to recognize the scope of their application.

a. The Code Itself

In its current form (which has been somewhat changed since its original enactment in 1978) the Code consists of nine chapters: 1, 3, 5, 7, 9, 11, 12, 13, and 15. This book does not cover Ch. 9, which governs municipal bankruptcies; Ch. 12, which is available only to debtors who qualify as family farmers or family fishermen; or Ch. 15, which was enacted by BAPCPA to deal with cross-border (international) insolvency cases. The remaining six chapters fall into two broad categories. The first three (Chs. 1, 3, and 5) contain general provisions that are meant to apply to all bankruptcy cases under consideration unless they are irrelevant on the facts or some overriding provision in the specific governing chapter applies instead. The second three (Chs. 7, 11, and 13) are each devoted to a separate and different form of bankruptcy. When a bankruptcy petition is filed, one of these chapters must be selected, and the specific provisions of that chapter will govern the case, together with general Chs. 1, 3, and 5. The provisions of the other specific chapters are not of force unless they

are expressly incorporated by the governing chapter. It is important to remember this because the temptation to generalize some of the sections in a specific chapter can be strong.

The three different types of bankruptcy covered by Chs. 7, 11, and 13 are explained more fully in Chapter 5. In short, Ch. 7 covers liquidation and may be used by both individuals and corporate entities where the goal is to liquidate the estate — that is, to realize its assets and distribute the proceeds to creditors. Chs. 11 and 13 allow a debtor to avoid liquidation by means of a plan of reorganization, under which the debtor devotes income or property to fund a distribution to creditors over time. Ch. 13 is the simpler of the two forms, and is confined to individual debtors with relatively small levels of debt. Ch. 11 is more complex and is more broadly applicable to both individual debtors and to corporate entities.

b. Other Statutes Related to Bankruptcy Cases

There are a number of federal statutes, in addition to the Code, that have a direct bearing[3] on bankruptcy. Title 28 of the U.S. Code has a number of important provisions relating to the bankruptcy system: Ch. 6 (§§151-158) deals with the appointment, duties, and functions of bankruptcy judges; Ch. 39 (§§581-589a) provides for the U.S. Trustee system; Ch. 85 (§1334) governs bankruptcy jurisdiction; and Ch. 87 (§§1408-1412) deals with matters of venue. These provisions of title 28 are covered in Chapters 4 and 6. Title 18 (not discussed further in this book) also has direct relevance to bankruptcy: 18 U.S.C. §§151-155 deals with crimes of dishonesty and embezzlement committed during the course of a bankruptcy case.

§3.4.3 Dollar Amounts in the Code

Many sections of the Code specify dollar amounts for a variety of different purposes, such as setting the debt limits for certain forms of relief, limiting the debtor's exemptions in property, limiting the amount of a qualifying claim that may be accorded priority status, or determining if a debtor's income is sufficient to support a payment plan. Until 1994, the Code had no mechanism for the adjustment of these dollar amounts for inflation, so they shrank in value as the years passed. The Bankruptcy Reform Act of 1994 brought the amounts up to date by increasing the dollar amounts to account for inflation over the preceding 16 years and provided for the administrative

3. These statutes must be distinguished from federal statutes, described in section 3.2.2, which are part of the nonbankruptcy law that is pertinent to transactions, rights, or obligations involved in the case. The statutes noted here deal directly with the operation of the bankruptcy system.

adjustment of dollar amounts every three years thereafter. The adjustments, based on changes in the Consumer Price Index, are made by the Judicial Conference of the United States at three-year intervals and apply to cases filed after the effective date of the adjustment, which is April 1.

The most recent adjustment took effect on April 1, 2016, and the next will be made on April 1, 2019. Because the 2016 dollar amounts are in effect at the time of writing this edition of the book, they are used in this edition. Note, however, that the adjusted dollar amounts apply only to cases commenced after their effective date. Therefore, a case commenced before April 1, 2016 or after April 1, 2019 will be subject to the dollar amounts in effect at that time. Although it is necessary to know the applicable amount in an actual bankruptcy case, for purposes of studying and understanding the law, you can simply rely on the amounts stated in this book and should not be confused if you see different amounts reflected in cases or in the version of the Code that you are using.

§3.4.4 The Bankruptcy Rules

The Code deals with the substantive law of bankruptcy. While it prescribes procedures in broad terms, it does not set out rules of procedure in detailed form. These rules have been promulgated by the Supreme Court in the exercise of its power under 28 U.S.C. §2075. They are intended to effectuate the provisions of the Code and are meant to supplement rather than contradict it. The rules may not alter substantive rights under the Code, and in the case of conflict the Code prevails. The Bankruptcy Rules incorporate some of the Federal Rules of Civil Procedure. Those that are not specifically included in the Bankruptcy Rules supplement them to the extent that they do not provide for a contrary procedure. In addition to the nationwide rules promulgated by the Supreme Court, each district court is empowered by Bankruptcy Rule 9029 to make its own local rules, provided that they are not inconsistent with the Bankruptcy Rules. This book does not focus on the Bankruptcy Rules, but does cite and mention them occasionally.

§3.5 THE POLICIES AND GOALS OF BANKRUPTCY LAW

§3.5.1 Introduction

The policies and goals of bankruptcy law are raised frequently in the discussion of the substantive rules and principles of bankruptcy law in the rest of this book. It is important to identify and understand the reasons for the

substantive rules and the ends that they are intended to achieve. This section alerts you to the fundamental goals that underlie bankruptcy law. It is just an overview of the themes that will recur in the remainder of the book. As you read through this overview of bankruptcy policy, bear in mind:

1. Bankruptcy relief is usually sought only after the debtor's economic difficulties have become serious enough to merit the drastic step of a bankruptcy filing. Therefore, the principal goal of bankruptcy is to manage financial distress and to do the best job possible of preserving what can be saved for the benefit of the debtor, creditors, and others whose interests are impacted by the debtor's financial circumstances.
2. Bankruptcy law is sensitive to the rights that creditors and other parties have under nonbankruptcy law. Although bankruptcy will have an adverse effect on many of these rights, the goal is to affect them only to the extent necessary to further the aims of the Code.
3. Bankruptcy policy cannot be considered in a vacuum. There are many other public policies, reflected in other state and federal laws, which may be implicated in a bankruptcy case. Where other public policies have to be taken into account, these policies may not be congruent with policies of bankruptcy law, so it may be necessary to reconcile or prioritize countervailing policy goals. For example, the bankruptcy goal of providing relief to the debtor from prepetition obligations may not be in accord with the policies and the goals of criminal law, tort law, environmental law, or family law, which may be obstructed by releasing the debtor from those obligations. Sometimes the Code itself indicates how bankruptcy policy should be accommodated to other public policies, but in other cases courts are left with the task of deciding how to accommodate bankruptcy policy to other public interests.

§3.5.2 The Fundamental Goals and Policies of Bankruptcy

a. The Protection of Both Debtor and Creditor Interests

In its original conception, bankruptcy was purely a creditor's remedy. It allowed creditors to place a delinquent debtor in bankruptcy for the purpose of liquidating his assets for the payment of his debts. To the extent that the bankruptcy distribution was not enough to pay the debts in full, the debtor could be imprisoned until friends or family could raise the money to settle what he owed. As the law developed, it gradually became more sympathetic to the protection of an honest debtor who suffered financial adversity and could not pay his creditors in full. In modern law, it is well established that

bankruptcy serves not only the interests of creditors, but also aims at providing relief from overwhelming debt to an honest debtor. It helps creditors by providing an evenhanded and controlled environment for the settlement of the debtor's affairs and the distribution of available assets. It helps the debtor by providing relief from the pressures of financial failure and making available the means of settling otherwise unmanageable debt.

Of course, the interests of the creditors and the debtor are often in conflict, so one of the difficult tasks of bankruptcy law is to strike an appropriate balance between them. The best way to balance these competing interests is subject to ongoing debate. Some commentators emphasize creditor protection and advocate for bankruptcy laws that will maximize creditor returns. Others take a broader view of the social costs and consequences of bankruptcy, and argue for rules that will best protect vulnerable debtors and place the least amount of stress on the social fabric. You will find the tension between these goals at the base of many discussions in later chapters of this book.

b. The Collective and Evenhanded Treatment of Creditors

The mandatory collective nature of the bankruptcy remedy is often identified as one of its most important hallmarks. Upon the filing of a bankruptcy petition, creditors are stayed from pursuing individual debt collection efforts and, whether they like it or not, are compelled to have their claims handled in the bankruptcy case. The debtor's assets at the time of the petition are placed under the control of the bankruptcy court and cannot be disposed of except in accordance with bankruptcy law. It is a fundamental principle of bankruptcy that creditors must be treated evenhandedly so that claims of equal legal rank must be treated the same. This does not mean that all creditors are paid the same. Secured claims are entitled to payment to the extent of their security interests, and the Code gives certain unsecured claims priority. However, differentiation between creditors is based on the strength of their legal rights, rather than on their speed in initiating collection procedures.

c. The Preservation of the Estate

One of the crucial goals of bankruptcy is the preservation of the debtor's assets. This both protects the debtor from creditor collection activity and protects creditors by preserving property so that it can ultimately be made available for distribution to pay their claims. Estate preservation is not simply a passive handover of the debtor's existing property. The Code provides several means by which the bankruptcy trustee can enhance the value of the estate, for example, by recovering dispositions, challenging claims to property, and dealing with unperformed contracts. In addition to protecting the

debtor and creditors, the preservation of the estate of a business debtor can achieve wider social goals where the aim of bankruptcy is the debtor's rehabilitation. Successful rehabilitation can benefit employees of the debtor, the community in which the business operates, and customers or suppliers reliant on the business.

d. The Debtor's "Fresh Start"

Provided that the debtor has complied with the Code's requirements and has surrendered executable assets or sufficient property and future income for distribution to creditors, the debtor is entitled to a new financial beginning, unburdened by the unpaid balance of prebankruptcy debts. This is commonly referred to as the debtor's "fresh start," and it is a firmly established goal of modern bankruptcy law. There are several Code provisions that aim at the debtor's fresh start: for example, the individual debtor's exemptions, the limitations on property to be included in the estate, and the discharge. Of these, the discharge is the most central. It releases the debtor from the balance of prepetition debts that were not fully paid in the case. The fresh start has an obvious and important benefit to the debtor, but it is also intended to benefit society as a whole by giving the debtor the opportunity of becoming self-sufficient and productive. Of course, the discharge comes at the expense of creditors, who lose the unpaid balance of their claims. Therefore, the Code seeks to balance the debtor's fresh start against the protection of creditor rights, and has a number of provisions that allow courts to restrict or refuse the discharge where the debtor has engaged in dishonest, improper, or abusive conduct.

e. Efficient Administration

The Code and related statutes create a system to handle bankruptcy cases, so it is worth adding efficient administration to the goals of bankruptcy law, none of which could be properly achieved if the system for administering the law is inadequate. Many provisions of the Code and related statutes deal with the structure and operation of the bankruptcy system, the efficient implementation of the law, and the prevention of abuse. The question of whether current statutory provisions succeed in making the system as efficient as it could be is the subject of ongoing debate.

f. The Preference for Reorganization and Debt Adjustment

As introduced in section 3.4.2 and explained more fully in section 5.2, the Code provides for two forms of bankruptcy—liquidation and rehabilitation. In essence, in a liquidation (provided for in Ch. 7), all the debtor's prepetition property is taken over by the bankruptcy trustee who realizes it

and uses the proceeds to pay creditors. Where the proceeds are insufficient to pay creditors in full, they receive payment only to the extent of available proceeds. Where the debtor is an individual, the balance of the debts is discharged provided that the debtor is in compliance with the requirements of the Code. In a rehabilitation case (provided for in Chs. 11 and 13),[4] the debtor is able to retain prepetition property and formulates a plan that provides for the settlement of debts from income and other sources over a period of time. As a general principle, the expectation in these chapters is that payments to creditors under the plan must at least equal but should ideally exceed what creditors would obtain in a liquidation. The Code has a preference for rehabilitation over liquidation. It could be argued that this is not really a goal in itself, but rather a mechanism through which bankruptcy may achieve its fundamental goals of creditor protection and the debtor's fresh start. Nevertheless, the Code's emphasis on rehabilitation as the preferred form of bankruptcy is strong, and therefore worth including in this overview of bankruptcy policies.

The benefits of rehabilitating a corporation are easy to see. If the corporation is liquidated, it dies. Its business comes to an end, its owners (shareholders) lose their investment, its employees lose their jobs, and its creditors recover no more than the liquidation value of its assets. Therefore, if it is possible to reorganize the corporation so that it emerges from bankruptcy as a viable business, creditors have a prospect of greater recovery and the enterprise can continue to provide jobs and to participate in the marketplace. (This does not mean that the corporation's employees and owners emerge unscathed. Reorganization often results in a reduction in the corporation's workforce and in employee benefits. Also, reorganization may wipe out the equity of prepetition shareholders and pass ownership to creditors or new investors.)

Where the debtor is an individual, liquidation under Ch. 7 is the debtor's only choice where he does not have enough income to support a payment plan that will give creditors at least as much as they would have gained from the liquidation. However, where a debtor does expect a good future income and has executable property of relatively low value, liquidation may be an attractive option to the debtor but a bad deal for creditors. By sacrificing his prepetition property to creditors, the debtor settles his debt at a fraction of its amount, obtains a discharge of the balance, and can keep his future income for himself. Although this promotes the fresh start policy, it has been a concern ever since the enactment of the Code in 1978 that liquidation can provide an easy way out for a debtor who has the financial ability to pay a greater percentage of his debts through rehabilitation under

4. As noted in section 3.4.2, Chs. 9 (municipal bankruptcy) and 12 (family farmer bankruptcy) also provide for rehabilitation, but those chapters are not covered in this book.

Ch. 13 or Ch. 11. Prior to the passage of BAPCPA, the Code provided some incentives to encourage an individual debtor to pursue rehabilitation rather than liquidation. However, the incentives were quite weak, which led to the argument that a firmer approach was needed to press individual debtors into making a greater effort to commit to a payment plan. Congress was persuaded by this argument, and it did include provisions in BAPCPA that make it more difficult for an individual debtor to seek liquidation bankruptcy under Ch. 7 where he has the apparent means to support a payment plan that would result in a greater return to creditors. Some believe that the BAPCPA amendments have achieved a better balance between debtor and creditor interests. Others criticize the amendments as creating undue complexity, causing hardship to many debtors, and hampering courts in the use of discretion to achieve fair and workable results in bankruptcy cases. (This is discussed in sections 5.4.3, 5.5, 5.7.2, and 6.8.)

Examples

1. Debtor sold a house to Buyer some years before Debtor filed a Ch. 7 petition. Although Buyer paid the full price of the house to Debtor, the parties never got around to executing and filing the documents that would transfer title to Buyer. Section 541(a) includes in property of the estate "all legal or equitable interests of the debtor in property as of the commencement of the case." Although the section does not state so expressly, it is well established that the question of whether a debtor has a legal or equitable interest in property must be determined under nonbankruptcy law.[5] Under the law of the state in which Debtor is domiciled, he is still owner of record and therefore continues to have a legal interest in the property. However, in the law of some other states, the sale of the house to a buyer and full payment of the price would extinguish the seller's rights in the property, so he would not be treated as having a legal interest in the house, despite the fact that the title is still registered in his name. The effect of this is that in Debtor's state, the house will be property of the estate, but in other states it would not be. Can an argument be made that different treatment of a debtor's interest in the house, dependent merely on the debtor's state of domicile, offends the constitutional requirement that Congress enacts a uniform law of bankruptcy?

2. A (hypothetical) federal statute enacted in 1975 provides for the issuance of a trading license to enable the license holder to import certain types of goods. The statute clearly states that the bankruptcy of the license holder

5. The issue of deciding what property of the debtor becomes property of the estate is discussed in sections 9.2 to 9.4.

results in automatic revocation of the license. As discussed more fully in Chapter 9, upon the filing of a bankruptcy petition, all the legal and equitable interests that a debtor holds as at the petition date become property of the bankruptcy estate under §541. The more inclusive the bankruptcy estate, the better creditors will fare in recovering their claims from the estate, so the policy of maximizing creditor returns is strongly implicated in ensuring that the estate does receive all the debtor's property. For this reason, §541(c) invalidates any provision in an agreement or applicable nonbankruptcy law that restricts the transfer of the debtor's property to the estate or that effects a forfeiture of it on bankruptcy. Does §541 preempt the provisions of the 1975 federal statute?

3. In college, Bratford Binge was described as a boy wonder. He was the youngest summa cum laude to graduate from a prestigious business school. As a result, he had no trouble landing a glorious job at an impressive salary. Although immensely talented at his work, Bratford was spoiled, and he denied himself nothing. As a result, he accumulated massive credit card debt by taking expensive vacations and eating at the finest restaurants. He now owes so much debt that, even on his generous salary, he cannot cope with the payments due his creditors. Because his expenditures are related to travel and entertainment, he has not acquired assets of any value. Bratford would like to eliminate this crushing debt and start over. Should he be able to file a bankruptcy petition so that he can enjoy the advantages of the Code's fresh start policy?

4. Precious Little, Inc. has filed a petition for liquidation under Ch. 7. It is badly insolvent. Its debts amount to $750,000 and the total value of its assets is $20,000. Its business has declined badly in the last couple of years, and its revenue is insufficient to cover its operating expenses. How does this significant disproportion between its assets and liabilities and its inadequate revenue affect the achievement of the goals of bankruptcy law in this case?

Explanations

1. As explained in section 3.3, this issue has been long settled. The constitutional requirement of uniformity means that the provisions of bankruptcy law enacted by Congress must apply nationwide. Congress cannot enact provisions that apply only to select states. Uniformity does not require that the rules in the Code apply with the same effect in each state. Section 541(a) does apply throughout the United States even though its interaction with the law of particular states may lead to different results. Section 541(a) is one of many provisions that require

recourse to nonbankruptcy law for the determination of rights that will be impacted by the bankruptcy case. This should not be surprising because it is one of the goals of bankruptcy law to try to mesh as closely as possible with rights held by parties under nonbankruptcy law.

2. Although federal bankruptcy law preempts conflicting state law, it is not appropriate to talk of preemption where the conflicting nonbankruptcy law is federal. Rather, the contradictory statutes must be reconciled by the process of statutory interpretation. The court must decide which provision was intended by Congress to be controlling. Congressional intent is clearest where one of the statutes expressly states that it overrides the other. In the absence of such a clear indication, a court will have to glean legislative intent by interpretation of the language of the statute, any legislative history, and enunciated or apparent policy goals. One of the canons of interpretation that may help in close cases is that Congress is supposed to remember what its earlier legislation said, so that a provision in a later statute is assumed to take precedence over an earlier conflicting statute. On the basis of this rule, the argument could be made that the Code, enacted three years after the other statute, was intended to override it. It must be stressed, however, that this canon of interpretation is just one factor to be considered, and it is not appropriately used where there are more reliable indications of congressional intent.

3. Bratford is a reckless spendthrift. He used credit irresponsibly and now wishes to discharge that debt and get a fresh start. Bankruptcy relief is intended to help the honest debtor who has encountered financial difficulty. A debtor whose financial troubles were caused by circumstances beyond his control, such as the loss of his job, unmanageable uninsured medical expenses, or the failure of his business, is a more sympathetic figure than a debtor who brought his problems upon himself by the irresponsible use of credit. Nevertheless, unless it can be shown that Bratford acted fraudulently or in bad faith in incurring the debt or in relation to the bankruptcy filing, his self-indulgent behavior is not likely to be grounds for refusing him bankruptcy relief. However, Bratford will be disappointed if he hopes to file a petition under Ch. 7 so that he can discharge most of his debt by sacrificing his few nonexempt assets. As explained in section 3.5.2 and discussed more fully in section 6.8, amendments to the Code by BAPCPA preclude Ch. 7 liquidation to an individual debtor like Bratford, who has a significant income, few assets, and owes primarily consumer debts. If Bratford seeks bankruptcy relief he will have to propose a plan under Ch. 11 or Ch. 13. To get the plan confirmed, he will have to commit his disposable income (his salary less his expenses as calculated under the Code) over some years to the payment of his debts. This is discussed in detail in Chapters 6 and 18. For now, this broad description of the obligation of higher payment,

imposed on an individual consumer debtor with a good income, is used merely to highlight the balance between the policies of debtor relief and creditor protection.

4. The goals and policies of bankruptcy law can only be fully satisfied where the estate is at least large enough to achieve all its purposes. Financial resources are needed to rehabilitate a business, and where, as here, the debtor has insufficient assets and no source of adequate future income, the Code's policy of providing a fresh start to the corporation and favoring its rehabilitation cannot be achieved. Where there is no means of funding a rehabilitation, it is simply not an option. This leaves the alternative of liquidation, but even here the paucity of assets means that the bankruptcy cannot fully satisfy all its desired ends. It can ensure that creditors are treated evenhandedly (so that the race for remaining assets can be stopped and any preferential payments made shortly before the filing can be recovered for the benefit of the estate as a whole), but the small pool of assets is likely to be expended fully or in substantial part on the costs of liquidating the bankrupt estate. This means that unsecured creditors will either receive no distribution at all or will receive a minimal payment on their claims.

   It is one of the sad realities of bankruptcy that many estates are just too poor to afford any significant distribution to unsecured creditors. The costs of administering an estate are paid as high priority before general unsecured creditors can receive anything, and these costs can be large. They include not only the trustee's compensation, but also any fees that must be paid to professionals (such as attorneys or accountants) engaged by the estate, and the costs of caring for and disposing of the estate's property. It does not take much to eat up a small estate, leaving it devoid of assets for funding a distribution. Of course, the policy of efficient and cost-effective administration dictates that the trustee's management of the estate should not be disproportionately expensive or wasteful, and the trustee has a duty to try to keep costs down as much as possible.

Chapter 3

THE AUTOMATIC STAY

Analysis

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A. INTRODUCTION

§ 3.1 Function of the Automatic Stay

An integral structural component of a bankruptcy case is the "*automatic stay*" against creditor collection actions. § 362(a). The stay is akin to a statutory injunction. It arises automatically upon the filing of a bankruptcy petition.

The stay is essential to the effective realization and implementation of the two core functions of a bankruptcy case: the equitable treatment of multiple creditor claims, and the provision of a financial fresh start for an honest debtor. Creditors are precluded from getting a jump on their fellow creditors, and the debtor is given a respite from creditor collection efforts. Instead of an uncontrolled self-help scramble for the debtor's assets, creditor claims must be dealt with in an orderly manner under the supervision and control of the bankruptcy court. The stay seeks to preserve the status quo as of the date the bankruptcy case is commenced, until such time as the bankruptcy court can act. As the legislative history explains:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors.... The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors.[1]

The § 362 stay is necessary because a bankruptcy case takes time to process.[2] If a bankruptcy case somehow could be wrapped up in one magical instant, the stay would be unnecessary. By its very nature, the stay serves only to provide *interim* protection for creditors and the debtor during the pendency of the bankruptcy case. Once a discharge is granted, a permanent statutory injunction against the collection of discharged claims comes into effect, § 524(a); at that point the need for an interim stay disappears, and that stay is terminated by operation of law. § 362(c)(2)(C). Similarly, once property ceases to be property of the bankruptcy estate, the reason for the interim stay disappears, because the race of diligence by creditors no longer would undermine the operation of the collective proceeding.

The stay is neither absolute nor permanent. As noted above, when the underlying reasons for the stay cease to apply, the stay terminates automatically.[3] The court also may decide to grant an aggrieved party relief from the stay under § 362(d), if fulfilling the purposes of the bankruptcy case no longer requires maintaining the stay of acts against property, § 362(d)(2), or if the need to protect the moving party becomes paramount.[4] § 362(d)(1).

Finally, not every action against the debtor or the debtor's property is stayed in the first instance. Instead, in some cases Congress decided that other policies, such as the state's interest in enforcing its criminal or environmental laws, are more important than those behind the bankruptcy stay. Congress excluded such cases from the scope of the automatic stay, § 362(b), even if the action otherwise would fall within the prohibitions described in § 362(a). In such an instance, the debtor bears the affirmative burden of obtaining an injunction from the court.[5] By contrast, for an action that is

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1 H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 340 (1977).

2 See Thomas H. Jackson, Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules, 60 Am. Bankr. L.J. 399, 404 (1986).

3 See § 3.15.

4 See § 3.17.

5 See, e.g., In re Storozhenko, 459 B.R. 693, 696 (Bankr. E.D. Mich. 2011) ("The nondischargeable debts listed in [§ 362(b)] are not automatically stayed by the filing of a bankruptcy petition. The burden is on

initially stayed under § 362(a) and not excepted under § 362(b), the stayed party bears the onus of going to court and obtaining relief from the stay.[6] The difference is in the default rule.

§ 3.2 Enforcing the Automatic Stay

The automatic stay of § 362(a) is extremely powerful and effective; it is not something with which creditors should trifle. The stay, while essentially a statutory injunction in effect, is unlike an injunction in at least two critical respects. First, the debtor does not have to do anything to trigger the stay, other than file a bankruptcy petition commencing a case. Thus, the debtor does not have to go to court to request injunctive relief. The imposition of the stay is *automatic* (thus the name). Second, the stay is effective against the world without the necessity of serving notice of the stay on affected parties. In all important respects, then, the stay is self-executing.

The practical importance of the automatic creation of the stay cannot be overemphasized. The debtor has the legal power to stop creditor actions in an instant. For example, a scheduled foreclosure sale must be cancelled; an imminent repossession must be halted; and an ongoing lawsuit must stop dead in its tracks. The debtor, with the right to file a bankruptcy petition and invoke the stay, in effect holds a trump card.

Once in place, the stay looms as an impenetrable barrier to unilateral creditor activity. If a creditor wants to avoid the operation of the stay, it must obtain permission from the bankruptcy court. What happens, however, if a creditor decides to take matters into its own hands, and acts in violation of the stay without first receiving the blessing of the court? For example, assume that after the debtor files bankruptcy and thereby triggers the stay, the creditor goes ahead with the scheduled foreclosure sale, or repossesses the debtor's property, or obtains a default judgment. What is the remedy?

The prevailing rule is that all acts taken in violation of the automatic stay are null and void *ab initio*, and without legal effect.[7] The foreclosure sale would be ineffective, the repossessed property would have to be returned, and the judgment would be nugatory. The creditor in each instance thus would lack any incentive to ignore the stay in the hope that its actions will not be challenged. Indeed, if the creditor knew

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the debtor or trustee to affirmatively seek injunctive relief from the enforcement of these debts." (quoting In re Embry, 10 F.3d 401, 404 (6th Cir. 1993))).

Generally, the debtor will file an adversary proceeding for an injunction and a determination that a particular creditor's actions do not fall within the § 362(b) stay exceptions. See, e.g., In re First Alliance Mortg. Co., 264 B.R. 634 (C.D. Cal. 2001); In re Bertuccio, 414 B.R. 604 (Bankr. N.D. Cal. 2008); In re Gandy, 327 B.R. 796 (Bankr. S.D. Tex. 2005).

[6] E.g., In re Palmdale Hills Prop., LLC, 654 F.3d 868, 876 (9th Cir. 2011) (stating that acts not within § 362(b) are not barred completely, but require the creditor to bring an adversary proceeding or otherwise file for relief from stay).

[7] E.g., Picard v. Fairfield Greenwich Ltd., 762 F.3d 199, 207 (2d Cir. 2014); In re C.W. Mining Co., 749 F.3d 895, 899 (10th Cir. 2014); In re Wardrobe, 559 F.3d 932, 934 (9th Cir. 2009) (citing In re Schwartz, 954 F.2d 569, 571 (9th Cir. 1992)); Acands, Inc. v. Travelers Cas. & Sur. Co., 435 F.3d 252 (3d Cir. 2006); Mann v. Chase Manhattan Mortg. Corp., 316 F.3d 1, 3 (1st Cir. 2003); Ellis v. Consol. Diesel Elec. Corp., 894 F.2d 371 (10th Cir. 1990); In re Vitale, 469 B.R. 595 (Bankr. W.D. Pa. 2012).

This doctrine stems from the Supreme Court's decision in *Kalb v. Feuerstein*, 308 U.S. 433 (1940), in which the Court held that a real property foreclosure was void.

about the stay, and acted anyway, it would likely be sanctioned by the bankruptcy court.

A minority view holds that acts taken in violation of the stay are voidable only, and not void.[8] The dispute between the courts on this point is in some respects a matter of semantics, and in others speaks to a real difference in judicial attitude toward the enforcement of the stay. The primary argument made for the "voidable" view is that § 362(d), which authorizes the court to grant relief from the stay, provides that the court may "annul" the stay, thereby according retroactive validity to an earlier action taken in contravention of the stay. These courts explain that a "void" action cannot later be ratified or validated (by "annulling"), while a voidable action can. When the Supreme Court in 1940 stated in *Kalb v. Feuerstein*[9] that actions violative of the stay were "void," the bankruptcy statute did not empower the judge to "annul" the stay, as it does now. Some courts suggest that perhaps a better word to describe the effect of a violative act would be "invalid."[10]

Another argument in favor of the voidable view rests on the fact that § 549 empowers the trustee to avoid and recover unauthorized postpetition transfers of estate property. The claim is that this power would be unnecessary if all such transfers were already void under § 362. Most courts have rejected this argument, however, pointing out that § 549 complements § 362, and applies to transactions (such as a sale of property to a non-creditor) that are not expressly prohibited elsewhere in the Code.[11]

If all that were at stake in the void-voidable debate was the legal terminology used, the outcome would be unimportant. By whatever name, the rule everywhere would be that an action taken in violation of the stay would not be given any legal effect unless the bankruptcy court later retroactively validated the action on motion of the creditor. If nothing is done, the act would be invalid. Danger lurks, though, if the void/voidable distinction reflects a difference in which party bears the burden of going forward. As the First Circuit explained in holding, correctly, that violations of the automatic stay should be deemed "void," even though the stay can still be annulled and the "void" actions retroactively validated:

> This semantic difference has practical consequences because the characterization of an infringing action as "void" or "voidable" influences the burden of going forward. Treating an action taken in contravention of the automatic stay as void places the burden of validating the action after the fact squarely on the shoulders of the offending creditor. In contrast, treating an action taken in contravention of the automatic stay as voidable places the burden of challenging the action on the offended debtor. We think that the

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[8] E.g., Bronson v. United States, 46 F.3d 1573 (Fed. Cir. 1995); In re Coho Res., Inc., 345 F.3d 338, 344 (5th Cir. 2003).

[9] 308 U.S. 433 (1940).

[10] See Easley v. Pettibone Michigan Corp., 990 F.2d 905, 909–11 (6th Cir. 1993); In re Bazzi, 481 B.R. 397, 402 (Bankr. E.D. Mich. 2012); In re Tyson, 450 B.R. 754, 764 (Bankr. W.D. Tenn. 2011).

[11] E.g., 40235 Washington St. Corp. v. Lusardi, 329 F.3d 1076 (9th Cir. 2003); In re Tippett, 542 F.3d 684 (9th Cir. 2008); In re Beery, 452 B.R. 825 (Bankr. D.N.M. 2011); In re Garcia, 109 B.R. 335 (N.D. Ill. 1989).

former paradigm, rather than the latter, best harmonizes with the nature of the automatic stay and the important purposes that it serves.[12]

Placing the burden on the debtor to act, rather than on the creditor, adopts a premise of "no harm, no foul." This view is plainly wrong, and would contradict the policy behind the *automatic* stay. A creditor would have some incentive to ignore the stay under the "voidable" view. Whatever term is used, the proper result should be that acts that violate the stay do not have any operative legal effect unless the bankruptcy court subsequently annuls the stay for cause shown.

A creditor who violates the automatic stay also may be liable for damages. There are two possible bases for a damages claim: the court's power to punish for contempt, and the statutory remedy provided in § 362(k). As to the first, the bankruptcy stay is analogous to an injunction, and disobedience of an injunction historically has been punishable by contempt sanctions. The leading case establishing that contempt was a viable means of redressing a knowing violation of the stay was the 1976 Second Circuit decision in *Fidelity Mortgage Investors v. Camelia Builders, Inc.*,[13] decided under the previous Bankruptcy Act. Indeed, even until 1984, after the enactment of the Code, contempt was the only means by which stay violations could be punished.

In 1984 Congress added § 362(k), which states, in operative part: "an individual injured by a willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." § 362(k)(1). In cases within its scope, § 362(k)(1) affords a private right of action to proper plaintiffs. Significantly, proof of the grounds necessary for contempt is not required to establish a right to relief under § 362(k). Instead, liability is imposed upon proof of a willful violation. The court is mandated to grant relief if the statute applies.

In 2005, a safe harbor against punitive damages was added in § 362(k)(2) in certain cases involving individual debtors, in conjunction with the addition of § 362(h). The new provisions give teeth to the requirement in § 521(a)(2) that, with respect to personal property subject to a lien, the debtor within a short time period must both file a "statement of intention" regarding what he plans to do with the subject property (e.g., redeem, reaffirm, or surrender) and then carry out the stated intention.[14] Under § 362(h), if the debtor fails to act within the required time periods, the stay automatically terminates. But what if the creditor believes that the debtor failed to act as required by § 521(a)(2), and thus assumes that the stay has terminated under § 362(h), and accordingly proceeds to seize the subject property, but in fact is in error? Certainly the creditor has violated the stay. What is the sanction? According to § 362(k)(2), if the creditor acted "in the good faith belief that subsection (h) applies to the debtor," then only actual damages may be recovered.

Some question has been raised as to whether § 362(k)(1) has displaced the contempt power. While a minority of courts have held the statute displaces contempt

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[12] In re Soares, 107 F.3d 969, 976 (1st Cir. 1997). See also In re Myers, 491 F.3d 120, 127 (3d Cir. 2007) (holding that "actions in violation of the stay, although void (as opposed to voidable), may be revitalized in appropriate circumstances by retroactive annulment of the stay").

[13] 550 F.2d 47 (2d Cir. 1976), cert. denied, 429 U.S. 1093 (1977).

[14] See § 7.28.

power,[15] a substantial majority conclude that contempt remains as an alternative means of punishing stay violations.[16] In cases within the scope of § 362(k)(1), the issue is largely academic, because the injured party (usually the debtor) ordinarily may obtain all the relief under § 362(k)(1) that it could under contempt.[17] However, as discussed below, § 362(k)(1) may have a limited reach, and for cases that lie outside of § 362(k)(1), contempt will be the only available avenue for sanctioning violations. Additionally, a debtor seeking to recover damages under § 362(k)(1) does not have to prove his case by clear and convincing evidence; the "clear and convincing standard applies only when [a debtor seeks] adjudication of contempt for the violation of an automatic stay."[18]

The interpretive scope question under § 362(k)(1) is whether Congress really meant to limit the pool of prospective plaintiffs to *"individuals"*, as the statutory language appears to indicate. Usage elsewhere in the Code indicates that "individuals" refers to natural persons—human beings—and not to corporations, partnerships, the government, and other legal entities. The definition of "person" in § 101(41) "includes individual, partnership, and corporation," obviously contemplating that corporations and partnerships must be something different from "individuals." Because of this "plain" statutory reading, a majority of courts have restricted § 362(k) to living, breathing, human beings,[19] meaning therefore that a corporate debtor injured by a willful stay violation would have no recourse under § 362(k)(1). Such an entity would have to proceed under a contempt theory. Some courts, however, take an expansive view of "individual," and do not limit § 362(k)(1) to natural persons.[20] These courts reason that the narrow view lacks any logical justification, that corporate or partnership debtors are as deserving as individual debtors of a remedy for willful stay violations, and that Congress accordingly must not have intended to use "individual" in the same technical sense as elsewhere in the Code. Nice try, but the statute just does not read that way; "individual" indisputably is a term of art in the Code, and means humans, not companies. Courts also disagree whether a trustee may bring an action to recover damages for willful violations of stay.[21]

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[15] E.g., In re Rimsat, Ltd., 208 B.R. 910 (Bankr. N.D. Ind. 1997).

[16] E.g., In re Gordon Props., LLC, 460 B.R. 681 (Bankr. E.D. Va. 2011); In re Johnston, 321 B.R. 262 (D. Ariz. 2005).

[17] Note that proceeding under a civil contempt or § 362(k) theory might affect the type of damages available. Compare In re Repine, 536 F.3d 512 (5th Cir. 2008) (holding emotional injury damages proper under § 362(k)), with McBride v. Coleman, 955 F.2d 571 (8th Cir. 1992) (holding that civil contempt is not an appropriate vehicle for awarding emotional distress damages).

[18] In re Florio, 229 B.R. 606, 608 (S.D.N.Y. 1999). See also In re Johnson, 501 F.3d 1163, 1170 (10th Cir. 2007) ("Accordingly, we hold that willful violations of an automatic stay [under § 362(k)] must be proven by a preponderance of the evidence.").

[19] E.g., In re Spookyworld, Inc., 346 F.3d 1, 7 (1st Cir. 2003); In re Jove Eng'g, Inc. v. IRS, 92 F.3d 1539, 1549–53 (11th Cir. 1996); In re Chateaugay Corp., 920 F.2d 183 (2d Cir. 1990); In re C.W. Mining Co., 477 B.R. 176, 193–94 (B.A.P. 10th Cir. 2012).

[20] E.g., In re Atl. Bus. & Cmty. Corp., 901 F.2d 325, 328–29 (3d Cir. 1990); Budget Serv. Co. v. Better Homes of Virginia, Inc., 804 F.2d 289, 292 (4th Cir. 1986). See also St. Paul Fire & Marine Ins. Co. v. Labuzan, 579 F.3d 533 (5th Cir. 2009) (holding that principals, in their capacity as creditors, and not owners/equity holders of a company, had standing to pursue damages under § 362(k)).

[21] Compare In re Howard, 428 B.R. 335 (Bankr. W.D. Pa. 2010) (holding that a trustee has standing regarding § 362(k)), with In re Glenn, 379 B.R. 760 (Bankr. N.D. Ill. 2007) (holding that the trustee was not the kind of individual § 362 provides a remedy for).

A party other than an "individual" who is injured by a stay violation is not remediless, however. As noted earlier, the remedy of *contempt* remains, in virtually all courts, as a form of redress for a stay violation. The major difference between contempt and the statutory sanction in § 362(k)(1) is that the decision whether to impose sanctions for contempt lies within the discretion of the court, and is not mandatory. Relief under § 362(k)(1), by comparison, is a matter of right if a sufficient showing is made.[22] A creditor will be held in contempt only if it has knowledge of the pendency of the bankruptcy case, and yet still undertakes intentional actions in violation of the stay. Thus, the creditor may escape punishment for contempt if it can show that it proceeded on a good faith belief that its action was valid, or if it can show that the action was inadvertent.[23] In other words, courts do not impose damages for all violations of the automatic stay, "but only those that are within its statutory definition, i.e., 'deliberate' actions that are 'willful.' "[24]

Some doubt has been expressed as to whether a bankruptcy judge, who is not an Article III judge, has the power to punish for contempt. The "power" question actually has several layers: first, does the bankruptcy court have the inherent equitable power to sanction for contempt; second, does § 105(a) purport to convey such a power to bankruptcy judges; and, finally, is the exercise of contempt powers by a non-Article III bankruptcy court constitutional? If the bankruptcy judge lacks the contempt power, then the contempt proceeding must be certified to the Article III district court judge. With regard to *civil* contempt, an early division in the case law as to whether the bankruptcy judge had the power to act[25] has been settled in favor of finding such authority.[26] More controversial is the issue of whether bankruptcy judges may enter an order of *criminal* contempt.[27] The better view is that they do not. Bankruptcy courts unquestionably do have the power to award damages under the specific statutory authorization of § 362(k)(1), however.

One might worry about whether the Supreme Court's decision in *Stern v. Marshall,*[28] which circumscribed (to an unknown and much-debated extent) the scope

[22] 11 U.S.C. § 362(k)(1) ("[A]n individual injured by any willful violation of a stay provided by this section *shall* recover actual damages." (emphasis added)). Additionally, note that debtors have an "unequivocal statutory right" to prove actual damages after a willful violation of automatic stay. In re Vazquez Laboy, 647 F.3d 367 (1st Cir. 2011).

[23] For example, a debtor-landlord's former tenants commenced a state court action to compel the debtor to refund their security deposit after commencement of the debtor's chapter 13 case, but did not receive notice of the bankruptcy case until the debtor filed an answer in state court. Accordingly, the court held that this "mere technical violation" did not give rise to damages. In re Kline, 424 B.R. 516 (Bankr. D.N.M. 2010).

[24] E.g., In re Bernstein, 447 B.R. 684, 704 (Bankr. D. Conn. 2011).

[25] Compare In re Sequoia Auto Brokers, Ltd., 827 F.2d 1281 (9th Cir. 1987) (no power), with In re Skinner, 917 F.2d 444 (10th Cir. 1990) (has power).

[26] See, e.g., In re Dyer, 322 F.3d 1178 (9th Cir. 2003); Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.), 77 F.3d 278 (9th Cir. 1996) (stating that recent developments had superseded the circuit's earlier decision in *Sequoia Auto Brokers*, 827 F.2d 1281).

[27] The cases are collected in *Dyer*, 322 F.3d at 1193 n.15. See also Cox v. Zale Delaware, Inc., 239 F.3d 901, 917 (7th Cir. 2001) ("Since punitive damages are punitive, and it is punitive purpose that distinguishes criminal from civil contempt, section [363(k)] implies that bankruptcy judges do have some criminal contempt power. . . .").

[28] 564 U.S. 462 (2011). See also §§ 4.2.g, 4.4; Ralph Brubaker, A "Summary" Statutory and Constitutional Theory of Bankruptcy Judges' Core Jurisdiction After *Stern v. Marshall*, 86 Am. Bankr. L.J. 121 (2012).

of the Article I bankruptcy court's constitutional powers, undercuts this settled jurisprudence, on the basis that issuing contempt orders is a fundamental aspect of the exercise of judicial power, which historically had not been part of the arsenal of the bankruptcy judge's summary powers. If so, a bankruptcy judge would not be able to enter a final order of contempt (even civil), but must seek the district court's blessing of the contempt order.[29] Cutting the other way, in favor of the bankruptcy court having constitutional power to enter a final order of civil contempt for a stay violation, is the argument that the automatic stay is solely a creature of the bankruptcy case and thus an action seeking contempt for violation of the stay could have no independent existence outside of bankruptcy;[30] instead, it is part and parcel of the core bankruptcy case itself.

Liability under § 362(k)(1) is more readily established than under a contempt theory. The statutory predicate is a "*willful violation*" of the stay. What constitutes "willful" action has been discussed in innumerable cases. The primary requirement is that the creditor (or other defendant) (1) must have had *knowledge* of the pendency of the bankruptcy case, and (2) must have had the *intent* to commit the proscribed act.[31] Significantly, a specific intent to violate the stay is not required.[32] Indeed, knowledge of the existence of the automatic stay itself is not necessary to establish liability; knowledge of the bankruptcy case constructively imputes notice of the stay as well.[33] However, note that courts are split whether a debtor's oral notice of his bankruptcy case to a creditor is enough to satisfy the "knowledge" element in § 362(k), or whether written confirmation of the bankruptcy petition filing is required.[34]

A purely innocent stay violation will not subject the creditor to damages, however, even though the action taken will be void (or "invalid"), as discussed above.[35] For example, assume that a creditor completes a foreclosure sale of collateral belonging to the debtor shortly after the bankruptcy petition is filed, *before* learning of the existence

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[29] See In re Brown, 481 B.R. 351, 354 n.1 (Bankr. W.D. Pa. 2012) ("This Court has subject matter jurisdiction. . . . However, if the [District Court] determines pursuant to the rationale set forth in *Stern*[ ] that this Court does not have the authority to enter final judgment, then the Memorandum Opinion and Order entered shall constitute the Court's proposed findings of fact and conclusions of law and recommendation to the District Court.").

[30] E.g., In re Mele, 486 B.R. 546 (Bankr. N.D. Ga. 2013); In re Brown, 481 B.R. 351 (Bankr. W.D. Pa. 2012).

[31] E.g., In re Waldo, 417 B.R. 854, 890 (Bankr. E.D. Tenn. 2009) ("A violation of the automatic stay is willful if the creditor deliberately carried out the prohibited act with knowledge of the debtor's bankruptcy case." (citing In re Printup, 264 B.R. 169, 173 (Bankr. E.D. Tenn. 2001)).

[32] For example, where a creditor's stay violation was a product of a clerical or ministerial error by its employee, the court nonetheless found the stay violation "willful." See In re Nixon, 419 B.R. 281, 287–90 (Bankr. E.D. Pa. 2009).

[33] See, e.g., In re Tyson, 450 B.R. 754, 766 (Bankr. W.D. Tenn. 2011) ("It is irrelevant to a court faced with imposing § 362(k) sanctions whether a defendant actually intended to violate the automatic stay . . . [s]o long as the defendant had knowledge of the bankruptcy case and took a deliberate act in violation of the automatic stay. . . ."); In re Theokary, 444 B.R. 306, 322 (Bankr. E.D. Pa. 2011) ("Knowledge of the existence of the bankruptcy case is treated as knowledge of the automatic stay for these purposes.").

[34] Compare In re Johnson, 478 B.R. 235 (Bankr. S.D. Miss. 2012) (holding oral notice is sufficient to trigger "knowledge"), with In re Collier, 410 B.R. 464 (Bankr. E.D. Tex. 2009) (holding that a creditor must receive written confirmation before being charged with "knowledge"). See also In re Henley, 480 B.R. 708 (Bankr. S.D. Tex. 2012) (holding that notifying a creditors' attorney of debtor's intention to file bankruptcy was not notice of stay to hold such creditors liable or violation of stay).

[35] See cases cited supra note 7.

of the bankruptcy case. While the sale is indisputably a violation of the stay, see § 362(a)(4), (5), the creditor has not acted "willfully" and therefore will not be liable for damages under § 362(k)(1). The sale is ineffective, however.

In some circumstances a creditor may have to take affirmative steps to undo a stay violation after learning of the bankruptcy filing in order to avoid liability under § 362(k)(1). For example, assume that a creditor repossesses collateral after the debtor files bankruptcy, but without knowing of the bankruptcy case. While the initial repossession would be impermissible, the innocent creditor would not be subject to § 362(k)(1) damages. Once the creditor finds out about the pendency of the bankruptcy case, however, the creditor must promptly return the repossessed property to the bankruptcy trustee, or it will then be held liable for a willful violation because of its continued retention of possession.

The statute provides that "*actual damages*" shall be recovered by the injured individual.[36] The most common form of damages awarded are costs and attorneys' fees incurred by the injured party in seeking to remedy the stay violation. These damages should be recoverable even if no other damages are proven. Other actual damages caused by the violation would of course also be recoverable, assuming they can be proven with the requisite certainty. Additionally, in "appropriate circumstances . . . *punitive damages*" may be awarded as well. § 362(k)(1). However, mere willfulness is not enough to support an award of punitive damages; instead, courts require proof that the creditor acted with heightened culpability, such as "egregious, intentional misconduct."[37] Factors a court might consider when determining what actions warrant punitive damages include the nature of the creditor's conduct, the nature and extent of harm to the debtor, the creditor's ability to pay damages, the level of sophistication of the creditor, the creditor's motives, and any provocation by the debtor.[38]

For example, a creditor who exhibits a pattern of defying the stay in multiple cases, or who seeks to humiliate or embarrass the debtor, might be subjected to punitive damages. To illustrate, the Eighth Circuit permitted the debtor to recover punitive damages when the creditor not only refused to turn over property requested by the debtor, but also attempted to have the debtor excommunicated from his church for having declared bankruptcy.[39]

While the creditor's good faith belief that its behavior is permitted would not protect it from liability for actual damages, such a belief would be a defense to the imposition of punitive damages. In addition, as explained above, § 362(k)(2) protects a creditor against an award of punitive damages, and limits its exposure to actual

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[36] Chapter 11 and 13 debtors should be aware that a court might require him or her to turn over any damages received, as being part of the estate. E.g., In re Crouser, 476 B.R. 340 (Bankr. S.D. Ga. 2012) (holding that chapter 13 debtor must turn over settlement proceeds received from a creditor who willfully violated the stay, due to the expanded definition of estate property in § 1306).

[37] E.g., In re Knaus, 889 F.2d 773, 776 (8th Cir. 1989); In re Repine, 536 F.3d 512, 521 (5th Cir. 2008); In re Johnson, 478 B.R. 235, 251–52 (Bankr. S.D. Miss. 2012).

[38] See, e.g., In re Gray, 519 B.R. 767, 775–76 (B.A.P. 8th Cir. 2014); In re Anderson, 430 B.R. 882, 889 (Bankr. S.D. Iowa 2010).

[39] *Knaus*, 889 F.2d at 776. Contrast this case with *In re Pearce*, 400 B.R. 126 (Bankr. N.D. Iowa 2009), where the court held that a creditor's contact with a prosecutor and police about a debtor's unpaid debt did not warrant punitive damages.

damages if the creditor had a good faith belief that § 362(h) applied to an individual debtor.[40]

Until the 1994 amendments, a loophole in the enforcement of § 362(k)(1) was that governmental units could assert sovereign immunity as a defense to an action to collect damages for willful stay violations. Two Supreme Court cases held that § 106 of the Code did not effectively waive sovereign immunity so as to permit an award of damages, unless the government specifically waived its immunity in the particular case, such as by filing a proof of claim.[41] In the 1994 amendments, however, Congress made clear that sovereign immunity could not be raised as a defense to a damages action under § 362(k)(1). Doubt as to the viability of that congressional abrogation with regard to *state* governments was raised by the Supreme Court's 1996 decision in *Seminole Tribe of Florida v. Florida*,[42] which held that Congress did not have the power under its Article I powers to abrogate the Eleventh Amendment immunity of a state without the state's consent. In 2006, however, the Supreme Court in *Katz* reversed course and held that the Bankruptcy Clause (alone, apparently, among Article I powers) trumped the Eleventh Amendment, and thus state sovereign immunity is not a barrier in bankruptcy cases.[43] States as creditors are therefore subject to the imposition of monetary sanctions under § 362(k)(1) just like any other creditor who willfully violates the stay.[44]

B. SCOPE OF THE STAY: ACTS STAYED UNDER § 362(a)

§ 3.3 Collecting Prepetition Debts

The critical first step in assessing an automatic stay issue is to ascertain whether the action in question is within one of the categories of acts stayed under § 362(a). If the act does not fall within § 362(a), then the inquiry is at an end. There is only a need to consider exceptions to the stay under § 362(b), or relief from the stay under § 362(d), if § 362(a) applies in the first instance. Subsection (a) of § 362 contains eight subparagraphs that describe the acts that are stayed. This listing of eight areas is exclusive; if an act does not come within at least one of those eight, it is not stayed. In that event, the court would have to enter an injunction in order to stay the action. Note that there is some overlap between the various subparts of § 362(a), i.e., an action may be stayed under more than one subpart. Only one subparagraph need apply, however, for the stay to operate. Because of the central importance of the stay to the entire bankruptcy system, courts have liberally interpreted the provisions of § 362(a), broadly extending its coverage to all close cases. If one of the subparts of § 362(a) applies, the next step is to turn to the long list of exceptions to the stay in § 362(b). If an exception is operative, then the stay again will not bar the activity in question.

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[40] See supra notes 14 and 23 and accompanying text.

[41] United States v. Nordic Vill., Inc., 503 U.S. 30 (1992); Hoffman v. Conn. Dep't of Income Maint., 492 U.S. 96 (1989).

[42] 517 U.S. 44 (1996).

[43] Cent. Virginia Cmty. Coll. v. Katz, 546 U.S. 356 (2006).

[44] But see In re Diquez, 477 B.R. 257 (Bankr. S.D. Fla. 2012) (holding that the Florida Department of Business and Professional Regulation and the Florida Construction Industry Licensing Board were arms of state, protected from suit by Florida's Eleventh Amendment immunity). Notably, this case never once mentioned *Katz*.

In considering what acts are stayed under § 362(a), it is helpful to focus initially on first principles: why is there a stay in the first place, and what is the stay designed to accomplish? The stay allows the orderly management of the collective proceeding through which creditors will be paid equitably, and affords the debtor protection from collection efforts.[45] To implement these goals, then, the stay should block (1) attempts to collect pre-bankruptcy debts by individual creditors and (2) efforts to interfere with property of the bankruptcy estate. Those types of actions, if unchecked, would impede the bankruptcy process. The various subparts of § 362(a) implement these basic goals.

One type of activity that must be stayed is the collection of prepetition debts by specific creditors. The concern is that these creditors will continue the "race of diligence" and attempt to grab part of the debtor's assets to satisfy their claim, without going through the bankruptcy process. The concern is not with the substantive entitlements of the creditor; the claim asserted may well be valid. Rather, the problem is with the procedural means by which the creditor seeks to collect. Once the bankruptcy case is filed, the creditor's collection efforts must be channeled through the formal bankruptcy proceeding. The creditor must go through the court to collect, either by filing a claim in the bankruptcy case and being paid out of the bankruptcy distribution, or by obtaining court permission to go forward with independent collection efforts.

Several subsections of § 362(a) implement this basic rule against efforts by "all entities"[46] to collect prepetition claims. Subsection (1) stays all formal proceedings against the debtor to recover prepetition claims. Subsection (2) stays the enforcement of a prepetition judgment. Actions to enforce liens against either property of the estate or the debtor are stayed under subsections (4) and (5), respectively.[47] Setoffs of prepetition debts are forbidden by subsection (7).[48] Finally, a catch-all provision, subsection (6), stays "any act" to collect a prepetition claim.[49]

Section 362(a)(1) stays:

> [T]he commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.

Two categories of proceedings are stayed under this subsection: (1) all proceedings against the debtor that either were commenced prepetition or that could have been commenced prepetition, and (2) all proceedings to recover a prepetition claim against the debtor. This section examines the latter category, and the next section of the book discusses the former. Several important points about § 362(a)(1) must be noted. First, it applies to the "commencement or continuation" of a proceeding. Second, a wide

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[45] See § 3.1.

[46] "Entity" is a broad term that includes "person [itself defined to include "individual, partnership, and corporation," § 101(41)], estate, trust, governmental unit, and United States trustee." 11 U.S.C. § 101(15).

[47] See § 3.5.

[48] See § 3.7.

[49] See § 3.8.

variety of proceedings are embraced. Third, for the claim recovery portion of § 362(a)(1) to apply, the creditor must be attempting to recover a "claim" as defined in § 101(5). Finally, the timing of the claim is critical: the stay only applies to claims that arose before the filing of the bankruptcy case.

The most obvious application of § 362(a)(1) would be to stay a creditor from filing a lawsuit against the debtor after the bankruptcy filing in order to recover on a prepetition claim. Such a filing would indeed be proscribed as a "commencement . . . of a judicial . . . proceeding." The reach of subsection (1) is much broader, though. Also stayed is the "continuation" of proceedings that were commenced prior to the bankruptcy case. Thus, there is no benefit to the creditor to "win the race to the courthouse" and file its lawsuit before the debtor files bankruptcy. The stay will still apply.

In some cases a creditor (or even a third party![50]) may even be obligated to take affirmative steps after bankruptcy to stop an ongoing proceeding. For example, if a creditor initiates a garnishment action prior to bankruptcy, the garnishment will continue in effect until the debt is paid, without the need for the creditor to do anything more. Postpetition passivity is not a defense, however; if the creditor does not take steps to halt that ongoing garnishment, it will violate the stay.[51]

The "continuation" provision also poses problems in cases in which the debtor is one of multiple parties to a lawsuit that is pending at the time the bankruptcy case is filed. The action cannot go forward with the debtor as a party, but the debtor's filing does not operate as a stay against the non-debtor parties. The usual solution is to sever the debtor from the case and then go forward against the non-debtor parties. Note that some courts extend the stay in these circumstances over non-debtor defendants if a suit against the non-debtor is essentially a suit against the debtor, or if the proceeding would have an adverse impact on the debtor's ability to reorganize successfully.[52]

The legislative intention was to extend the stay to a wide range of proceedings.[53] Thus, while a traditional lawsuit would be stayed, so too would the stay apply to an arbitration proceeding, or a hearing before an administrative agency. If the proceeding does not pose a threat to the bankruptcy administration, the bankruptcy court may lift the stay under § 362(d)(1), but that decision is for the bankruptcy judge to make, not the other litigants or the non-bankruptcy forum.

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[50] In re Tyson, 450 B.R. 754 (Bankr. W.D. Tenn. 2011) (holding that the purchaser in a postpetition foreclosure sale—which violated the stay—violated the automatic stay themselves when they refused to cooperate in voiding the foreclosure sale). But see In re TLB Equip., LLC, 479 B.R. 464 (Bankr. S.D. Ohio 2012) (holding no violation of the stay occurred when defendant repossessed the debtor's property prepetition and sold it postpetition).

[51] In re Scroggin, 364 B.R. 772 (B.A.P. 10th Cir. 2007); In re Russell, 441 B.R. 859 (Bankr. N.D. Ohio 2010). But see In re Henson, 477 B.R. 786 (Bankr. D. Colo. 2012) (distinguishing between taking additional steps to collect a debt from allowing a prepetition action to collect a debt continue, and holding that the latter does not violate the stay).

[52] E.g., Rivera-Olivera v. Antares Oil Servs., 482 B.R. 44 (Bankr. D.P.R. 2012). See also In re Gander Partners LLC, 432 B.R. 781 (Bankr. N.D. Ill. 2010) (issuing an injunction to prevent a creditor from pursuing state court lawsuits against third-party guarantors of debtors' debt). But see Kreisler v. Goldberg, 478 F.3d 209 (4th Cir. 2007) (denying stay protection for a suit against the debtor's wholly-owned non-debtor subsidiary).

[53] See H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 340 (1977).

An important limitation on the scope of the stay under the second clause of § 362(a)(1) is that the creditor must be seeking to recover on a "*claim*," and that claim must arise before the bankruptcy filing. "Claim" is defined in § 101(5):[54]

> "[C]laim" means—(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. . . .

This definition of claim is intentionally broad. The intent of Congress was "that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."[55] To be "dealt with in the bankruptcy case," collection activities on claims must be stayed. As both the Code and the legislative history make clear, a creditor has a "claim" and will be stayed even if its right to be paid at the time bankruptcy is filed is unliquidated, or contingent, or unmatured, or disputed.

To illustrate, a creditor with a tort claim that arose prepetition but which has not been reduced to judgment by the time of bankruptcy still would have a claim—"*unliquidated*"—that would be stayed. A guarantor or surety of an obligation of the debtor has a claim—"*contingent*"—even if the contingency that would trigger the creditor's guaranty obligation (the debtor's default) has not occurred prior to bankruptcy. A creditor with a note of the debtor that was executed before bankruptcy but which is scheduled to come due after bankruptcy has a claim—"*unmatured*." And a bankruptcy claim exists if it arose prior to bankruptcy even if the debtor contests the validity and amount of that claim—"*disputed*".

The date of the bankruptcy filing serves as the point of cleavage; actions rooted in the pre-bankruptcy past are subject to the bankruptcy case, and are stayed, but those that are connected to the post-bankruptcy world are not. Courts are fond of quipping that the debtor is entitled to a "fresh start, but not a head start."

Sometimes it is hard to pinpoint exactly when a claim arises, however.[56] This difficulty has been especially pronounced in tort and environmental cases. A prominent example is the Fourth Circuit decision in *Grady v. A.H. Robins Co.*[57] The creditor, Rebecca Grady, had a Dalkon Shield intrauterine device inserted *before* Robins filed bankruptcy. However, Grady did not manifest injury until *after* the filing. The court held that Grady's claim arose prior to bankruptcy and therefore was stayed. The court explained that the claim arose when Robins engaged in the tortious conduct.

Note, though, that courts since *Robins* have been careful not to go too far with a pure "conduct" test to determine when a claim arises. Indeed, in *Robins* the tort victim also was *exposed* to the defective product prior to bankruptcy. The same problem has been encountered in environmental cases, with regard to when the environmental agency's claim against the debtor for cleanup costs arises. The difficulty occurs in

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[54] See § 7.1.

[55] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 309 (1977).

[56] See § 7.2.

[57] 839 F.2d 198 (4th Cir. 1988).

situations in which the debtor engages in conduct that leads to pollution prior to the bankruptcy filing, but the responsible governmental agency does not discover the pollution until after filing.

The trend in the courts has been to adopt a "relationship" test in tort[58] and environmental[59] cases to determine when a claim arises. Under this approach, the debtor and the claimant must have had some relationship, "such as contact, exposure, impact, or privity," at the time the bankruptcy petition was filed. In *Robins*, Rebecca Grady still would have a claim under the relationship test, because she was exposed to the defective product prior to bankruptcy. If she had not yet been exposed, however, she would not have a claim, even if Robins had already engaged in the operative conduct of manufacturing and selling the defective and dangerous product. A variant of the "relationship" test is the "fair contemplation" test, often used in environmental cases, with the operative principle being that the affected governmental unit must have had "fair contemplation" of the fact of the debtor's environmental violation at the time of the bankruptcy filing.[60] If the environmental agency has notice of the pollution, it would have a claim. However, if the government does not have notice of a pollution problem, no claim would have arisen—and the stay would not apply. Thus, unknown pre-bankruptcy pollution by a debtor would not trigger a claim under this view.

A completely different approach to determining when a claim arises for purposes of the stay was adopted by the Third Circuit in the case of *In re M. Frenville Co.*[61] The *Frenville* court linked the time when a bankruptcy claim arises to the time the claim could have been brought under state law. In that case, an accounting firm sued the debtor after bankruptcy as a third-party defendant, seeking contribution or indemnity. The Third Circuit held that the action was not stayed. The court relied on the fact that the accounting firm could not have sued the debtor under state law until after bankruptcy, when the accounting firm itself was sued. The circuit court reasoned that the firm did not have a "right to payment" until its state law claim was ripe. The Third Circuit's approach accordingly has been described as the "accrued state law theory," meaning that a claim only arises when an action has accrued against the debtor under state law. However, the *Frenville* approach has been roundly criticized and finally in 2010 was overruled by the Third Circuit itself in the *Grossman* case.[62] All of the operative facts that gave rise to the contribution or indemnity claim occurred prior to bankruptcy, in connection with the preparation of the debtor's financial statements. Under the federal bankruptcy definition of "claim," that should have been sufficient.

Of course, even if the timing problem is not fatal, the creditor still will only be stayed if it has a "claim." While the legislative history certainly suggests that Congress intended a broad definition, the affected entity still must have a *"right to payment"* in order to have a "claim." Many of the problem cases have involved § 101(5)(B), which

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[58] In re Grossman's, Inc., 607 F.3d 114, 125 (3d Cir. 2010); In re Placid Oil Co., 463 B.R. 803, 815 (Bankr. N.D. Tex. 2012), aff'd, 753 F.3d 151 (5th Cir. 2014).

[59] See, e.g., In re Jensen, 995 F.2d 925 (9th Cir. 1993). See also In re Ritter Ranch Dev., LLC, 255 B.R. 760 (B.A.P. 9th Cir. 2000).

[60] See, e.g., *Jensen*, 995 F.2d 925.

[61] 744 F.2d 332 (3d Cir. 1984), cert. denied, 469 U.S. 1160 (1985), (overruled by In re Grossman's, Inc., 607 F.3d 114 (3d Cir. 2010)).

[62] 607 F.3d 114, 125.

classifies an equitable remedy as a "claim" if there is an alternative right to payment.[63] The courts have had considerable difficulty with the environmental cases.[64] The issue usually is whether an order directing the debtor to clean up polluted property is a "claim." Does the environmental agency have a "right to payment"? Note that even if a cleanup order is classified as a claim initially, the enforcement of the order might be excepted from the stay under § 362(b)(4) as a permissible exercise of the government's police and regulatory powers.[65]

The environmental cases are a mess (so to speak). In *Ohio v. Kovacs*,[66] the Supreme Court held that a cleanup order was a dischargeable claim. In that case, however, the debtor had been dispossessed by a receiver, and could not personally effect the cleanup. The only performance sought from the debtor was the payment of money. Subsequent cases have seized on this fact to distinguish *Kovacs*, and many courts have held that an injunction directing the debtor itself to clean up a site is not a claim that is stayed or dischargeable. As the Second Circuit explained in *In re Chateaugay Corp.*,[67] the governmental environmental agency may not have the option to accept monetary payment from the debtor in lieu of cleaning up. That court did hold, however, that the agency's right to be reimbursed for response costs that it incurs or is likely to incur constitutes a claim. Other courts have been even more reluctant to find any sort of "claim" in the environmental area, thereby permitting the government to ignore both the stay and the discharge.[68]

The prohibition against attempting to collect on prepetition claims is reinforced by § 362(a)(2), which stays "the enforcement, against the debtor or against property of the estate, of a judgment obtained before commencement of the case under this title." Thus, a judgment creditor would be stayed from proceeding with execution and levy against property of the debtor or the estate to enforce the judgment, or from garnishing the debtor's wages. The judgment creditor would have a claim that would be dealt with in the bankruptcy case. If that creditor had obtained a valid and unavoidable judicial lien prior to bankruptcy, then it would be treated as a secured creditor. An exception to the stay permits the enforcement of prepetition judgments other than money judgments by a governmental unit to enforce the government's police or regulatory powers. § 362(b)(4).

§ 3.4 Proceedings Against Debtor

The "breathing spell" for the debtor provided by the automatic stay extends beyond merely freeing the debtor from creditor efforts to collect prepetition debts, although that is the central concern. All entities are also stayed from "the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case." § 362(a)(1).

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[63] See § 7.3.a.

[64] See § 7.3.b.

[65] See § 3.11.

[66] 469 U.S. 274 (1985).

[67] 944 F.2d 997 (2d Cir. 1991).

[68] See, e.g., United States v. Apex Oil Co., 579 F.3d 734 (7th Cir. 2009); In re Torwico Elecs., Inc., 8 F.3d 146 (3d Cir. 1993).

Note that this provision does *not* also require that the proceeding be linked to the collection of a debt. The only requirements are that: (1) it be some form of "proceeding"; (2) it be against the debtor, and (3) it either actually was commenced before bankruptcy or at least could have been brought in that time period. The legislative history makes clear that the sweep of this provision is broad, covering "all proceedings . . . , including arbitration, license revocation, administrative, and judicial proceedings," and that the proceedings need not be before government tribunals."[69] For example, a non-judicial contractual procedure to reduce the number of the debtor's landing slots was held to violate § 362(a)(1).[70]

Sometimes a question arises whether a proceeding is "against" the debtor. The stay does not operate against proceedings "by" the debtor. Many courts have grappled with this issue when the debtor appeals from an adverse judgment in a case commenced before bankruptcy. The resolution is to focus on the status of the debtor as either aggressor or defender at the inception of the case, not whether the debtor is appellant or appellee. If the original action was against the debtor, then the appeal is stayed as a continuation of that action, even if the debtor brings the appeal.[71] This rule applies even when the original action against the debtor was a counterclaim by the creditor, if the appeal is of a judgment on that counterclaim.[72] However, if the debtor brought the original action, the stay does not apply when the debtor later appeals a judgment on the debtor's original claim.[73]

The broad scope of § 362(a)(1), if not qualified by any exclusions, would operate to stay many types of proceedings against the debtor that should not be stayed in the normal course of events. Bankruptcy is not the only show in town; other important societal policies must be implemented, and the filing of a bankruptcy case may sometimes impede the realization of those policies. Accordingly, some of the most important exceptions to the automatic stay in § 362(b) permit certain types of proceedings against the debtor to go forward even if a bankruptcy case is filed. The burden then falls on the debtor to obtain an injunction from the bankruptcy court against the continuation of the excluded proceeding. So, for example, a criminal action against the debtor will go forward even if the debtor files bankruptcy, § 362(b)(1); the state's interest in enforcing its criminal laws is paramount.[74] Many domestic relations matters, such as the establishment of paternity; the establishment or modification of an order for a domestic support obligation; a proceeding concerning child custody or visitation; and a proceeding concerning marriage dissolution, are not stayed. § 362(b)(2)(A). An action by a governmental unit to enforce its police or regulatory powers will not be stayed.[75] § 362(b)(4). Other examples could be given.[76] Thus, to

[69] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 340 (1977); S. Rep. No. 95–989, 95th Cong. 2d Sess., at 50 (1978).

[70] In re Am. Cent. Airlines, Inc. 52 B.R. 567 (Bankr. N.D. Iowa 1985).

[71] E.g., TW Telecom Holdings Inc., v. Carolina Internet Ltd., 661 F.3d 495 (11th Cir. 2011); Ass'n of St. Croix Condominium Owners v. St. Croix Hotel Corp., 682 F.2d 446 (3d Cir. 1982).

[72] E.g., Parker v. Bain, 68 F.3d 1131 (9th Cir. 1995).

[73] E.g., Schoppe v. C.I.R., 711 F.3d 1190 (10th Cir. 2013); Carley Capital Grp. v. Fireman's Fund Ins. Co., 889 F.2d 1126 (D.C. Cir. 1989).

[74] See § 3.10.

[75] See §§ 3.11, 3.12.

[76] E.g., § 362(b)(8), (9), (12)–(16), (22)–(23).

properly understand the scope of the stay, it is crucial to remember that subsections (a) and (b) must be read together.

Also, even if a proceeding is stayed under (a) and is not expressly excepted from the stay under (b), relief from the stay still might be obtained from the bankruptcy court under subsection (d). If the proceeding would not interfere with realization of the goals of the bankruptcy case, the court is likely to grant the requested relief. Indeed, the legislative history contemplates that stay relief should be granted routinely to permit actions to go forward "before specialized or non-governmental tribunals . . . in their place of origin, when no great prejudice to the bankruptcy estate would result."[77] By funneling the matter through the bankruptcy court, though, Congress has given that court the chance to exercise appropriate oversight of all matters affecting the debtor or the estate.

Section 362(a)(8) also stays "the commencement or continuation of a proceeding before the United States Tax Court concerning" the debtor. This prohibition is consistent with the power of the bankruptcy court to determine tax liability under § 505. Subsection (a)(8) was amended in 2005 to distinguish between corporate and individual debtors; as to the former, all actions are stayed regarding the corporate debtor's tax liability for a taxable period the bankruptcy court may determine, whereas with regard to individual debtors, the stay applies only regarding taxable periods that ended prior to bankruptcy. Note that not all governmental actions directed toward tax collection are automatically stayed. Thus, for example, § 362(b)(9) excepts from the stay a tax audit, the issuance of a notice of tax deficiency, a demand for tax returns, or the assessment of a tax.

§ 3.5 Lien Creation, Perfection and Enforcement

Another essential component of the automatic stay is the prohibition against the creation, perfection, or enforcement of liens against property of the estate, § 362(a)(4), or against property of the debtor to the extent the lien secures a prepetition claim. § 362(a)(5). Without this part of the stay, creditors could obtain preferential treatment by converting unsecured claims into secured claims, could obtain early payment on secured claims and possibly undermine a prospective reorganization, could interfere with the bankruptcy court's exclusive jurisdiction over estate property, and could undermine the debtor's discharge.

To illustrate, assume the debtor has three unsecured creditors, A, B, and C, each of whom is owed $10,000, and assume further that the debtor has $15,000 in unencumbered property. Outside of bankruptcy, state collection law gives precedence to the first creditor to act to seize the debtor's property or to obtain a lien against that property. Thus, if Creditor A were able to obtain a judicial lien against the debtor's property, A would have a secured claim, and ultimately would be paid in full, leaving Creditors B and C to divide up the remaining $5,000. Bankruptcy is designed to stop this race of diligence and substitute collective action for the benefit of the entire creditor group. Once the debtor files bankruptcy, Creditor A cannot obtain a lien; in short, the stay serves to freeze the status quo as of the time of the bankruptcy filing.

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[77] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 341 (1977); S. Rep. No. 95–989, 95th Cong., 2d Sess., at 50 (1978).

Note that the stay in § 362(a)(4) and (5) is broad. It applies not only to acts to "*create*" a lien, but also to acts to "*perfect*" or to "*enforce*" a lien. For example, assume that Creditor A in the above example did have a security interest in the debtor's property prior to bankruptcy, but had not yet perfected that security interest when the debtor filed bankruptcy. The automatic stay would prevent A from taking the steps necessary to perfect the security interest after the bankruptcy filing. A's lien would remain unperfected. As such, it could be avoided by the bankruptcy trustee under § 544(a)(1).[78]

Even if Creditor A had a perfected lien prior to bankruptcy, it could not decide to go forward with the enforcement of the lien by foreclosure after bankruptcy. In fact, one of the most common reasons for a bankruptcy filing is to stop an impending foreclosure. While Creditor A would retain its secured status in the bankruptcy case, the bankruptcy court would have to grant A permission to proceed with the enforcement of its lien under § 362(d). The interests of the debtor and the creditor group as a whole might dictate against allowing A to foreclose at once. For example, the collateral subject to A's lien might be necessary to an effective reorganization of the debtor, and it might be possible for the debtor to provide A with adequate protection of A's interest. If so, the stay against foreclosure should be continued. Even if not, the decision to lift the stay is for the court to make, not for the creditor acting in its own self-interest.

The stay against lien enforcement applies even if the creditor has already taken preliminary steps to foreclose its lien, including repossessing the collateral. The Supreme Court established in *United States v. Whiting Pools, Inc.*[79] that a secured creditor who has rightfully repossessed collateral prior to a chapter 11 bankruptcy filing cannot foreclose, and must turn that property over to the debtor in possession.

"*Lien*" is defined broadly in the Code as a "charge against or interest in property to secure payment of a debt or performance of an obligation." § 101(37). This sweeping definition includes consensual liens (i.e., those that arise by agreement, § 101(51)),[80] statutory liens (i.e., those arising solely by force of statute, § 101(53)), and judicial liens (i.e., those arising through the judicial process "by judgment, levy, [or] sequestration," § 101(36)).

The extension of the lien enforcement stay to acts against property of the debtor in § 362(a)(5) is necessary to give full effect to the debtor's discharge. Section 362(a)(4) already stays lien enforcement efforts against estate property. That provision does not help the debtor, however, with regard to property that is not included within the estate, such as property that the debtor acquires after bankruptcy, exempt property, or abandoned property. Section 362(a)(5) thus supplements the reach of (a)(4). The point of the discharge is to prevent attempts by creditors to collect dischargeable debts from the debtor. The discharge is limited to debts that arose prior to bankruptcy. § 727(b). One way to collect a debt is to obtain and enforce a lien against the debtor's property.

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[78] See § 6.3.

[79] 462 U.S. 198 (1983). See § 5.13.

[80] These are defined in the Code as "security interests," § 101(51), but cover all types of consensual liens, including not only Article 9 "security interests" in personal property, but also consensual mortgages in land.

Thus, if a creditor could create or enforce a lien against property of the debtor to collect a prepetition debt, the debtor would lose the benefit of the discharge as to that debt. Section 362(a)(5) forestalls such efforts. Consistent with its purpose of protecting the discharge, § 362(a)(5) only applies to lien enforcement efforts directed at the collection of prepetition debts. For debts that arise after bankruptcy, the debtor receives no special protection because of the pendency of the bankruptcy case.

An important exception to the stay against lien enforcement efforts against the debtor's property is § 362(b)(2)(B), which permits "the collection of a domestic support obligation from property that is not property of the estate." This rule is consistent with the provision that nondischargeable debts for domestic support obligations may be enforced against exempt property. § 522(c)(1).

The lien enforcement provisions of the automatic stay are subject to several other exceptions in § 362(b). Probably the most important in practice is the exception in § 362(b)(3), which allows the postpetition perfection of liens when that perfection has a retroactive effect under non-bankruptcy law.[81] The most common example is a purchase money security interest (PMSI), where Article 9 of the Uniform Commercial Code gives the secured party a grace period within which to perfect the PMSI and still maintain priority over intervening lien creditors. U.C.C. § 9–317(e). If the debtor files bankruptcy during that grace period, § 362(b)(3) permits the secured party to go ahead and perfect its PMSI, and that perfection is given retroactive effect under § 546(b).

Some other exceptions to the stay deserve note. The stay does not apply to the commencement of an action to foreclose a HUD mortgage, if the mortgage was insured under the National Housing Act and covers property consisting of five or more living units. § 362(b)(8). The foreclosure by the Secretary of Transportation of ship mortgages under the Merchant Marine Act is allowed. § 362(b)(12), (13). The 1994 Amendments overruled several cases and added an exception permitting the creation or perfection of an *ad valorem* property tax that comes due after the filing of the petition. § 362(b)(18).

The 2005 amendments added an exception in § 362(b)(20) for the enforcement of a lien against real property following entry of a stay relief order under § 362(d)(4). So too in 2005 did Congress add an exception allowing enforcement of a lien in real property if the debtor is ineligible under § 109(g) or if the case was filed in violation of a prior bankruptcy court order prohibiting a bankruptcy filing. § 362(b)(21). These changes were part of a series of amendments designed to stop abusive serial filing tactics.[82]

§ 3.6 Acts Against Property of the Estate

The filing of a bankruptcy petition automatically creates an "estate." § 541(a). That estate is composed initially of all of the debtor's interests in property as of the date of the bankruptcy filing. § 541(a)(1). The federal court has exclusive jurisdiction of all property of the bankruptcy estate. 28 U.S.C. § 1334(e). One of the core functions of a bankruptcy case is to administer property of the estate in an orderly manner, and to make an equitable distribution of that property to creditors. In order "to prevent dismemberment of the estate" and to ensure that the bankruptcy case "proceed[s] in an

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[81] See § 3.13.

[82] See § 3.16.

orderly fashion,"[83] all entities are stayed from taking "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." § 362(a)(3). An entity that wants to obtain possession of or exercise control over estate property may do so only if given permission by the bankruptcy court. Creditor self-help is prohibited.

The reach of § 362(a)(3) is quite broad. To begin with, "any act" regarding estate property is stayed. Furthermore, property of the estate is broadly defined in § 541(a).[84] In addition, the stay applies not only to acts to obtain possession of property of the estate, but also to acts to "exercise control over" estate property. Finally, the stay reaches acts to obtain property "from" the estate, even if that property does not belong to the estate, but is only in the possession of the estate.

The stay against interfering with estate property in § 362(a)(3) goes hand-in-hand with other provisions of the Bankruptcy Code dealing with estate property. Entities in possession of property of the estate must turn that property over to the bankruptcy trustee. §§ 542, 543. The trustee then may use, sell, or lease that property in the bankruptcy case, subject to the obligation to provide adequate protection to parties with an interest in the property. § 363. If the trustee cannot provide adequate protection, then the entity with an interest is entitled to relief from the automatic stay. § 362(d)(1). If the trustee does not perceive any benefit to the bankruptcy process to continue administering the property, the trustee may abandon the property. § 554.

These statutory interactions have generated substantial controversy in the following common scenario. Prior to bankruptcy, following a default by debtor, creditor lawfully repossesses collateral (often an automobile) from the debtor. After debtor files bankruptcy (typically a reorganization chapter, often chapter 13), debtor demands immediate return of the property. Creditor says it will gladly turn the property over—just as soon as it receives the "adequate protection" to which it is entitled. Until then, though, creditor says it will maintain the status quo by holding onto the collateral. Is creditor's refusal to turn over the collateral in this situation and on those terms a violation of the stay under § 362(a)(3)?

Most courts that have considered the issue hold—wrongly, I believe—that the creditor has violated the stay by withholding possession.[85] These courts reason that the creditor violates § 362(a)(3) by exercising control over property of the estate. The fact that creditor already has possession when bankruptcy is filed precludes any argument that the creditor has violated the stay under § 362(a)(3) by an act "to obtain possession" of property. But what about the "exercise control over property" clause, which Congress added to the Code in 1984? While that seems to be a plausible basis for finding a stay violation on these facts, one difficulty is identifying what constitutes the "property" over which the creditor supposedly is wrongfully exercising control. The answer cannot simply be "the collateral." Why not? Because the creditor is *rightfully in possession* of

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[83] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 341 (1977).

[84] See §§ 5.2, 5.3.

[85] A leading case adopting the majority view is *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009). For one of the best presentations of the arguments pro and con (in the majority and dissent), see TranSouth Fin. Corp. v. Sharon (In re Sharon), 234 B.R. 676 (B.A.P. 6th Cir. 1999). See also In re Weber, 719 F.3d 72 (2d Cir. 2013); Unified People's Fed. Credit Union v. Yates (In re Yates), 332 B.R. 1 (B.A.P. 10th Cir. 2005). Contra In re Young, 193 B.R. 620 (Bankr. D.D.C. 1996).

the collateral when bankruptcy is filed. Of the proverbial property "bundle of sticks," at least one stick—possession—belongs to the creditor at the time of filing. Courts who rule against the creditor on these facts conclude, however, based on some loose dictum in the Supreme Court's decision in *United States v. Whiting Pools, Inc.*,[86] that upon the filing of the bankruptcy case, the turnover provision in § 542(a) gives the bankruptcy estate—not the creditor—the possessory interest in the collateral. With the creditor's possessory right thereby supplanted, these courts reason, continued retention of possession by the creditor violates the stay. In sum, these courts hold that the creditor's turnover obligation is immediate and self-executing once bankruptcy is filed.

The problem with this reasoning is that it completely ignores the central role of "adequate protection" in the Code's scheme. When the *Whiting Pools* court stated that § 542(a) gives the estate a possessory interest, it did so on the clear understanding that the *quid pro quo* for turnover is the provision of adequate protection to the to-be-dispossessed creditor.[87] Properly read, § 542(a) is *not* self-executing; adequate protection must be provided in exchange for turnover. In effect, turnover and adequate protection are contemporaneous conditions for each other. Section 542(a) says only that an entity must turn over "property that the trustee may use . . . under section 363," and under § 363, in turn, the trustee may only use property in which a party has a lien on the condition that the trustee afford the lienholder "adequate protection" of its lien interest. § 363(e). Once a court determines that adequate protection has been offered, then, and only then, must the creditor turn over the property.[88] To hold that a secured creditor must turn over rightfully repossessed collateral immediately upon the filing of the petition, before it is given adequate protection, negates the creditor's adequate protection rights and undermines the Code's carefully drawn balance of power between a secured creditor and the debtor.[89]

In addition to the situation just discussed, the breadth of the (a)(3) stay can be seen by looking at some other examples. Consider the case where the debtor holds a leasehold interest in property. When the debtor files bankruptcy, the non-debtor lessor is stayed from taking any act to terminate that lease or to retake possession of the leased property. This is true even if the debtor is in default on the lease and the lessor would have the right outside of bankruptcy to terminate the lease and evict the debtor.

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[86] 462 U.S. 198 (1983). The Supreme Court stated: "In effect, § 542(a) grants to the estate a possessory interest in certain property of the debtor that was not held by the debtor at the commencement of reorganization proceedings." Id. at 207. The Court's holding, though, emphasized that the secured creditor was entitled to adequate protection in exchange for possession. See § 5.13.

[87] Indeed, in the very next sentence after the always-quoted sentence in note 86, supra, the Supreme Court went on to say: "The Bankruptcy Code provides secured creditors various rights, including the right to adequate protection, and these rights replace the protection afforded by possession." 462 U.S. at 207.

[88] The estate's property interest in possession arises under § 541(a)(7) following a turnover order under § 542(a). Technically, then, the Supreme Court's broad statement that § 542(a) grants a possessory interest to the estate is at best incomplete and at worst mischievously misleading. While that loose statement made no difference in the *Whiting Pools* case itself, it has led subsequent courts to misapply § 362(a)(3) in the context discussed in the text.

[89] The difficulties with the majority view are underscored by the fact that after turnover, the secured creditor could move immediately for relief from the stay on the ground that it is entitled to adequate protection, § 362(d)(1), and the court must grant stay relief—and give the collateral back to the secured creditor!—if adequate protection is not provided. It makes more sense to read these various provisions together and make a single decision up front whether to compel turnover and what sort of adequate protection to require in return.

That leasehold may be a valuable property right. The bankruptcy trustee is afforded an opportunity to evaluate the worth of that leasehold to the estate and to take appropriate steps to capture that value for the estate. The lessor's remedy is to petition the bankruptcy court for relief from the stay—not to act unilaterally. The stay applies under (3) even if the debtor at the time of bankruptcy holds only a tenancy by sufferance.[90] The Second Circuit has held that the stay even applies to prevent a non-debtor lessor from terminating the lease of a non-debtor prime tenant, when doing so would adversely affect the interests of the debtor subtenant.[91]

If the debtor's property interest has been finally and completely terminated prior to the bankruptcy filing, the stay will not apply.[92] In that event, there is no interference with "property of the estate." All steps necessary to termination must have been completed prior to bankruptcy, however. Even then, the non-debtor party will be stayed from taking possession of property back from the debtor, but should be able to obtain relief from the stay in order to do so.

Some exceptions apply to leases. For a lease of nonresidential real property, § 362(b)(10) excepts from the stay "any act by a lessor . . . under a lease . . . that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property." Note that this stay exception applies only to commercial leases, and only when the lease terminated by expiration of the stated term. For residential leases, two exceptions were added in 2005. Under § 362(b)(22), the lessor can continue an eviction action if it obtained a judgment for possession of the premises prior to bankruptcy. This right, in turn, is subject to an exceedingly detailed provision in § 362(*l*), also added in 2005, which spells out very specifically the operative dates, procedures, and rights of the lessor and debtor.[93] The second personal property lease exception, also new in 2005, permits the lessor to pursue eviction based on endangerment to the premises or the illegal use of controlled substances on the property. § 362(b)(23). Again, this exception is subject to a detailed provision covering the procedures to be followed and the rights of the lessor and debtor. § 362(m).

A situation that has generated controversy is whether the stay applies under § 362(a)(3) to prevent a non-debtor from terminating or cancelling a contract with the debtor. To give one example, the debtor may at the time of filing have an insurance policy in force, and the insurance company may seek to cancel the policy on the giving of notice, in accordance with the terms of the contract. Most courts have held that cancellation of a contract with the debtor, even as authorized by the contract, is stayed.[94] Their reasoning is that the debtor's contract rights are a form of property and that cancellation of the contract would deprive the debtor of that property. If the non-debtor wishes to enforce its termination rights, it must do so with the blessing of the

[90] In re Atlantic Bus. & Cmty. Corp., 901 F.2d 325 (3d Cir. 1990).

[91] In re 48th St. Steakhouse, Inc., 835 F.2d 427 (2d Cir. 1987), cert. denied, 485 U.S. 1035 (1988).

[92] E.g., In re Mann, 907 F.2d 923 (9th Cir. 1990); Boone Coal & Timber Co. v. Polan, 787 F.2d 1056 (6th Cir. 1986).

[93] Indeed, one wonders why Congress felt impelled to legislate so specifically on this matter rather than leaving the administration of the dispute to the sound discretion of the bankruptcy judge.

[94] See, e.g., In re Computer Commc'ns, Inc., 824 F.2d 725 (9th Cir. 1987); In re Minoco Grp. of Cos., 799 F.2d 517 (9th Cir. 1986).

bankruptcy court. Care must be taken by the bankruptcy court in these cases not to give the bankruptcy estate greater rights in the contract than the debtor would have had outside of bankruptcy. As discussed below, an important question in the insurance policy cases is whether the estate or debtor has any property interest in the proceeds of the policy; if not, then the stay will not apply.[95]

If the termination of the contract is automatic and self-executing, without the need for any action by the non-debtor party, the stay will not prevent that termination.[96] In that situation, there is no "act" to be stayed. Furthermore, the automatic termination provision limits the extent of the property interest held by the estate. Note, however, that special rules applicable to executory contracts and leases in § 365 will override certain contractual termination provisions that are contrary to bankruptcy policy, such as clauses that would terminate the contract if the debtor files bankruptcy. See § 365(e)(1). Apart from those special rules, however, the general principle applies that the estate only succeeds to the rights that the debtor had. In one case, for example, the First Circuit held that the FAA did not violate the stay when it terminated the debtor airline's right to landing slots, when it did so in accordance with mandatory federal rules governing the use and allocation of those landing slots.[97]

Courts have been quite willing in borderline cases to find that the non-debtor party has committed an "act" with regard to estate property. The stay applies even if the non-debtor did not act coercively; for example, a creditor that merely accepted a voluntary postpetition payment of estate funds by the debtor was held to have violated the stay.[98] Courts have not permitted creditors to "hold" funds of the debtor.[99] This rule has even been applied when the creditor implemented the hold prior to the bankruptcy filing; the passive continuation of the hold was held to violate the stay.[100]

Often the inquiry in cases assessing whether the stay has been violated under § 362(a)(3) turns on whether the estate has an interest in property that is affected by the creditor's actions. This determination depends on the application of § 541(a). The courts in this area have also resolved close calls in favor of the application of the automatic stay. If the estate's interest is very remote, then relief can be granted by the court or adequate protection can be awarded with little difficulty.

Many cases have addressed the question of whether creditors can continue to pursue actions against non-debtor insurance companies on insurance policies held by the debtor. This issue has been of great importance in mass tort cases. The courts usually find that the stay is applicable, reasoning that the insurance policy is a valuable asset of the estate, and that some creditors should not be allowed to deplete

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[95] In re Pintlar Corp., 124 F.3d 1310 (9th Cir. 1997).

[96] E.g., Hazen First State Bank v. Speight, 888 F.2d 574 (8th Cir. 1989); Cntys. Contracting & Constr. Co. v. Constitution Life Ins. Co., 855 F.2d 1054 (3d Cir. 1988).

[97] In re Gull Air, Inc., 890 F.2d 1255 (1st Cir. 1989).

[98] In re Germansen Decorating, Inc., 149 B.R. 517 (Bankr. N.D. Ill. 1992). Contra In re Anderson, 511 B.R. 481, 495 (Bankr. S.D. Ohio 2013) ("[N]o ivolation of the automatic stay occurs when a debtor voluntarily transfers estate property to a creditor.").

[99] SBA v. Rinehart, 887 F.2d 165 (8th Cir. 1989).

[100] Knaus v. Concordia Lumber Co. (In re Knaus), 889 F.2d 773 (8th Cir. 1989). See also In re Weber, 719 F.3d 72 (2d Cir. 2013).

the pool of money available under that policy to the detriment of all other creditors.[101] However, as noted above, if neither the debtor nor the estate has a direct interest in the proceeds of the policy, then the stay is not applicable.[102]

In a similar vein, creditors have not been allowed in their individual right to pursue causes of action against third parties that would be available to the estate. The potential recovery under that cause of action belongs to the estate. Examples where this issue arises include fraudulent conveyance claims[103] and corporate alter ego actions.[104]

Actions by creditors against third parties are not stayed, however, if the action does not affect estate property. For example, most courts have permitted creditors who are beneficiaries of a letter of credit to make a draw on the credit against the issuing bank even after the debtor-customer files bankruptcy.[105] The letter of credit is a separate contract, independent of the underlying debt between the debtor and creditor, and the property being claimed by the creditor-beneficiary is that of the non-debtor issuing bank, not that of the debtor's estate.

§ 3.7 Setoffs, Freezes and Recoupment

One of the most powerful state law remedies of a creditor is the right of setoff. The right of setoff exists when the creditor and the debtor owe mutual debts to each other. The most common example involves a bank-creditor and a customer-debtor, where the customer has a checking account at the bank and has also taken out a loan from the bank. The bank owes a debt to the customer in the amount of the balance in the checking account; the customer owes a debt to the bank for the unpaid loan balance. If the debtor defaults on the loan, the bank may exercise its setoff right simply by deducting the loan balance due from the amount owing on the checking account. For example, if the debtor has $5,000 in the checking account, and defaults on a $8,000 loan, the bank may setoff the checking account debt against the loan, leaving a balance of $3,000 due on the loan and reducing the checking account to zero.

The Bankruptcy Code has several interrelated provisions that deal with the effect of the setoff right in bankruptcy cases. As a starting premise, the right of setoff is preserved in bankruptcy. § 553(a). Furthermore, the creditor is deemed to have a secured claim in the bankruptcy case in the amount subject to setoff. § 506(a)(1). In the example given above, prior to setoff the creditor would have a $5,000 secured claim and a $3,000 unsecured claim. The checking account is in effect collateral for the loan. A creditor with a setoff right may assert that right as a defense to turnover under § 542(b); in our example, the bank would not have to pay over $5,000 of the balance in the checking account to the bankruptcy trustee. In addition, when the "collateral" subject to the setoff right is a cash equivalent, such as a bank account, special rules

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[101] See, e.g., A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir. 1986), cert. denied, 479 U.S. 876 (1986); In re Johns-Manville Corp., 40 B.R. 219 (S.D.N.Y. 1984).

[102] See *Pintlar*, 124 F.3d 1310.

[103] E.g., In re Sherk, 918 F.2d 1170 (5th Cir. 1990).

[104] E.g., In re S.I. Acquisition, Inc., 817 F.2d 1142 (5th Cir. 1987). A useful discussion can be found in *Baillie Lumber Co. v. Thompson (In re Icarus Holding, LLC)*, 391 F.3d 1315 (11th Cir. 2004).

[105] E.g., In re Prime Motor Inns, Inc., 130 B.R. 610 (S.D. Fla. 1991). But see In re Twist Cap, Inc., 1 B.R. 284 (Bankr. M.D. Fla. 1979) (court enjoined draw on letter).

limit the bankruptcy trustee's ability to use that "cash collateral." § 363(c)(2). The trustee may use cash collateral only with the creditor's consent or with permission of the bankruptcy court, which will only be granted if the creditor is afforded "adequate protection." § 363(e).

The provisions just noted all favor the creditor. As a policy matter, this pro-creditor outcome is somewhat controversial, because the creditor is effectively preferred over other creditors to the extent of the setoff right.[106] To illustrate, assume in our example that unsecured creditors will be paid a 25% dividend in the bankruptcy case. If the bank's setoff right were not honored, the bank would receive $2,000 (25% of $8,000). With the setoff right intact, the bank will receive $5,750 (the $5,000 subject to setoff, plus 25% of the remaining $3,000). In short, the creditor with a setoff right is paid in full to the extent of that right, instead of the percentage dividend payable to general creditors. As a policy matter, the Supreme Court decreed long ago that this result should be permitted in order to avoid "the absurdity of making A pay B when B owes A."[107]

In certain important respects, the setoff right is restricted in bankruptcy. Some of these limitations are discussed later in the book.[108] For example, a creditor may not exercise or obtain a setoff right in the time period shortly prior to the bankruptcy case so as to improve its position vis-à-vis other creditors. § 553(a)(2),(3), (b).

For purposes of this chapter, the important limitation on the creditor's freedom of action is that the creditor is stayed from "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." § 362(a)(7). In our ongoing example, while the bank would retain its setoff right after the debtor files bankruptcy, the bank would be stayed from actually effectuating that setoff. If the bank wants to set off, it must obtain relief from the stay. This limitation is consistent with the treatment of other secured claims in bankruptcy. The secured creditor thus retains the benefit of its lien or setoff right, but is stayed from enforcing that lien or setoff "pending an orderly examination of the debtor's and creditor's rights."[109]

The most difficult question under § 362(a)(7) has been determining whether the stay applies to an administrative "freeze" or "hold" of the debtor's checking account by the bank. The issue arises when the debtor seeks to withdraw money from the checking account or a check drawn on the account is presented after the bankruptcy petition is

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[106] See John C. McCoid, II, Setoff: Why Bankruptcy Priority?, 75 Va. L. Rev. 15 (1989). Professor McCoid, as always, captured the problem precisely:

> Between solvent parties, setoff makes perfect sense. If you owe me $10 and I owe you $7, it is certainly efficient for you simply to pay me $3; it also avoids the possibility of my default after you have paid what you owe me. Striking that balance affects no one else. If, however, one of us is insolvent and has other creditors, the sense of this solution is less obvious. It is hardly news that setoff, whether it takes place postbankruptcy or in the period immediately preceding bankruptcy, is preferential in effect. A creditor who owes money to his debtor receives, to the extent of the debtor's claim against him, 100 cents on the dollar from his claim against the debtor, while other creditors receive less.

Id. at 15.

[107] Studley v. Boylston Nat'l. Bank, 229 U.S. 523, 528 (1913).

[108] See §§ 6.27–6.28.

[109] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 342 (1977).

filed. The problem for the bank is that it will lose its setoff right if the money is released; the right of setoff under state law continues only to the extent mutual debts are still owing between the creditor and debtor. Note also that the "cash collateral" in the account may not legally be used without the consent either of the bank or the bankruptcy court. The response of many banks in this situation has been to freeze the account, and not to honor any checks drawn on the account or to permit any monies to be withdrawn. The bank does not actually effect the setoff; the prior balance in the account remains outstanding, but may not be accessed without court permission. By taking this action the bank preserves its right of setoff—but, until 1995, it also ran the risk of violating the stay; thus, courts described this scenario as the "banker's dilemma."

Before 1995, one line of cases had held that the bank violated the stay by freezing the debtor's account.[110] A similar issue arose in cases where the IRS refused to refund a debtor's tax overpayment.[111] These courts reasoned that the bank's unilateral action in placing a hold on the account was "tantamount to the exercise of a right of setoff"[112] that "effectively deprives the debtor of the use of the funds." Furthermore, they concluded that the bank's action was an exercise of control over estate property, in violation of § 362(a)(3). The bank's proper recourse was to apply to the bankruptcy court for emergency relief from the stay or for an injunction against the debtor. A competing line of authority held that the bank's action in placing a hold on the debtor's account did not amount to a setoff and did not violate the stay.[113]

In 1995 the Supreme Court settled the issue in favor of the banks in *Citizens Bank of Maryland v. Strumpf*,[114] holding that an administrative freeze did not violate the stay. In a unanimous opinion, the Court held that the freeze was not a "setoff" as typically understood under state law, because the bank did not intend to permanently reduce the debtor's account balance by its actions. Thus, the § 362(a)(7) stay did not apply by its terms. The Court further stated that federal law determines whether a "setoff" has occurred under § 362(a)(7), and dictates the same conclusion—that a freeze is not a setoff. This result is necessary to give effect to other sections of the Code, which excuse a creditor from paying over a debt subject to setoff, § 542(b), and which recognize the general right of setoff. § 553(a). The Court also could have pointed to the prohibition against the debtor using cash collateral without permission, § 363(c)(2), and to the treatment of the setoff right as a secured claim. § 506(a)(1). The Court likewise declined to find that the bank had violated either § 362(a)(3) or (6), concluding that the bank had not exercised control over any "property" of the debtor, but had simply refused to perform a promise to pay a debt. In *Strumpf*, the Court did not decide how long the bank could leave the freeze in place, emphasizing that the hold there was only temporary, until the bank could seek relief from the stay from the bankruptcy

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[110] E.g., In re Patterson, 967 F.2d 505 (11th Cir. 1992).

[111] E.g., United States v. Norton, 717 F.2d 767 (3d Cir. 1983).

[112] Citizens Bank of Maryland v. Strumpf, 37 F.3d 155, 158 (4th Cir. 1994), rev'd, 516 U.S. 16 (1995).

[113] E.g., In re Edgins, 36 B.R. 480 (B.A.P. 9th Cir. 1984).

[114] 516 U.S. 16 (1995).

court. Courts applying *Strumpf* accordingly have held that while a temporary hold is permissible, an indefinite freeze violates the stay.[115]

The stay against setoff only applies to *prepetition* debts. If the debts both arise postpetition, the creditor will not be stayed from exercising its right of setoff. Applying this rule in practice will require the courts to identify the time the debts arise. In making that identification, courts should remember that a debt is deemed to exist for purposes of the Bankruptcy Code even if the right to payment is "unliquidated," "contingent," "unmatured," or "disputed," § 101(5), and that Congress intended to bring "all legal obligations of the debtor, no matter how remote or contingent"[116] within the purview of the bankruptcy case.

The stay under § 362(a)(7) will not apply if the creditor is asserting a right of "*recoupment*" on a claim.[117] Recoupment is distinguishable from setoff in that in recoupment the debts must arise out of the *same transaction*. Courts have narrowly construed the doctrine of recoupment in bankruptcy because of the concern that the creditor will obtain an advantage over other creditors.[118] An example of recoupment is where the creditor makes advance payments on a contract, and the debtor later asserts rights under the same contract. Under the equitable doctrine of recoupment, the creditor is allowed to raise its prior payments as a defense to the debtor's claim. In one case, for instance, advance royalties were paid to a musician before the musician filed bankruptcy.[119] After bankruptcy, the sale of records generated a claim for royalties by the musician's bankruptcy estate. The recording company was permitted to recoup the advance royalties paid against the claim for subsequent royalties. A common recoupment scenario arises in the Medicare context, involving health care providers whose relationship with the federal government involves ongoing Medicare reimbursements and credits. Most courts have allowed the government to recoup in this setting.[120]

Several exceptions to the stay under subsection (b) permit setoff in specific narrowly defined situations. § 362(b)(6), (7), (17), (26), (27). Virtually all of these exceptions concern sophisticated financial contracts, and were enacted by Congress to ensure the integrity of those financial markets and to protect the participants. Thus, for example, subsection (b)(6) permits setoff in the case of securities contracts (see also § 555) and commodities and forward contracts (see also § 556). Subsection (7) allows setoff for repurchase agreements (see also § 559). Setoff under swap agreements (see also § 560) is covered by subsection (b)(17). In 2005 Congress added a provision, § 362(b)(27), allowing setoff under master netting agreements (see also § 561).

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[115] See, e.g., In re Kleinsmith, 361 B.R. 504 (Bankr. S.D. Iowa 2006) (stay violated when creditor maintained hold on debtor's account for a year and a half after the bankruptcy filing and never sought stay relief to pursue setoff).

[116] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 309 (1977).

[117] See, e.g., In re Slater Health Ctr., Inc., 398 F.3d 98 (1st Cir. 2005); In re Holford, 896 F.2d 176 (5th Cir. 1990); In re B & L Oil Co., 782 F.2d 155 (10th Cir. 1986).

[118] See, e.g., Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138 (2d Cir. 2002) (denying recoupment obligations arising from discrete and independent units in single contract).

[119] Waldschmidt v. CBS, Inc., 14 B.R. 309 (M.D. Tenn. 1981).

[120] E.g., *Slater Health Center*, 398 F.3d 98. Contra In re Univ. Med. Ctr., 973 F.2d 1065 (3d Cir. 1992).

The final stay exception allowing setoff was also added in 2005, and permits the government to set off an income tax refund pertaining to a pre-bankruptcy taxable period against a pre-bankruptcy income tax liability. § 362(b)(26). This last exception mooted the controversy over whether the government's "hold" of a refund violated the stay, as discussed above. Now the government is free to proceed with setoff.

§ 3.8 Catch-All Provision

The intention of Congress to implement a pervasive stay against all conceivable creditor collection efforts is demonstrated by § 362(a)(6), which stays "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title." The legislative history to the Code emphasizes the congressional concern that "sophisticated creditors" might take advantage of "inexperienced, frightened, or ill-counseled debtors" and coerce them into repaying dischargeable debts, thus evading the purpose of bankruptcy to afford debtors a fresh start.[121] Subsection (6) responds to this concern by staying all formal and informal actions to collect prepetition debts. Courts have broadly construed this catch-all provision.

Most fundamentally, § 362(a)(6) fills a useful gap by outlawing informal collection efforts, such as dunning letters or phone calls demanding payment of prepetition debts. Creditors must leave the debtor alone once the debtor files bankruptcy. This freedom from harassment gives the debtor the "breathing spell" from his or her creditors that Congress viewed as a central purpose of the automatic stay.

This prohibition against even informal contact with the debtor raises a problem of coordination with other provisions that bear on the scope of the debtor's fresh start. A debtor is permitted to repay voluntarily an otherwise dischargeable debt. § 524(f). Thus, if the debtor makes a voluntary payment, the creditor may keep the money without violating the Bankruptcy Code. Even more saliently, a debtor is allowed to reaffirm a dischargeable debt, subject to certain procedural limitations. § 524(c), (d). The debtor's promise to pay a reaffirmed debt is enforceable by the creditor notwithstanding the discharge.

Given these provisions, may the creditor contact the debtor and request either voluntary payment or reaffirmation? Reading § 362(a)(6) literally, and taking to heart its underlying purposes as expressed in the legislative history, the answer should be no; to avoid a stay violation the initiative must come from the debtor. Otherwise, "[i]nexperienced, frightened, or ill-counseled debtors may succumb to suggestions to repay notwithstanding their bankruptcy," thereby allowing "evasion of the purpose of the bankruptcy laws by sophisticated creditors."[122] Many courts, however, have found no stay violation if the creditor "merely" sends a request (typically in a standard form letter) for reaffirmation. Instead, these courts require something more, such as a threat, coercion or harassment.[123] These holdings are in line with a broader, and I believe regrettable, trend to read § 362(a)(6) not as a prohibition of all contact between

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[121] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 342 (1977).

[122] Id.

[123] See, e.g., Pertuso v. Ford Motor Credit Co., 233 F.3d 417 (6th Cir. 2000); In re Duke, 79 F.3d 43 (7th Cir. 1996).

creditor and debtor, but only to prevent specific harassment.[124] Furthermore, even if the contact were of the type that might otherwise violate the stay if made directly with the debtor, some courts have held that a creditor does not violate the stay if it contacts the debtor's attorney, rather than the debtor.[125]

Courts also have struggled in applying § 362(a)(6) in situations where the creditor has the power to exert leverage against the debtor, by engaging in otherwise legal behavior that might coerce the debtor into repaying a dischargeable debt. For example, what happens if a physician that has not been paid by the debtor declines to provide further treatment;[126] or if a key supplier refuses to ship more goods to the debtor;[127] or a university withholds the debtor's transcript?[128] In each instance the creditor is acting within its legal rights to refuse to provide the item sought. Yet, if the debtor were to pay the unpaid debt, one suspects that the physician might resume treatment, the supplier might ship goods, and the university might release the transcript. Faced with this situation, courts have attempted to divine the creditor's motive in asserting its legal rights. If the court believes that the creditor is trying to coerce payment of the prepetition debt, the court will hold that the creditor has violated the automatic stay. Furthermore, the court may even order the creditor to provide the goods or services requested by the debtor on a current basis.[129] If, however, the court takes a more benign view of the creditor's motives, it may find no stay violation.[130]

In some cases creditors have given vent to their anger at the debtor's default, and have engaged in conspicuous conduct and speech condemning the debtor's default. By so indulging themselves, the creditors may violate the stay under (a)(6)—although pure speech may find constitutional protection in the First Amendment. In *In re Reed*,[131] Judge Mabey held that an unpaid creditor violated the stay when he dumped garbage on the debtor's lawn. The court in *In re Sechuan City, Inc.*[132] similarly condemned the actions of the creditor in posting signs in the hotel lobby proclaiming that the debtor restaurant was a deadbeat and urging people not to patronize it. The evidence showed that the creditor hoped to embarrass and humiliate the debtor into paying the debt. The court did not believe that actions by the creditor that contravened § 362(a)(6) fell within the ambit of speech protected by the First Amendment. In another case, however, where the creditor parked a display truck outside the debtor's business making a similar "deadbeat" announcement, the court held that the creditor's "speech" was constitutionally protected.[133]

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[124] See, e.g, In re Connor, 366 B.R. 133 (Bankr. D. Haw. 2007) (no stay violation by sending monthly loan statements while debtor in chapter 13, but violation occurred once debtor converted to chapter 7).

[125] See United States ex. rel. Farmers Home Admin. v. Nelson, 969 F.2d 626 (8th Cir. 1992).

[126] In re Olson, 38 B.R. 515 (Bankr. N.D. Iowa 1984).

[127] In re Sportfame of Ohio, Inc., 40 B.R. 47 (Bankr. N.D. Ohio 1984).

[128] In re Walker, 336 B.R. 534 (Bankr. M.D. Fla. 2005); In re Merchant, 958 F.2d 738 (6th Cir. 1992). See also In re Aleckna, 494 B.R. 647 (Bankr. M.D. Pa. 2013); In re Parker, 334 B.R. 529 (Bankr. D. Mass. 2005).

[129] For a strong criticism of such judicial activism, see Daniel Keating, Offensive Uses of the Bankruptcy Stay, 45 Vand. L. Rev. 71 (1992).

[130] E.g., In re Jamo, 283 F.3d 392 (1st Cir. 2002); In re Brown, 851 F.2d 81 (3d Cir. 1988).

[131] 11 B.R. 258 (Bankr. D. Utah 1981).

[132] 96 B.R. 37 (Bankr. E.D. Pa. 1989).

[133] In re Stonegate Sec. Serv., Ltd., 56 B.R. 1014 (N.D. Ill. 1986).

§ 3.9 Application to Nondebtor Parties

The automatic stay does not normally apply to actions against nondebtor parties. Section 362(a)(1), for instance, stays actions "against the debtor," and § 362(a)(6) stays any act to collect a prepetition claim "against the debtor." The purposes of the stay, to protect the debtor from harassment and to preserve the property of the estate to permit an orderly distribution, are not typically implicated by proceedings against a nondebtor.

Thus, the stay will not apply to a suit against nondebtor general partners of a debtor partnership.[134] Nor will the stay stop actions versus guarantors of a debt of the debtor. A lawsuit brought initially against multiple defendants, including the debtor, may still proceed against the nondebtor co-defendants after the debtor files bankruptcy.[135] A beneficiary is permitted to make a draw against the issuer of a letter of credit after the debtor-customer files bankruptcy.[136] Similarly, a proceeding against a surety of the debtor may continue unless affirmatively enjoined by the court.[137]

In very limited circumstances, however, actions against nondebtors may be stayed. One such situation is where there is an "identity of interest" between the nondebtor and the debtor. Stated otherwise, if the debtor should be considered the real party in interest, the action nominally against the nondebtor but effectively against the debtor should be stayed. The most prominent example is the case of *A.H. Robins Co. v. Piccinin.*[138] The Fourth Circuit held that the stay applied to actions against third parties who were entitled to indemnification from the debtor.[139] Other courts have made clear that this exception does not apply if the third party is independently liable, but only if their liability is derivative of the debtor.[140] The Second Circuit has held that "[t]he automatic stay can apply to non-debtors, but normally does so only when a claim against the non-debtor will have an immediate adverse economic consequence for the debtor's estate."[141]

A second exception to the general rule is in cases where the action against the third party will interfere with property of the bankruptcy estate or the debtor. In such a situation, the stay under § 362(a)(3) will be operative.[142] In the *Robins* case, the court

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[134] E.g., Patton v. Bearden, 8 F.3d 343 (6th Cir. 1993).

[135] E.g., In re Delta Air Lines, 310 F.3d 953 (6th Cir. 2002); Lynch v. Johns-Manville Sales Corp., 710 F.2d 1194 (6th Cir. 1983).

[136] E.g., In re Prime Motor Inns, Inc., 130 B.R. 610 (S.D. Fla. 1991).

[137] Two circuit courts reached the conclusion that the automatic stay did not apply to the action against the surety in the *Celotex Corp.* case. See Willis v. Celotex Corp., 978 F.2d 146 (4th Cir. 1992), cert. denied, 507 U.S. 1030 (1993); Edwards v. Armstrong World Indus., Inc., 6 F.3d 312 (5th Cir. 1993), rev'd on other grounds, 514 U.S. 300 (1995). Those courts parted company on the appropriateness of the injunction, on the bankruptcy court's jurisdiction to issue the injunction, and on the permissibility of collaterally attacking the injunction order; the Supreme Court sided with the Fourth Circuit and prohibited the collateral attack.

[138] 788 F.2d 994 (4th Cir.), cert. denied, 479 U.S. 876 (1986).

[139] Id. at 999. The Fourth Circuit reaffirmed this exception in *Kreisler v. Goldberg*, 478 F.3d 209 (4th Cir. 2007).

[140] See In re Lockard, 884 F.2d 1171 (9th Cir. 1989).

[141] Queenie, Ltd. v. Nygard Int'l., 321 F.3d 282, 287 (2d Cir. 2003) (stay applies when suit is against wholly owned subsidiary of debtor).

[142] See § 3.6.

further held that a suit against a nondebtor insurer was stayed because the insurance policy itself was property of the estate.[143] An action to terminate the lease of a nondebtor prime tenant was held to be stayed in another case, where the effect would have been to terminate the debtor's sublease.[144] Where the debtor makes a fraudulent conveyance to a third party, creditors may not pursue the third party after bankruptcy, because the fraudulent conveyance cause of action is property of the bankruptcy estate.[145]

In cases under chapter 12 and chapter 13, a direct statutory stay of actions against codebtors is provided with regard to consumer debts.[146] § 1201, 1301. The purpose of the codebtor stay in these consumer cases is to "protect a debtor . . . from indirect pressures" from his creditors.[147] A debtor whose elderly grandmother has cosigned his note on a consumer debt might go ahead and pay the creditor in order to keep the creditor from hounding grandma; the codebtor stay stops the action against grandma during the bankruptcy case. However, the creditor "does not lose the benefit of his bargain"; after the bankruptcy case, or if the creditor can obtain relief from the stay, the creditor may pursue its substantive rights against the codebtor.

Even if the automatic stay of § 362(a) does not apply to the action against the nondebtor third party, the bankruptcy court still may issue an injunction against such a proceeding under its general equitable powers under § 105(a). The Supreme Court observed in *Celotex Corp. v. Edwards* that the bankruptcy court has jurisdiction to issue such an injunction if the injunction could have a "*conceivable effect*" on the bankruptcy case.[148] In *Celotex*, the bankruptcy court had issued an injunction prohibiting creditors from executing on supersedeas bonds against independent sureties, on the ground that execution would have an adverse effect on the debtor's reorganization. Other courts have also upheld third-party injunctions premised on the need to protect the debtor's chances of reorganizing under chapter 11.[149] This interference with the rights of one nondebtor against another nondebtor should not be ordered, however, except in "unusual circumstances" where the benefit to the reorganization clearly outweighs the detriment to the enjoined party.

C. SCOPE OF THE STAY: ACTS EXCEPTED UNDER § 362(b)

§ 3.10 Criminal Actions Against Debtor

Not all actions that fall within the ambit of § 362(a) are automatically stayed. Ascertaining whether the stay applies also requires consulting § 362(b), which specifies a long list of exceptions to the stay. If an action is excepted from the stay under any of the provisions of subsection (b), the burden is on the debtor to obtain an injunction

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[143] *Robins*, 788 F.2d at 1001.

[144] In re 48th St. Steakhouse, Inc., 835 F.2d 427 (2d Cir. 1987), cert. denied, 485 U.S. 1035 (1988).

[145] E.g., In re Sherk, 918 F.2d 1170 (5th Cir. 1990).

[146] See §§ 12.8, 13.5.

[147] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 426 (1977).

[148] 514 U.S. 300 (1995).

[149] E.g., In re Eagle-Picher Indus., Inc., 963 F.2d 855 (6th Cir. 1992); In re Drexel Burnham Lambert Grp., 960 F.2d 285 (2d Cir. 1992), cert. dismissed, 506 U.S. 1088 (1993).

against that action from the bankruptcy court. The exclusions in (b) implement a wide array of disparate policy objectives.

One of the most important of those policy objectives is that a bankruptcy case should not be permitted to interfere with the operation of essential governmental functions. The interests of the body politic in furthering the common weal presumptively outweigh the interests of the debtor in obtaining a fresh start or the interests of creditors in equitable collection proceedings. This premise is codified most generally in § 362(b)(4), which exempts from the stay "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's . . . police or regulatory power."[150] A more specific instance of the same broad policy is § 362(b)(1), which excludes from the stay "the commencement or continuation of a criminal action or proceeding against the debtor." As the legislative history emphasizes, "the bankruptcy laws are not a haven for criminal offenders."[151]

The exclusion in § 362(b)(1) for criminal proceedings most often counters the stay provision in § 362(a)(1) for the commencement or continuation of proceedings against the debtor that could have been brought prior to bankruptcy,[152] although other provisions in § 362(a) also arguably might block criminal actions without the (b)(1) exception. In most cases, the application of § 362(b)(1) is simple and straightforward. A debtor standing trial for murder cannot bring that trial to a halt by filing a bankruptcy petition.

The hard cases arise, however, when the criminal action carries with it the incidental but unmistakable overtones of debt collection. This can happen when the criminal law in some manner requires the debtor to make restitution to a victimized creditor. A common example is a bad check case, where the debtor-criminal's "sentence" often is to make good on the check. Allowing the criminal proceeding to go forward might well result in the creditor being paid in preference to other creditors, and in contravention of the debtor's fresh start. Indeed, the primary motivation for the criminal action in the first place may be to compel the debtor to pay a debt. The difficult balancing task for the courts in these cases is to protect the state's interest in the unfettered operation of its criminal justice system while not permitting the state criminal law to be used as a convenient means of evading the federal bankruptcy law.

Even in such quasi-collection cases, § 362(b)(1) applies on its face. If the action against the debtor is brought pursuant to the state criminal laws, the literal language of (b)(1) operates to except that proceeding from the automatic stay. While some courts have read § 362(b)(1) to be limited by a "debt collection" exception, wherein the stay will still apply if the criminal action is motivated by a primary purpose to collect a debt,[153] the better (and majority) view is that subsection (b)(1) is unqualified, and applies to exclude from the bankruptcy stay any criminal proceeding, irrespective of the underlying prosecutorial purpose.[154]

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[150] See §§ 3.11, 3.12.

[151] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 342 (1977).

[152] See § 3.4.

[153] E.g., In re Dovell, 311 B.R. 492 (Bankr. S.D. Ohio 2004).

[154] See In re Gruntz, 202 F.3d 1074 (9th Cir. 2000).

That subsection (b)(1) applies to exclude the criminal proceeding from the automatic stay does not, however, necessarily preclude a federal bankruptcy court from issuing an injunction against the commencement or continuation of the criminal action. Accordingly, the battle will be joined when the debtor asks the bankruptcy court to issue such an injunction. The courts agree that the bankruptcy court has the power to issue such an injunction under § 105(a). The question is one of application.

The starting point in answering that question must be the Supreme Court's 1971 decision in *Younger v. Harris*.[155] In sweeping language, the Court reaffirmed the longstanding policy against federal courts enjoining state proceedings except in special and extraordinary circumstances, in keeping with "our federalism." *Younger* only allows an injunction to be issued if the movant can demonstrate a "great and immediate" danger of irreparable injury to his federally protected rights, and if the danger cannot be eliminated by a defense in a single criminal prosecution.[156] An exception applies if the movant can show that the criminal proceeding was brought in bad faith or for purposes of harassment.[157]

A handful of bankruptcy and district courts have issued injunctions against state criminal proceedings in bankruptcy cases, reasoning that the "primary motivation" of the action was to collect a debt.[158] The overwhelming trend in the courts of appeals, however, has been to deny such injunctions. For example, in *Barnette v. Evans*,[159] the debtor issued $37,000 in bad checks to an auto dealer, and was prosecuted criminally. The state criminal law mandated full restitution to the creditor. The Eleventh Circuit overturned the issuance of an injunction against the continuation of the criminal action, holding that the strict *Younger* tests were not satisfied. The debtor's interest in receiving a discharge was not a sufficient federally protected right (especially since discharge of the debt might well be denied anyway under § 523(a)), and the creditor's "motivation" in seeking collection did not by itself constitute bad faith or harassment. Furthermore, the debtor could raise bad faith as a defense in the criminal action itself. Several circuit courts have also held that the revocation of the debtor-criminal's probation and ensuing incarceration of the debtor for failure to make restitution payments ordered as a condition of probation did not violate the bankruptcy stay and should not be enjoined.[160]

The Supreme Court's 1986 decision in *Kelly v. Robinson*[161] further cemented the view that state criminal actions should not be interfered with just to accommodate a supposed bankruptcy interest. In *Kelly*, the Court held that a criminal restitution obligation was not dischargeable under § 523(a)(7), relying heavily on the policy of federal deference to the operation of the state criminal justice system. The Court so

155 401 U.S. 37 (1971).

156 Id. at 46.

157 Id. at 49–50.

158 E.g., In re Penny, 414 F. Supp. 1113 (W.D.N.C. 1976) (under Bankruptcy Act); In re Curly, 25 B.R. 260 (Bankr. E.D. Pa. 1982) (alternatively held § 362(b)(1) inapplicable because of debt collection purpose).

159 673 F.2d 1250 (11th Cir. 1982).

160 See, e.g., Hucke v. Oregon, 992 F.2d 950 (9th Cir.), cert. denied, 510 U.S. 862 (1993), overruled on other grounds, In re Gruntz, 202 F.3d 1074 (9th Cir. 2000); United States v. Caddell, 830 F.2d 36 (5th Cir. 1987).

161 479 U.S. 36 (1986).

held notwithstanding apparently clear statutory language in the Bankruptcy Code to the contrary. After *Kelly*, the courts have readily concluded that debtors do not have a cognizable federal interest in avoiding criminal restitution, and that seeking restitution is not bad faith or harassment within the meaning of the *Younger* exception.[162] While the Court's 1990 holding in *Pennsylvania Department of Public Welfare v. Davenport*[163] that a criminal restitution obligation is a debt potentially dischargeable in a chapter 13 case might suggest some retreat from the strong policy of deference indicated by *Younger* and *Kelly*, the rapid amendment of the Code in 1991 to overrule the result in *Davenport*[164] signals congressional approval of the deferential approach. Cases decided post-1991 confirm that, almost without constraint, the states remain free to use restitution in criminal cases notwithstanding the happenstance of bankruptcy.[165]

§ 3.11 Environmental Pollution Cases

One of the most vexing and persistent problems under the Bankruptcy Code has been the application of the environmental protection laws in cases involving polluting debtors. Congress certainly did not intend for bankruptcy to be either a haven for polluters or a license to pollute. However, care must be taken by the courts not to afford an unintended preference in the bankruptcy distribution to governmental environmental protection agencies acting in their status as a creditor. Courts often must navigate this fine line in the context of the automatic stay.

As originally enacted in 1978, two subsections of § 362(b) were pertinent to the inquiry. Subsection (b)(4) excluded from the automatic stay "the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power." The next subsection, (b)(5), further excepted from the stay "the enforcement of a judgment" obtained in an action to enforce that police or regulatory power, but then "excepted to the exception" an action to enforce a money judgment. In 1998, Congress combined former subsections (b)(4) and (b)(5) into a single subsection (b)(4); however, no substantive changes in prior law were intended. The legislative history makes clear that environmental protection is one of the prototypical exercises of the government's police or regulatory power to which these sections were intended to apply.[166]

The concern that a governmental unit acting as a creditor will use the police power exception as a means of indirectly capturing a preference over other creditors is addressed by the "exception to the exception" referred to above. The stay exclusion allowing the government to enforce a judgment to enforce its police power is itself qualified: the government is only permitted to enforce a judgment "*other than a money judgment*." In other words, the government is stayed from enforcing a "money judgment," even if that money judgment is connected with the government's police and

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[162] See Fussell v. Price, 928 F.2d 712 (5th Cir. 1991), cert. denied, 502 U.S. 1107 (1992); *Caddell*, 830 F.2d 36.

[163] 495 U.S. 552 (1990).

[164] An exception to the chapter 13 discharge was added for criminal restitution obligations in § 1328(a)(3).

[165] See *Hucke*, 992 F.2d 950.

[166] H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 343 (1977).

regulatory powers. In seeking to collect money, the government must stand in the bankruptcy distribution line with all of the other creditors of the debtor. As the legislative history explains:

> Since the assets of the debtor are in the possession and control of the bankruptcy court, and since they constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors.[167]

Stating the rules is one thing; applying them is another. Courts, as they are wont to do, have devised various tests in an attempt to divine whether the government's actions fall within the exception (thus permitting the government to act) or within the exception-to-the-exception (thus prohibiting the government from acting). The most commonly used tests are (1) the "*pecuniary purpose*" test, which asks if the government is acting primarily to protect its pecuniary interest or to protect the public safety, and (2) the "*public policy*" test, which distinguishes between actions to adjudicate private rights and those to effectuate public policy.[168] In the environmental cases, the resolution is almost invariably in the government's favor, no matter what test is used.

Several different fact patterns illustrate the application of § 362(b)(4) in the environmental context. In one common type of case, the government brings an action against the debtor to recover costs that the government has incurred in cleaning up polluted property. The courts usually allow such an action to proceed notwithstanding the stay, up to the point of assessing and fixing the damages, but do not allow the government to execute on the judgment obtained.[169]

Another fairly easy case is where the debtor continues in possession of its property, and the government obtains an injunction ordering the debtor to cease polluting. A bankruptcy debtor must obey the environmental laws just like everybody else. Thus, neither the obtaining nor the enforcement of that prohibitory injunction would be stayed.

The hardest case is when the government seeks to obtain a mandatory injunction ordering the debtor to clean up past pollution. Note that the government could itself effect the cleanup, and then sue the debtor to recover those response costs—but recall that the actual collection of any money judgment for response costs would be stayed under the "exception to the exception." To the extent the government can make the debtor do the cleanup, the government will not have to spend that money itself, and will in effect have obtained a priority over other creditors in the amount of saved response costs. Nevertheless, when the debtor is continuing in possession of the polluted site as a chapter 11 debtor in possession, the government properly is permitted to compel the debtor to bring the site into compliance with the

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[167] Id.

[168] See Lockyer v. Mirant Corp., 398 F.3d 1098 (9th Cir. 2005); Chao v. Hosp. Staffing Servs., Inc., 270 F.3d 374 (6th Cir. 2001); In re Commerce Oil Co., 847 F.2d 291 (6th Cir. 1988).

[169] E.g., City of New York v. Exxon, 932 F.2d 1020 (2d Cir. 1991); United States v. Nicolet, Inc., 857 F.2d 202 (3d Cir. 1988); *Commerce Oil*, 847 F.2d 291.

environmental laws.[170] A debtor in possession or trustee operating a business is required by 28 U.S.C. § 959(b) to "manage and operate the property in his possession according to the requirements of the valid laws of the State."

Does that same logic hold, however, when the debtor is not continuing in business under chapter 11, but is liquidating under chapter 7? The Third Circuit confronted this issue in the well-known case of *Penn Terra Ltd. v. Department of Environmental Resources.*[171] Prior to bankruptcy, a corporate debtor entered into a consent order requiring the debtor to bring its coal mines into compliance with the relevant Pennsylvania statutes. The debtor did not complete the reclamation work, however, but instead ceased operations and filed chapter 7. The total cost of the cleanup exceeded the total assets of the debtor. The Pennsylvania Department of Environmental Resources brought an action in state court to compel the bankruptcy trustee to abide by the consent order and expend the remaining assets of the estate in doing the reclamation work. In a debatable decision, the Third Circuit held that the action to compel the trustee to spend the estate's money was not the "enforcement of . . . a money judgment," either in form or substance, and thus was not stayed. The court instead characterized the proceeding as "an equitable action to prevent future harm."[172] The practical effect of the court's holding, however, was to give the government's cleanup claim a *de facto* priority over all other creditors of the debtor. Once the trustee spent the limited assets of the estate on the cleanup, there would be nothing left for anyone else.

§ 3.12 Other Police Power Activities

The range of police power activities by a governmental unit exempted from the automatic stay extends far beyond the environmental protection area[173] and the enforcement of the criminal laws.[174] The legislative history states that the exception in (b)(4) would apply "where a governmental unit is suing a debtor to prevent or stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law."[175] As a matter of first principles, the filing of bankruptcy by itself should not excuse compliance with other laws, absent a compelling bankruptcy-specific justification. However, the government should not be able to use the guise of "police or regulatory laws" as a cover for obtaining preferential treatment in its status as a creditor of the debtor. The sponsors of the 1978 Code stated that the exception "is intended to be given a narrow construction in order to permit governmental units to pursue actions to protect the public health and safety and not to apply to actions by a governmental unit to protect a pecuniary interest."[176]

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170 In re Commonwealth Oil Refining Co., 805 F.2d 1175 (5th Cir. 1986), cert. denied, 483 U.S. 1005 (1987).

171 733 F.2d 267 (3d Cir. 1984).

172 Id. at 277–79.

173 See § 3.11.

174 See § 3.10.

175 H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 343 (1977).

176 124 Cong. Rec. H11,092 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,409 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

Notwithstanding the sponsors' admonition to give the exception a narrow construction, the courts have excluded a wide range of governmental actions from the stay. The Supreme Court held that an administrative proceeding against a financial holding company by the Board of Governors of the Federal Reserve System fell squarely within § 362(b)(4) in *Board of Governors, FRS v. MCorp Financial, Inc.*[177] A number of circuit court decisions have held that the N.L.R.B. may obtain the entry of a back pay award for violation of the labor laws.[178] However, the N.L.R.B. cannot actually enforce that back pay order, because of the prohibition against enforcing a money judgment.[179] Enforcement would have to be sought in the bankruptcy court. The Secretary of Labor has been permitted to enforce an injunction against the sale of "hot goods" produced in violation of the Fair Labor Standards Act, even though the practical effect would be to coerce the payment of back wages.[180] The EEOC is not stayed from enforcing the requirements of Title VII.[181] Nor is the SEC precluded from enforcing the securities laws.[182] The list goes on and on.

In some cases, however, the courts do find that the protection of the government's pecuniary interest is paramount and that the stay therefore applies. This has come up particularly in instances where the regulatory law in question itself purports to define the rights of affected creditors and speaks directly to the proper means of liquidating and distributing the debtor's assets. Courts have little trouble finding that such laws do not directly affect public "health, welfare, morals and safety," and should be stayed.[183]

Even if the regulatory law itself does implicate a legitimate governmental police power, the issue may arise whether the government is seeking the "enforcement of ... a money judgment," which then would be stayed. A leading case is the Second Circuit's decision in *S.E.C. v. Brennan.*[184] The debtor, Brennan, was found to have committed a massive securities fraud and ordered to disgorge $75 million. Brennan responded by filing chapter 11 and moving millions of dollars in assets to off-shore havens. The SEC, in turn, obtained an order in federal district court directing Brennan to repatriate the assets to the registry of the court, to be held while the New Jersey bankruptcy court sorted out how those assets should be handled in the pending bankruptcy case.

The Second Circuit held that the repatriation order constituted the "enforcement of a money judgment" and therefore violated the stay. Up through the moment of the entry of the $75 million judgment, the SEC unquestionably was acting squarely within its police and regulatory powers and was not stayed. For the Second Circuit majority, however, once the money judgment had been entered, anything beyond that point necessarily constituted the impermissible enforcement of that money judgment. Fixing

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177 502 U.S. 32 (1991).

178 E.g., N.L.R.B. v. P*I*E Nationwide, Inc., 923 F.2d 506 (7th Cir. 1991); N.L.R.B. v. Evans Plumbing Co., 639 F.2d 291 (5th Cir. 1981).

179 See N.L.R.B. v. Cont'l Hagen Corp., 932 F.2d 828 (9th Cir. 1991).

180 Brock v. Rusco Indus., Inc., 842 F.2d 270 (11th Cir. 1988), cert. denied, 488 U.S. 889 (1989).

181 E.g., E.E.O.C. v. Rath Packing Co., 787 F.2d 318 (8th Cir.), cert. denied, 479 U.S. 910 (1986).

182 S.E.C. v. First Fin. Grp., 645 F.2d 429 (5th Cir. 1981).

183 E.g., In re Cash Currency Exch., Inc., 762 F.2d 542 (7th Cir. 1985); Missouri v. U.S. Bankr. Court for the E.D. of Ark., 647 F.2d 768 (8th Cir. 1981), cert. denied, 454 U.S. 1162 (1982).

184 230 F.3d 65 (2d Cir. 2000).

liability, the court said, did vindicate the public interest; once liability was fixed, however, "the government necessarily acts only to vindicate its own interest in collecting its judgment. Except in an indirect and attenuated manner, it is no longer attempting to deter wrongful conduct. It is therefore no longer acting in its 'police or regulatory' capacity."[185]

Judge Calabresi dissented, emphasizing that the repatriation order did not enhance the government's recovery prospects vis-à-vis other creditors, since the order only brought the assets back into a U.S. court, where those assets could be distributed to the entire body of creditors in accordance with the bankruptcy law's distribution scheme.[186] In his view, the "exception to the exception" should only be read to prohibit the government acting as a creditor from getting the jump on competing creditors. For the Second Circuit majority, the focus instead was on whether the government's action was necessary to vindicate public policy.[187]

The question of whether the action is being brought by a "governmental unit" sometimes arises. In cases involving administrative agencies, the courts uniformly find the requirement met. The issue gets more difficult when the plaintiff is a private entity acting in the role of a "private attorney general" to enforce some public law. The Seventh Circuit held that a private person who brought a motion for sanctions under Rule 11 qualified as a "governmental unit" on a private attorney general theory.[188] Other courts have not been willing to take that step, however.[189]

Normally a bankruptcy court is free to enjoin an action that is excepted from the stay under § 362(b). In the area of governmental regulatory powers, however, other federal statutes sometimes may prohibit the entry of injunctions. For example, a bankruptcy court may not enjoin a labor strike.[190] In *MCorp*, the Supreme Court pointed out that the courts lacked injunctive power under the Financial Institutions Supervisory Act.[191]

§ 3.13 Retroactive Perfection

One of the primary applications of the automatic stay is to stop the creation, perfection, or enforcement of liens against property of the estate, § 362(a)(4), or against property of the debtor to the extent the lien secures the payment of a prepetition claim, § 362(a)(5).[192] Otherwise, unsecured creditors could enhance their standing vis-à-vis the remaining pool of unsecured creditors by achieving secured status.

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[185] Id. at 73.

[186] Id. at 78–79 (Calabresi, J., dissenting).

[187] It is also worth noting an important undercurrent that could have affected the court's decision. Prior to obtaining the repatriation order in the federal district court, the S.E.C. had sought such a repatriation order from the bankruptcy court itself, which that court had denied. The Second Circuit thus was dealing with the spectre of another court interfering with the bankruptcy court's administrative control of estate property.

[188] Alpern v. Lieb, 11 F.3d 689 (7th Cir. 1993).

[189] See In re Revere Copper & Brass, Inc., 29 B.R. 584 (Bankr. S.D.N.Y.), aff'd, 32 B.R. 725 (S.D.N.Y. 1983) (Clean Water Act).

[190] E.g., In re Crowe & Assocs., Inc., 713 F.2d 211 (6th Cir. 1983).

[191] 502 U.S. 32, 43 (1991).

[192] See § 3.5.

In some situations, however, the broad stay of § 362(a)(4) and (5), if left unqualified, would actually operate to make certain creditors *worse* off than they would have been outside of bankruptcy. Such a result would run counter to the purposes of the stay, which is meant only to preserve the status quo and maintain the place of creditors in the chain of distribution as of the time of the bankruptcy filing. The problem arises when a creditor could perfect a lien outside of bankruptcy with retroactive effect, i.e., when the creditor's perfected status would be good against competing prior lien creditors. Section 362(b)(3) provides an exception to the stay of § 362(a)(4) and (5) to allow such a creditor to perfect its lien postpetition without hindrance by the automatic stay.

Two other sections of the Code, § 544(a) and § 546(b), bear directly on the issue. Section 544(a), called the "strong-arm" power, gives the bankruptcy trustee the right to "avoid" (set aside) certain interests that are unperfected or unrecorded as of the time the bankruptcy case is commenced.[193] For example, a creditor holding an unperfected security interest in property of the debtor when bankruptcy is filed will lose its security interest and will be relegated to the ranks of unsecured creditors. § 544(a)(1). The trustee is given the status of a "lien creditor," U.C.C. § 9–102(a)(52)(C), 11 U.S.C. § 544(a)(1), and a lien creditor usually takes priority over a security interest that is unperfected. U.C.C. §§ 9–317(a)(2). The trustee is also accorded the status of a bona fide purchaser of real property, and as such will normally be able to avoid an unrecorded real property interest. § 544(a)(3).

Non-bankruptcy law, however, recognizes some exceptions where a lien creditor or bona fide purchaser would not defeat an unperfected or unrecorded interest as of a particular point in time. These exceptions share a common feature: they accord *retroactive effect* to the perfection or recordation of the lien or interest, which is good against intervening parties. Section 546(b) recognizes the validity in bankruptcy of such non-bankruptcy retroactive perfection rules. The most common of these non-bankruptcy retroactive perfection rules are for purchase money security interests in personal property and for mechanics' and materialmens' liens.

An example involving a purchase money security interest will illustrate the point. Assume that on March 1, Creditor loans Debtor $5,000 to enable Debtor to buy a machine, Debtor uses the money to buy the machine, and Debtor signs a security agreement giving Creditor a security interest in the machine. Creditor's security interest "attaches" on March 1, U.C.C. § 9–203(a), (b), but will not be perfected until Creditor files a financing statement. U.C.C. § 9–310(a). As mentioned above, normally a "lien creditor" (which includes the bankruptcy trustee) will take priority over an unperfected security interest in collateral. § 9–317(a)(2). However, as the holder of a "purchase money security interest," U.C.C. § 9–103(a), Creditor is afforded a grace period of 20 days to perfect its security interest and still maintain priority in the collateral over any lien creditors whose rights attach in the interim. U.C.C. § 9–317(e). Thus, if Creditor perfects by filing a financing statement by March 21 (20 days after March 1), it will defeat any lien creditors who acquire their lien status between March 1 and March 21. In effect, once Creditor perfects (if by the 20-day deadline of March

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[193] See §§ 6.3, 6.4.

21), its perfected status is deemed to "relate back" to the time its security interest first attached—here, to March 1.

What happens, however, if the Debtor files bankruptcy after March 1 and before March 21, and before Creditor has filed a financing statement to perfect its security interest? As of the time Debtor files bankruptcy, Creditor has not yet perfected, and thus is vulnerable to losing its security interest under § 544(a)(1). However, as explained above, under non-bankruptcy law (the U.C.C.), Creditor should have until March 21 to perfect. If Creditor does perfect by March 21, its perfection will relate back to March 1, prior to bankruptcy, and thus will be immune from attack under § 544(a)(1). Section 546(b)(1) gives effect to that non-bankruptcy right. The problem, however, is that § 362(a)(4) by itself would stay Creditor from perfecting its security interest. Section 362(b)(3) saves the day for Creditor in this situation, by permitting Creditor to go ahead and perfect its security interest notwithstanding the stay. Without § 362(b)(3), § 546(b) would be a dead letter, and creditors with retroactive perfection rights outside of bankruptcy would lose those rights if bankruptcy intervened.

The application of § 362(b)(3) and § 546(b) is not limited to purchase money security interests; any non-bankruptcy law which permits perfection with retroactive effect is covered. As noted above, one common example is mechanics' and materialmens' liens.[194] In those cases, state law usually allows a mechanic who has performed work or a materialman who has provided materials to file a notice of lien within a statutory grace period thereafter, with the perfection of the lien then relating back to the time the services were performed or the materials supplied. State environmental liens to secure cleanup costs also may provide for retroactive priority.[195]

Note that § 362(b)(3) also permits the maintenance or continuation of liens that have previously been perfected. For example, a secured creditor can continue perfection in collateral under Article 9 of the U.C.C. by filing a continuation statement. U.C.C. § 9–515(d), (e). The automatic stay will not prevent the filing of a continuation statement. However, § 362(b)(3) only permits acts to perfect a lien or maintain perfection; it does not permit a secured creditor to enforce a lien. Such enforcement would be an improper interference with property of the bankruptcy estate. Relief from the stay must still be obtained before enforcement will be allowed.

Section 362(b)(3) also applies to permit a creditor to take acts to perfect a transfer within the grace period allowed by § 547(e)(2)(A). Section 547 governs the avoidance of preferential transfers, and subsection (e) speaks to the time when a transfer is deemed to be made. The timing of the transfer is important both to determine whether the transfer was made within the preference period and whether the transfer was made on account of an antecedent debt. Under subsection (e)(2)(A), a transfer is deemed made when it became effective between the transferor and transferee, if it is perfected within a 30-day grace period. If bankruptcy is filed during the running of that 30-day grace period, § 362(b)(3) will allow the creditor to perfect its interest and thus perhaps to

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194 See, e.g., In re Yobe Elec., Inc., 728 F.2d 207 (3d Cir. 1984).

195 See, e.g., In re 229 Main St. Ltd. P'ship, 262 F.3d 1 (1st Cir. 2001); In re Perona Bros., Inc., 186 B.R. 833 (D.N.J. 1995).

avoid preference liability. Note, however, that the creditor still might be exposed to avoidance of its interest under the strong-arm clause of § 544(a).

§ 3.14 Other Exceptions

The exceptions to the stay for criminal actions, police power activities, and retroactive perfection just scratch the surface of the statutory list of actions excluded from the reach of the automatic stay. Section 362(b) has proven to be one of the more fertile areas for special interest legislation in the Code. After the passage of the 1994 Amendments to the Code, a total of 18 separate provisions graced § 362(b). With the 2005 amendments, the number of stay exceptions had grown yet again, totaling 28 as of 2016. Three-fourths of these have been added since 1978, and several of the original exceptions have been expanded as well.

Two of the exceptions merit comment here, those relating to domestic relations issues, § 362(b)(2), and activities by taxing authorities, § 362(b)(9). As to the former, a fundamental policy of our federal system has been a position of presumptive noninterference in domestic relations issues, resolution of which is vested almost exclusively in the states. The federal bankruptcy law does have a number of provisions that bear on domestic relations questions, but those statutes usually adopt a "hands off" approach. In other words, for the most part a debtor cannot circumvent his obligations under state domestic relations laws by filing a bankruptcy case. Debts for domestic support obligations are not dischargeable, § 523(a)(5), a prohibition that applies in chapter 13 cases as well, § 1328(a)(2). Even property settlement debts are nondischargeable. § 523(a)(15). Furthermore, the debtor's exempt property may be liable for alimony and support debts. § 522(c)(1). A debtor may not avoid a judicial lien that secures domestic support obligations even if that lien impairs an exemption. § 522(f)(1)(A).

This deferential approach to state domestic relations issues is reflected in the exclusions from the automatic stay in § 362(b)(2). Perhaps most significantly, a creditor is not stayed from "the collection of a domestic support obligation[196] from property that is not property of the estate." § 362(b)(2)(B). The family debt creditor is stayed from collecting against property of the estate; as to that property, the creditor must wait with all other creditors for a pro rata distribution of estate assets in the bankruptcy case. In the meantime, however, the creditor is free to pursue the debtor's assets, which the debtor obtains either by exemption, abandonment, or from postpetition earnings. Recall that such a debt is excluded from discharge, § 523(a)(5), and may be enforced against exempt property, § 522(c)(1). Expedition in collection may be necessary to avoid hardship to the debtor's ex-spouse or to the debtor's children. Since collection is limited to non-estate assets, other creditors of the debtor are not prejudiced.[197]

Numerous domestic relations actions are excepted from the stay. The 2005 amendments in particular greatly expanded the number of domestic relations matters excluded from the bankruptcy stay. Indeed, after 2005, a safe rule of thumb is to

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[196] Defined in § 101(14A).

[197] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 342–43 (1977).

assume a domestic relations matter probably is not affected by bankruptcy. The additional domestic relations stay exclusions include:

- the commencement or continuation of civil[198] actions or proceedings:
  - To establish paternity, § 362(b)(2)(A)(i);
  - To establish an order for domestic support obligations, or to modify an existing order, § 362(b)(2)(A)(ii);
  - Concerning child custody or visitation, § 362(b)(2)(A)(iii);
  - For the dissolution of a marriage as long as it does not determine the division of property that is property of the estate, § 362(b)(2)(A)(iv);
  - Regarding domestic violence, § 362(b)(2)(A)(v).
- a number of methods to facilitate collection of domestic support obligations; several of these reference the Social Security Act (title 42, § 666):
  - Withholding of income that is property of the estate or property of the debtor for payment of a domestic support obligation, § 362(b)(2)(C);
  - Withholding or revoking a license, § 362(b)(2)(D);
  - Reporting overdue support, § 362(b)(2)(E);
  - Intercepting a tax refund, § 362(b)(2)(F);
  - Enforcing a medical obligation, § 362(b)(2)(G).

Another important stay exception affects tax collection. Some latitude in the automatic stay is afforded to taxing authorities by § 362(b)(9). The breadth of the exception was expanded considerably in the 1994 Amendments. Now the government is permitted to take most of the preliminary steps necessary to the fixing of a tax liability against the debtor and the imposition of a tax lien on the debtor's property, but still may not complete the tax collection process without relief from the stay. Thus, the government is allowed to:

- conduct an audit to determine tax liability, § 362(b)(9)(A);
- issue a notice of tax deficiency, § 362(b)(9)(B);
- make a demand for tax returns, § 362(b)(9)(C); and, finally,
- to make an assessment for any tax and issue a notice and demand for payment of the assessment, § 362(b)(9)(D).

Under this latter provision the government will not have a tax lien attach to property by reason of the assessment unless (1) the debt in question is not dischargeable (under § 523(a)(1)) and (2) the affected property is that of the debtor, not of the estate. Allowing the government to make a tax assessment during the pendency

[198] The modifier "civil" was added in 2005. Criminal actions are of course already excepted from the stay under § 362(b)(1). See § 3.10.

of the bankruptcy case will be advantageous in chapter 11, where the plan must provide for full payment of a priority tax claim within five years after the date of the bankruptcy order for relief. § 1129(a)(9)(C). The provision permitting the government to issue the notice of tax deficiency fulfills the precondition to the debtor's ability to bring a proceeding in Tax Court. Note, however, that relief from the stay must be obtained to proceed with a Tax Court action. § 362(a)(8).

The government's ability to collect tax debts was further facilitated in the 2005 amendments by the addition of § 362(b)(26), which allows the government to set off a tax refund with respect to a pre-bankruptcy taxable period against a prepetition tax liability. Even if the applicable nonbankruptcy law does not allow a setoff because the tax liability is still being contested, under subsection (b)(26) the government can hold the tax refund, rather than turn it over, pending the resolution of the tax liability.

The many, many remaining (and ever-growing) exceptions typically address very specific special interest matters. A number of these were added in 2005 as part of a larger package of amendments addressing particular problems. Some of the new exceptions may be quite important in the narrow realm in which they operate, but are not of consuming interest in a general study of bankruptcy. Those interested can consult § 362(b) as well as, where applicable, the legislative history to the 2005 amendments[199] to learn more about the exceptions for:

- setoffs under various sophisticated financial contracts, including commodity contracts, forward contracts, or securities contracts (§ 362(b)(6)); repurchase agreements (§ 362(b)(7)); swap agreements (§ 362(b)(17)); and master netting agreements (§ 362(b)(27)). Note that the court does not even have the power to issue a stay with regard to actions covered by these provisions, see § 362(*o*);
- foreclosure of mortgages by HUD (§ 362(b)(8)), or of ship mortgages (§§ 362(b)(12), (13));
- actions to retake possession of leased premises, either with regard to expired nonresidential real property leases (§ 362(b)(10)), or to residential leases, either where the lessor obtained a judgment for possession prior to bankruptcy (§ 362(b)(22)), or where the property is endangered or there is illegal use of controlled substances (§ 362(b)(23));
- presentment and dishonor of a negotiable instrument, § 362(b)(11);
- accreditation and licensing of an educational institution (§§ 362(b)(14), (15)), and the participation of such institutions in guaranty programs, (§ 362(b)(16));
- the creation or perfection of statutory liens for ad valorem property taxes that come due postpetition, § 362(b)(18);
- withholding and collection of a debtor's wages under a pension plan, to the extent the amounts withheld are used for payment of certain loans, § 362(b)(19);

[199] H.R. Rep. No. 109–31 (pt. 1), 109th Cong., 1st Sess. (2005).

- acts to enforce liens, in cases involving abusive serial filings (§§ 362(b)(20), (21));[200]
- unavoidable transfers, § 362(b)(24);
- actions by securities self-regulatory organizations to enforce their regulatory powers, § 362(b)(25); and
- exclusion of the debtor from participation in Medicare and other federal health care programs, § 362(b)(28).

D. TERMINATION OF STAY AND RELIEF FROM STAY

§ 3.15 Automatic Termination Under § 362(c): The Basic Provisions

The automatic stay is not intended to be permanent. Its function is to preserve the status quo on a temporary basis, during the pendency of the bankruptcy case, in order to permit the collective proceeding to go forward in an orderly manner. The stay will terminate automatically under § 362(c), by operation of law, when the reason for its existence no longer applies. In addition, a creditor may obtain relief from the stay from the court at an earlier time under § 362(d), if an appropriate showing is made.[201]

Section 362(c) is divided into four subsections. Until 2005, there were just two: subsection (1) governs when the stay terminates with respect to acts against property of the estate, and subsection (2) controls the expiration of the stay as to all acts other than those affecting estate property. This section addresses the original provisions for automatic termination, subsections (1) and (2).

Subsections (3) and (4) were added in 2005 to handle serial filings and discourage bad faith repeat filings.[202] Subsection (3) deals with debtors who have filed one prior bankruptcy case in the year before the current bankruptcy, while subsection (4) is concerned with debtors who have filed more than one prior bankruptcy case in the previous year (other than a case refiled under a chapter other than chapter 7 after dismissal under section 707(b)[203]). Another "termination" provision (§ 362(h)) speaks to the situation where the debtor either fails to file or perform a statement of intention with respect to personal property collateral as required by § 521(a)(2). Finally, 2005 also saw the introduction of a rule negating the stay in small business cases where a prior case was dismissed in the prior two years. § 362(n). The following section of the book examines those provisions, and related 2005 amendments, in more detail.[204]

For acts against property of the estate, the stay will continue in effect until that property ceases to be property of the estate. § 362(c)(1). This rule helps to implement the bankruptcy court's exclusive jurisdiction over estate property. The stay will remain in effect for estate property even after the expiration of the time limits spelled out in (c)(2), as long as that property remains in the estate.[205] Acts against property of the

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[200] See § 3.16.

[201] See § 3.17.

[202] H.R. Rep. No. 109–31 (pt. 1), 109th Cong., 1st Sess., at 69 (2005).

[203] This exception to the rule in subsection (4) was added in 2010. See Pub. L. No. 111–327, 124 Stat 3557.

[204] See § 3.16.

[205] See In re Pace, 159 B.R. 890 (B.A.P. 9th Cir. 1993), aff'd in part, 56 F.3d 1170 (9th Cir. 1995).

estate that are stayed are spelled out in § 362(a)(2) (the enforcement of judgments against that property), § 362(a)(3) (any act to obtain possession of or to exercise control over estate property), and § 362(a)(4) (any act to create, perfect, or enforce a lien against property of the estate).

Property may pass out of the estate in a variety of ways. The property may be abandoned (§ 554), sold (§ 363), or exempted (§ 522). A word of caution must be raised, however. If the property passes out of the estate and then to the debtor, the stay still may be in force. Recall that prepetition judgments may not be enforced against the debtor, § 362(a)(2), and a creditor may not take any act to create, perfect, or enforce a lien that secures a prepetition claim against the debtor's property. § 362(a)(5). Property could pass from the estate to the debtor if the property is abandoned, since the normal rule is that abandoned property revests in the entity that had the possessory interest prior to bankruptcy. Thus, a secured creditor would not be able to foreclose a lien on collateral if the trustee abandoned the encumbered property, because the (a)(5) stay would still be in effect. Relief from the stay under § 362(d) still would have to be obtained. Similarly, if the debtor exempts property, the stay may still be in effect.

For all acts other than those affecting property of the estate, the stay will terminate automatically at the earliest of the time when the case is closed, dismissed, or the debtor's discharge is either granted or denied. § 362(c)(2). If the case is dismissed, of course, there is no reason to continue the bankruptcy stay. Otherwise, the earliest time when the stay is likely to terminate is when the discharge decision occurs. That determination normally occurs before the case is closed. Note that in chapter 7 cases the automatic termination only occurs for individual debtors; the (c)(2) rule would not make any sense for corporate or partnership debtors, who cannot receive a discharge. § 727(a)(1). In chapter 7 cases, objections to discharge must be filed early in the proceeding, within 60 days after the first meeting of creditors. If no objection is filed, the court "shall forthwith" grant the discharge. Rule 4004(c)(1).

This early automatic termination of the stay under § 362 does not mean, however, that creditors then have carte blanche to resume collection efforts as to prepetition debts. Once the discharge is granted, a permanent statutory injunction against the collection of discharged debts goes into effect.[206] § 524(a). Thus, at no point in time may creditors attempt to collect discharged debts: until the discharge decision is made, the § 362 stay operates; thereafter, the § 524 stay is in effect. However, if the court denies the debtor's discharge under § 727(a), the stay will terminate and creditors may attempt to collect their debts. Recall, though, that creditors may not go against estate property as long as that property remains in the estate.

One question that has arisen is whether the stay terminates as to a specific debt when a creditor obtains a determination from the bankruptcy court that the particular debt is not dischargeable under § 523(a). The statutory language in § 362(c)(2)(C) provides that the stay terminates when "a discharge is granted or denied." A number of bankruptcy courts have concluded that the plain meaning of that language is that the stay only terminates if the discharge is denied generally under § 727(a), and not when only a particular debt is excepted from the discharge under § 523(a). The Sixth Circuit held otherwise, however, deciding that a creditor did not violate the stay when it

[206] See § 10.31.

garnished the debtor's bank account after the bankruptcy court held that the debt was nondischargeable under § 523(a)(2).[207] The court saw no reason to make the creditor wait to collect from non-estate assets.

In rehabilitation cases, the discharge may be entered at a much later stage of the case than in chapter 7. In chapter 11 cases involving corporate or partnership debtors, the confirmation of the reorganization plan discharges prior debts. § 1141(d)(1). Confirmation may not occur, however, for many months or even years after the filing of the case. In chapters 12 and 13, and in chapter 11 cases involving individual debtors, the discharge normally will not be entered until the debtor completes performance under the plan, or obtains a hardship discharge excusing nonperformance. §§ 1141(d)(5), 1228(a), (c), 1328(a), (c). Thus, the stay will remain in effect during the entire time the debtor is performing under the plan. Note also that in chapter 12 (§ 1207(a)) and 13 cases (§ 1306(a)) as well as chapter 11 cases involving individual debtors (§ 1115(a)), the estate includes property acquired postpetition and postpetition earnings of the debtor during this time period, and the stay against acts affecting property of the estate therefore will be in effect as well.

§ 3.16 Combating Abusive Serial Filings

The very characteristic that makes the automatic stay so effective and useful—its automatic self-executing nature—also invites abuse. Debtors figured out long ago that they could use the stay to frustrate a particular creditor's exercise of state-law remedies.[208] In particular, debtors have been able to stop repeatedly—effectively indefinitely—a mortgagee's attempts to foreclose on a particular piece of real property, and a landlord's attempts to evict a residential tenant. And they can do this without having to suffer through a full bankruptcy case.

How do debtors manage this trick? Simple, really. A debtor facing foreclosure on his home files what is called a "face sheet" petition, which contains the minimum information necessary to trigger a bankruptcy case. Once the petition is filed, the stay goes into effect, automatically, instantaneously, and good against the world. Under § 362(a)(4), the mortgagee's foreclosure action is stayed immediately. For a "good faith" debtor, who needs bankruptcy relief, this dramatic legal consequence is seen as a positive good, and indeed as a cornerstone of our bankruptcy system. But what if the debtor is in "bad faith," and has no intention of going through with the bankruptcy case? Assume that the debtor does not file schedules or take any other action necessary to prosecute his bankruptcy case to conclusion. The case then will be dismissed in due course. But the bad faith debtor does not care about the dismissal; that debtor got what he wanted—the initial benefit of the automatic stay, which stopped the foreclosure. Being "automatic," the stay cannot distinguish between good faith and abusive debtors. All who file a petition get the benefit of the automatic stay. Under state foreclosure law, the mortgagee will have to start over, beginning anew the foreclosure proceedings. What then? Once the foreclosure gets close to fruition, after the running of statutorily

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[207] In re Embry, 10 F.3d 401 (6th Cir. 1993).

[208] See Laura B. Bartell, Staying the Serial Filer—Interpreting the New Exploding Stay Provisions of § 362(c)(3) of the Bankruptcy Code, 82 Am. Bankr. L.J. 201 (2008); Kimberly L. Nelson, Abusive Filings: Can Courts Stop the Abuse Within the Confines of the Bankruptcy Code?, 17 Emory Bankr. Dev. J. 331 (2000); Final Report of the Bankruptcy Foreclosure Scam Task Force, 32 Loy. L.A. L. Rev. 1063 (1999).

mandated time periods and such, the abusive debtor simply files another "face sheet" petition, to the same effect, and the sequence repeats itself, possibly in perpetuity. Obviously, something must be done to counteract such abusive serial filings.

The 1984 amendments first tried to combat abusive serial filings, in § 109(g).[209] Under that provision, an individual or family farmer debtor is conclusively precluded from being an "eligible" bankruptcy debtor if he was a debtor in a bankruptcy case pending within the preceding 180 days that "was dismissed by the court for willful failure of the debtor to abide by orders of the court, or to appear before the court in proper prosecution of the case." § 109(g)(1). This provision will stop some of the serial filing abuses noted above, but not all. Note that this ban applies only if the *court* dismisses the case. That may take care of a bad faith debtor who initially files under chapter 7, because a debtor does not have an absolute right to dismiss a chapter 7 case. However, a debtor *does* have an absolute right to dismiss under chapter 13, § 1307(b) (as long as the case had not previously been converted to chapter 13 from another chapter), so a debtor could evade the reach of § 109(g)(1) simply by filing under chapter 13, and then himself voluntarily dismissing the case. *See* § 1307(b). To prevent that abuse, § 109(g)(2) also imposes a 180-day eligibility ban if a debtor voluntarily dismisses his case after a creditor files a motion for relief from the stay. A diligent mortgagee, then, whose pending foreclosure is frustrated by a debtor's bankruptcy filing, should file a motion for relief from stay as soon as possible. Then, if the debtor dismisses the case, that debtor will be ineligible for bankruptcy relief for 180 days, and the mortgagee can try to complete foreclosure in that time period.

Clever debtors continued to find ways to frustrate creditors, notwithstanding § 109(g), so the 2005 amendments enacted a number of additional provisions designed to curb abusive serial filings. Even if a debtor were not "eligible" under § 109(g), most courts have held that a filing by such a debtor is not a jurisdictional defect, and that means that the debtor still gets the benefit of the stay, even if only for a short while—which is all the debtor needs to make the mortgagee start over in foreclosure. To counter this problem, in 2005 Congress enacted § 362(b)(21)(A), which creates a new stay exception, so that a bankruptcy petition filed in violation of the 180-day refiling bar of § 109(g) does not give rise to an automatic stay at all.

The refiling ban of § 109(g) will not always apply. The bankruptcy court has the power (under the majority view) to dismiss the first case "with prejudice" and judicially impose a ban on refiling under § 349(a) in addition to anything dictated by § 109(g).[210] In that situation, another stay exception added in 2005, § 362(b)(21)(B), provides that no stay goes into effect if the debtor files a subsequent petition "in violation of a bankruptcy court order in a prior case . . . prohibiting the debtor from being a debtor in another case."

Congress also added two provisions for automatic termination of the stay in 2005 in serial filing cases. These rules further complement § 109(g) and also relieve the bankruptcy court of the need to enter a dismissal with prejudice in the original case. First consider § 362(c)(3). That section applies if an individual or joint debtor's chapter 7, 11, or 13 case was commenced within *one year* of the dismissal of an earlier case. The

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[209] See discussion of § 109(g) in § 2.3.a.

[210] See § 2.18.

section applies even if the new filing is involuntary. Nor are there any limitations such as those found in § 109(g). If case #1 was dismissed within the preceding year, then § 362(c)(3) is triggered in case #2 filed within the year. The only exception is if case #1 was dismissed under § 707(b) (the "abuse" provision[211]), and then refiled under another chapter after dismissal.

This new rule adds bite to the requirement in § 109(h) that an individual debtor get prepetition credit counseling in order to be eligible for bankruptcy relief. Assume that a debtor files a case without getting the required prepetition credit counseling under § 109(h), and thus has his case dismissed on the ground that he is an ineligible debtor. That debtor then gets the required counseling, and (within a year) tries again, filing a new bankruptcy case. Section 362(c)(3) will apply in the new case.[212]

If § 362(c)(3) is triggered, then the automatic stay in the second case will terminate by operation of law *30 days* after the petition filing, § 362(c)(3)(A), unless the court specifically finds, after motion by a party in interest (presumably the debtor), that case #2 was filed in "good faith." § 362(c)(3)(B). The court must hold the hearing within the 30-day period, and must find good faith by "clear and convincing evidence." If the court so finds, then it can continue the automatic stay in effect "as to any or all creditors." In essence, § 362(c)(3) reverses the burden of going forward from normal stay practice, establishing as a default rule that the stay will terminate at the 30-day mark unless the debtor obtains a ruling to keep the stay in effect.

In practice under § 362(c)(3), it will be of paramount importance to identify what constitutes "good faith." Congress spelled out a detailed set of presumptions, identifying various circumstances that would *not* be "good faith." § 362(c)(3)(C)(i)–(ii). If a presumption arises, the debtor has the burden of rebutting that presumption by clear and convincing evidence. The presumption of "not in good faith" as to all creditors is triggered if any of the following apply:

- more than one case involving the debtor was pending in the prior year, § 362(c)(3)(C)(i)(I);
- a previous case was dismissed within the 1-year period based on the debtor's failure to file necessary documents, even if that failure was inadvertent, unless caused by the debtor's attorney's negligence, § 362(c)(3)(C)(i)(II)(aa);
- a previous case was dismissed after the debtor failed to provide adequate protection as ordered by the court, § 362(c)(3)(C)(i)(II)(bb);
- a previous case was dismissed after the debtor failed to perform the terms of a confirmed plan, § 362(c)(3)(C)(i)(II)(cc);
- there has not been a substantial change in the debtor's financial or personal affairs since the dismissal of the next most previous case, § 362(c)(3)(C)(i)(III);

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[211] See § 2.15.

[212] See § 2.3.b. This feature of the 2005 law has prompted some judicial anger at the harshness of that law. See, e.g., In re Sosa, 336 B.R. 113 (Bankr. W.D. Tex. 2005).

- it does not appear that the new case under chapter 7 will be concluded with a discharge, § 362(c)(3)(C)(i)(III)(aa); or
- it does not appear that the new case under chapter 11 or chapter 13 will be concluded with a confirmed plan that the debtor will fully perform, § 362(c)(3)(C)(i)(III)(bb).

Furthermore, a presumption of "not in good faith" as to a particular creditor is triggered if that creditor had filed an action in the prior case (most likely for relief from the stay) and that action was either still pending or had been resolved by some form of stay relief. § 362(c)(3)(C)(ii). Under this provision, apparently, if the creditor and debtor agree to an adequate protection order after the creditor files for relief from stay, and the case is then dismissed, if the debtor refiles within a year then the stay presumptively will terminate as to that creditor after 30 days. The debtor can only keep the stay in effect by proving his good faith by clear and convincing evidence. That is a pretty big stick to give secured creditors.

If the subsequent case is filed on the heels of *two* dismissals within the previous year [and, as added in 2010, unless the case was refiled under a chapter other than chapter 7 after dismissal under § 707(b)], § 362(c)(4)(A)(i) provides that the "stay . . . shall not go into effect upon the filing of the later case." In the 2-dismissal situation under subsection (c)(4), there is no 30-day grace period, as there is in the 1-dismissal case under subsection (c)(3). The starting point in the 2-dismissal case is *no stay at all.* Rather, the only way a stay will *ever* go into effect is if a party in interest (i.e., the debtor) files a request within 30 days and at the hearing proves that the new case was filed in "good faith." § 362(c)(4)(B). Even if the court so orders, the stay is only effective from that point forward, § 362(c)(4)(C), suggesting that the court does not have the power to retroactively impose the stay. Thus, if the creditor can complete foreclosure before the court can rule on the debtor's "I filed in good faith" motion, then the creditor wins, and there is nothing the debtor can do about it. As was the case with subsection (c)(3), under subsection (c)(4) Congress lists a slew of circumstances (essentially mirroring those under subsection (3)) that will trigger a presumption that the new case was not filed in good faith. § 362(c)(4)(D).

Creditors who want comfort that the draconian provisions of § 362(c)(3) or (c)(4) really are operative in their favor in a particular case can get a confirmatory order from the court that the stay has terminated. § 362(j). See also § 362(c)(4)(A)(ii). With such an order in hand, the creditor can complete a foreclosure sale with peace of mind.

The 2005 amendments also enacted a provision for automatic dismissal of "face sheet" petitions. If an individual debtor fails to file financial schedules, statements, and certificates required by § 521(a)(1) within 45 days after the petition date, the case will be *automatically* dismissed on the 46th day.[213] § 521(i)(1). The debtor may request up to an additional 45 days to file such information and thereby prevent automatic dismissal, but must justify that extension to the court's satisfaction. § 521(i)(3). Even if the debtor fails to file the required documents, the court has the power to prevent automatic dismissal on a request by the trustee, if (1) the best interests of creditors would be served by administration of the case (e.g., because the debtor's estate has

[213] See § 2.5.c.

substantial nonexempt assets) and (2) the debtor attempted in good faith to provid evidence of all employer payments received within 60 days before the petition date § 521(i)(4). If a case is automatically dismissed for failure to file required information the court must enter an order confirming the dismissal upon request of any party ir interest "not later than 7 days after such request." § 521(i)(2).

Another provision combating serial filings was added in 2005 in "small business" cases. § 362(n). If § 362(n) is triggered, then the stay "does not apply." A "small business" case is a defined term, see §§ 101(51C), (51D), applying to debtors who are engaged in commercial or business activities (other than owning or operating real property) with total debts of no more than $2,566,050 (indexed as of April 2016) and where there is no unsecured creditors committee. Congress identified four situations where the serial filing stay bar would apply in the small business context:

- the debtor is a debtor in another pending small business case, § 362(n)(1)(A);
- the debtor was a debtor in a small business case that was dismissed in the preceding two years, § 362(n)(1)(B);
- the debtor was a debtor in a small business case in which a plan was confirmed in the preceding two years, § 362(n)(1)(C); or
- the debtor acquired substantially all of the assets or business of a small business debtor otherwise covered in the three preceding subsections, unless the debtor can prove it acted in good faith and not for the purpose of evading the serial filing bar, § 362(n)(1)(D).

If the present case was filed involuntarily against the debtor, the bar of § 362(n)(1) does not apply, unless the debtor acted collusively with the petitioning creditors. § 362(n)(2)(A). For voluntary cases, the only way a debtor who falls within the ambit of subsection (n)(1) can avoid the bar of that section and enjoy the benefit of a stay is to prove to the court that the current filing was due to unforeseeable circumstances beyond the debtor's control, § 362(n)(2)(B)(i), *and* it is more likely than not that the court will confirm a feasible plan—and not a liquidating plan—within a reasonable time. § 362(n)(2)(B)(ii).

In Rem Stay Relief

Even the detailed and extensive "serial filing" rules just discussed can be evaded by what is known as the "fractional interest transfer" scheme. The way this scheme works is that a homeowner facing foreclosure transfers small fractional interests in the home to numerous other people. One of those people (Debtor #1) will then file a "face sheet" bankruptcy petition, staying (even if only briefly) foreclosure of that person's small fractional interest in the home. While the interest as to which foreclosure is stayed may be small, the impact is not. Since the mortgagee now cannot transfer 100% ownership of the home in a foreclosure sale, effectively *all* of the foreclosure proceedings are stopped. Nor would it help to ban or limit the effect of any bankruptcy refiling by Debtor #1. Debtor #2 could then step up and do the same thing, and then Debtor #3, and on and on—indeed, there would be a virtually endless supply of transferee-debtors available, in succession, to stop the foreclosure proceedings through subsequent bankruptcy filings.

The courts devised a response to the fractional interest transfer scheme, known as *in rem* stay relief, in which they would enter an order that limited the effect of any future stays, as against the *property*, rather than with respect to any particular debtor. Then, whoever filed, the prior *in rem* order would vitiate the stay. The 2005 amendments expressly validated this practice in § 362(d)(4). This provision allows relief from the stay of an act against real property if "the filing of the petition was part of a scheme to delay, hinder, or defraud creditors," involving either (A) transfer of any interest in the real property without the consent of the secured creditor, or (B) multiple bankruptcy filings affecting the same real property. The remedy is critical: if stay relief is granted under subsection (d)(4), and if the stay relief order is recorded in the appropriate public records for the giving of "notices of interests or liens in real property," then the stay relief order "shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after" the *in rem* stay relief order. Furthermore, a stay exception in § 362(b)(20) makes explicit that during this 2-year period, a bankruptcy filing by *any* person will not stay "any act to enforce any lien against or security interest in . . . such real property," unless the debtor in the subsequent case obtains "relief from such [*in rem*] order based upon changed circumstances or for other good cause shown, after notice and a hearing."

§ 3.17 Introduction to Relief from the Stay Under § 362(d)

Automatic termination of the stay under § 362(c)(1) and (2)[214] provides a useful default rule. In practice, however, creditors with a security interest in collateral held by a debtor in possession or trustee are rarely content to bide their time and wait until the bankruptcy case runs its course to seek recourse to their collateral. In chapter 11 cases in particular, the stay could remain in effect for a very long time before it would terminate by operation of law under § 362(c). Creditors and other affected parties need not wait for automatic termination. A stayed creditor may ask the bankruptcy court for earlier relief from the automatic stay upon proof of one of the grounds specified in § 362(d). Stay relief motions are one of the most common forms of litigation under the entire Bankruptcy Code. Most of those actions involve a secured creditor seeking stay relief so that it may foreclose on its collateral.

The grounds for relief from the stay reflect a carefully considered congressional attempt to balance fairly the interests of the secured creditor against the goals of the bankruptcy proceeding. The secured creditor's interest is to realize as much as it can on its collateral as quickly as possible. However, absolute protection of that interest often might prevent full realization of the potential benefit of the bankruptcy proceeding. This tension is seen most clearly in a chapter 11 reorganization case. In chapter 11, the usual hope is to reorganize the debtor's business in order to capture the full going concern value of that business for creditors and stockholders and also to preserve jobs. If a secured creditor is allowed to repossess and foreclose on collateral that is indispensable to the debtor's business, the policy in favor of reorganization will be undermined.

Assume, for example, that the secured creditor holds a security interest in the inventory of a debtor toy store. If the secured creditor is allowed to repossess and sell

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[214] See § 3.15.

that inventory, the debtor probably will be out of business and any chance of reorganization will be lost (and some children may have a less than merry Christmas). And yet, the secured creditor has a legitimate interest in realizing on the value of its security interest in that inventory. The desire to foster the debtor's chances for reorganizing should not come at the expense of the secured creditor.

The resolution of this tension is found in § 362(d). Congress and the Supreme Court have recognized that the secured creditor has a property interest in collateral that is deserving of protection, both under the Fifth Amendment and as a matter of policy.[215] But, the Court has only recognized the secured creditor's interest in receiving the *value* of its collateral, rather than the exact rights for which it originally bargained. That the creditor might be delayed in receiving that value, or might have to reap that value through alternative procedures, has been held not to be objectionable.

Two fundamental premises drive the stay relief decision with regard to secured creditors. First, relief will be granted if no bankruptcy policy necessitates interfering with the secured creditor's non-bankruptcy right to repossess and foreclose.[216] § 362(d)(2). In other words, there must be a good bankruptcy reason to keep the stay in place. Second, even if there is a legitimate bankruptcy interest to be served by staying the secured creditor from exercising its rights—such as promoting the chance for a successful reorganization—relief from the stay still will be granted if the secured creditor's interest in the collateral is not "adequately protected." § 362(d)(1). In a sense, then, the secured creditor's interest is given precedence.

The full extent of that precedence depends on the exact meaning of "*adequate protection*," a term of art in the Bankruptcy Code that is dealt with in § 361. A fuller discussion of the meaning of adequate protection is found in the following sections.[217] Basically, adequate protection demands that the value of the secured creditor's collateral position should not be allowed to decline because of the stay. In a momentous 1988 decision, the Supreme Court held in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*[218] that a secured creditor is not entitled to receive compensation for delay in foreclosure as part of adequate protection.[219] In this respect, the broader policy interest in promoting reorganizations is given priority over the secured creditor's interest in foreclosing expeditiously. Returning to the toy store hypothetical, adequate protection will be found if the secured creditor retains a security interest in a constant level of toy inventory (probably through replacement

[215] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977) (citing Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935)). See also United States v. Sec. Indus. Bank, 459 U.S. 70 (1982). See generally Charles J. Tabb, Credit Bidding, Security, and the Obsolescence of Chapter 11, 2013 U. Ill. L. Rev. 103 (2013) (hereinafter "Obsolescence of Chapter 11"). I have questioned whether the Court's assertion (especially in *Radford*) that the Fifth Amendment applies to protect a secured creditor's lien rights is correct, and have suggested that only the Bankruptcy Clause should limit the scope of the permissible treatment of secured creditors' collateral rights in bankruptcy. See Charles J. Tabb, The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy, 2015 U. Ill. L. Rev. 765 (12015) (hereinafter "Limited Rights of Secured Creditors").

[216] See § 3.21.

[217] See §§ 3.18–3.20.

[218] 484 U.S. 365 (1988).

[219] See § 3.19.

liens), assuming that the inventory is properly insured and maintained and that taxes are paid.

Stay relief also may be granted if no bankruptcy reason exists to keep the stay in place. This idea is embodied in § 362(d)(2), which provides that relief should be granted if (A) the debtor does not have equity in the property,[220] *and* (B) the property is not necessary to an effective reorganization. In a chapter 7 liquidation case, obviously only part (A) of this test is applicable. In chapter 7, if the debtor does not have any equity in the property, there is no reason for the bankruptcy trustee to administer the encumbered property. All of the proceeds from the sale of that property will go to the secured creditor in any event. Nothing will be left for general creditors. In such a case, the trustee should agree to an order abandoning the collateral to the secured creditor and lifting the stay to allow foreclosure.

In a chapter 11 case, however, the mere fact that the debtor lacks equity in the property does not mean that a bankruptcy purpose would not be served by keeping the stay in place. Equity in the collateral only matters if the property is being sold; in chapter 11, however, the likelihood is that the debtor (as debtor in possession) will want to retain the collateral and use it in operating its business. In chapter 11 cases, stay relief will not be granted solely on a showing that the debtor lacks equity, under § 362(d)(2)(A). Proof also must be made that the property is not necessary to an effective reorganization, under § 362(d)(2)(B). If the debtor does need the collateral in order to reorganize, a bankruptcy reason exists to stay foreclosure. This is the "necessity" component of (d)(2)(B).[221] Keeping the stay in place because the debtor needs the property in order to be able to reorganize only makes sense, of course, if a successful reorganization is a realistic possibility. If it is not, the secured creditor should not be stayed any longer. This latter notion embodies the "feasibility" facet of (d)(2)(B).[222]

In the 1994 Amendments, a third ground for relief from the stay was added to deal with the special case of single asset real estate.[223] Section 362(d)(3) embodies aspects of both of the basic principles enunciated above; first, that a bankruptcy reason must support the maintenance of the stay, and second, that the secured creditor must be protected in the interim. The rules of (d)(3) only apply to a creditor whose claim is secured by an interest in "single asset real estate." § 101(51B). Under (d)(3), the court must grant relief from the stay 90 days after filing or 30 days after the court determines the debtor is subject to this subsection, whichever is later, unless one of two events occurs. First, if the debtor files a plan that "has a reasonable possibility of being confirmed within a reasonable time," § 362(d)(3)(A), relief may be denied. This rule merely makes explicit the "feasibility" test that is implicit in subsection (d)(2)(B). Second, relief may be denied if the debtor begins making monthly interest payments to the secured creditor. § 362(d)(3)(B). These payments offer some interim protection to the affected creditor.

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[220] See § 3.22.

[221] See § 3.23.

[222] See § 3.24.

[223] See § 3.25.

The burden of proving the grounds for relief from the stay are divided between the movant and the party resisting relief (e.g., the trustee or debtor in possession). § 362(g). The movant has the burden of proving that the debtor does not have equity in property under § 362(d)(2)(A). On all other issues, the party opposing relief has the burden of proof. This means that the trustee or debtor in possession would have to prove adequate protection under § 362(d)(1), necessity and feasibility under § 362(d)(2)(B), and either the filing of a feasible plan or the commencement of interest payments under § 362(d)(3).

The procedures governing the resolution of a motion for relief from stay are designed to compel a quick response. Congress sought to protect secured creditors from the situation under pre-Code law where a motion for relief from the stay often would languish on the bankruptcy court's docket. Relief delayed in practice effectively may mean relief denied. To counter this problem, several procedural provisions were placed in the Code itself, which is highly unusual, because very few procedural rules are included in the Code. Section 362(e)(1) provides that the stay will terminate by operation of law 30 days after a request for relief from the stay of an act against property is filed, unless the court orders the stay continued in effect after notice and a hearing. If the court chooses to treat this initial hearing as a preliminary hearing rather than a final hearing, the court must find a "reasonable likelihood" that the party opposing relief will prevail at the final hearing. The statute goes on to require that the final hearing be concluded no later than 30 days after the conclusion of the preliminary hearing, unless the parties agree to extend the time or the court finds "compelling circumstances" requiring an extension of time. In cases where the debtor is an individual, § 362(e)(2) provides that the stay will terminate by operation of law 60 days after a request for relief from the stay. This rule will not apply if the court makes a final decision during the 60-day period. § 362(e)(2)(A). The 60-day period can be extended, either by agreement of all parties in interest, § 362(e)(2)(B)(i), or by the court for a specific period of time as is required for "good cause." § 362(e)(2)(B)(ii).

In addition, in emergency situations a creditor may obtain *ex parte* relief from the stay. § 362(f). Such relief may only be granted in order to "prevent irreparable damage" to the creditor's property interest, if "such damage" will occur if the normal time procedures are followed.

If a ground for relief is established, the Code mandates that relief be ordered, stating that the court "shall" grant relief. § 362(d). However, the court has considerable discretion in choosing the exact form of relief to award; it does not necessarily have to lift the stay completely. Instead, the relief to be granted may include "terminating, annulling, modifying, or conditioning" the stay. Thus, for example, the court may order that the stay will be lifted if the debtor does not satisfy stated conditions, such as making certain adequate protection payments, or granting designated replacement liens, or obtaining insurance on the collateral, or filing a plan by a set date, and so on. This flexibility permits the court to take an active role in managing the case.

If relief is denied, the game is not necessarily up for the secured creditor. A determination by the court that stay relief is not warranted at a particular stage of the bankruptcy case is not given *res judicata* effect.[224] The secured creditor is free to try

[224] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54 (1978).

again later. This tactic is common in practice. In reorganization cases bankruptcy courts often are inclined to give the debtor a chance to reorganize, and thus may deny a motion for stay relief brought early in the case. However, the same motion renewed six months or a year later may find a more receptive court, if the debtor has made little progress in the interim towards effectuating a reorganization.

Relief from the stay is not limited to cases involving secured creditors, although those cases comprise the bulk of the decisions. In other situations good "cause" may exist to lift the stay. § 362(d)(1). This may be the case in particular with regard to the stay of all proceedings against the debtor under § 362(a)(1).[225] Sometimes those proceedings have little if anything to do with the bankruptcy proceeding, other than the happenstance that the debtor is involved, and the stay should be lifted. Some examples given in the legislative history include divorce or child custody cases,[226] probate proceedings in which the debtor is the executor or administrator of the estate of another, proceedings in which the debtor is acting as a fiduciary and not in his or her personal capacity, and actions involving postpetition activities of the debtor.[227]

§ 3.18 Adequate Protection: Basic Applications

"Adequate protection" is the fundamental right bestowed on secured creditors by the Bankruptcy Code. It is through the invocation of "adequate protection" that secured creditors are enabled to insist on the recognition in bankruptcy of the value of their secured claim. See § 361. Bankruptcy does not create that secured claim, however. The nature and extent of a secured creditor's interest in collateral is established by applicable nonbankruptcy law. Thus, for example, state law will govern whether a creditor has a security interest in certain personal property, and what priority that creditor has in the collateral. State law will control the incidents of mortgages and deeds of trust in realty. The Internal Revenue Code reigns supreme over federal tax liens. But when it comes to actually *enforcing* a secured claim in bankruptcy, the bankruptcy concept of "adequate protection" controls the play of the game. At bottom, adequate protection replaces the secured creditor's nonbankruptcy *remedies* during the pendency of the bankruptcy case and defines how the creditor may preserve its secured claim for that interim period.

Adequate protection plays a central coordinating role in calibrating the treatment of secured creditors in bankruptcy cases, and the utilization of the creditor's collateral by the trustee or debtor in possession. In effect, it is the glue that holds together the multiple sections affecting the rights of a secured creditor. Several provisions of the Code are implicated. Section 363 governs the use, sale, or lease of estate property by the trustee or debtor in possession.[228] On request of the affected secured creditor who has a lien on that estate property, the court shall prohibit or condition that use, sale, or lease in order to assure that the creditor's interest is adequately protected. § 363(e). If the creditor has already repossessed the collateral prior to bankruptcy, the court may order the creditor to turn over the collateral to the trustee under § 542(a), thus

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[225] See § 3.4.

[226] After the 2005 amendments, these two situations are now covered under 362(b)(2) and exempt from the stay. See § 362(b)(2)(A)(iii), (iv).

[227] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 343–44 (1977).

[228] See §§ 5.16–5.18.

enabling the estate to use, sell, or lease the property under 363—but only if adequate protection is given.[229] Meanwhile, any attempts by the secured creditor to enforce its lien are stayed under § 362(a)—but relief from the stay will be given under § 362(d)(1) unless the creditor receives adequate protection. Finally, if the estate wants to borrow money and grant the new lender a senior lien on property that is already subject to a lien, that may only be done if the subordinated lender is afforded adequate protection.[230] § 364(d).

The concept of adequate protection rests on twin pillars. First, and in my opinion more dubiously, the Supreme Court has recognized that a secured creditor's lien interest is an interest in property entitled to protection under the Fifth Amendment.[231] Congress thought that this constitutional imperative was the bedrock on which the adequate protection concept rests and was the source from which it was derived.[232] However, I have questioned whether that jurisprudence is correct, and have suggested that, properly understood, the Fifth Amendment does not apply to protect a secured creditor's lien rights; but instead, only the limits of the Bankruptcy Clause itself dictate what can be done to modify those lien rights in bankruptcy.[233]

Second, and more defensibly, Congress emphasized that the principles embodied by adequate protection are not to be limited to the supposed constitutional minimum, but reflect important considerations of bankruptcy policy. That policy is that "[s]ecured creditors should not be deprived of the benefit of their bargain."[234] Congress did not intend, though, that the secured creditor should receive the benefit of the literal and exact bargain which it could have enforced under non-bankruptcy law, because such enforcement might interfere with the realization of the goals of bankruptcy. For example, if a secured creditor were permitted to foreclose on essential collateral early in the case, an otherwise feasible reorganization might be torpedoed. The aim, then, is to provide *alternative* means of giving the secured creditor "in *value* essentially what he bargained for."[235] By doing so, the best of all possible worlds can be achieved: the reorganization is given a chance to succeed, and the secured creditor gets the value of its security.

So, what exactly *is* adequate protection, *what* is protected, and *from* what is the protection offered? Section 361 is the governing section. But no definition of adequate

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[229] United States v. Whiting Pools, Inc., 462 U.S. 198, 207 (1983). Note, though, that the courts disagree on whether or not adequate protection must be given *before* (or contemporaneously with) turnover, or whether instead it suffices if adequate protection is given after turnover is made. The prevailing trend in the courts is that adequate protection need not be given at or before turnover; that is, a secured creditor who has repossessed collateral before bankruptcy must turn over the property to the debtor without first receiving adequate protection as the quid pro quo. See, e.g., Thompson v. Gen. Motors Acceptance Corp., 566 F.3d 699 (7th Cir. 2009). See §§ 5.12, 5.13.

[230] See § 11.10.c.

[231] See, e.g., Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935). See generally Tabb, supra note 215, Obsolescence of Chapter 11, 2013 U. Ill. L. Rev. 103.

[232] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 49 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

[233] Tabb, supra note 215, Limited Rights of Secured Creditors, 2015 U. Ill. L. Rev. 765.

[234] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 53 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

[235] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

protection is given. Instead, three illustrative means of providing that protection are described in § 361(1), (2), and (3), discussed below. This congressional vagueness was intentional. The legislative history left the explication of adequate protection to "case-by-case interpretation and development. It is expected that the courts will apply the concept in light of [the] facts of each case and general equitable principles."[236] As one learned judge explained:

> Congress was aware of the turbulent rivalry of interests in reorganization. It needed a concept which would mediate polarities. But a carefully calibrated concept, subject to a brittle construction, could not accommodate the 'infinite number of variations possible in dealings between debtors and creditors.' This problem required, not a formula, but a calculus, open-textured, pliant, and versatile.[237]

According to the language of the Bankruptcy Code, *what* is protected by the concept of "adequate protection" is "an interest of an entity in property." § 361. In laymen's terms, in the case of a secured creditor this language refers to the creditor's security interest in the collateral. The statutory language does not fully resolve, however, the important question of what *aspects* of the creditor's "interest in property" deserve protection. At a minimum, the *value* of that interest must be preserved during the pendency of bankruptcy. In plain terms, the creditor's collateral value must be maintained.[238]

That interest must be protected *from* "a decrease in the value" caused by the imposition of the bankruptcy case, during the pendency of the case. § 361. For example, the § 362 stay may prevent immediate foreclosure, and § 363 may authorize the estate to use the collateral. Just as the automatic stay is designed to preserve the status quo for all interested parties during the life of the bankruptcy case, so too is adequate protection the creditor's temporary palliative while the bankruptcy case is in effect. Adequate protection is necessary because bankruptcy cases cannot be resolved in an instant, and in the interim rights might be adversely affected.

An example will illustrate the concept of adequate protection. Assume that Creditor has a valid security interest in a fleet of Zambonis (ice resurfacing machines, for the uninitiated), to secure a debt of $500,000. Debtor uses the Zambonis to resurface ice rinks in a region. At the time Debtor files chapter 11, the Zambonis have a value of $500,000. The Debtor is in default on its payments to Creditor, and thus Creditor would have the right outside of bankruptcy to foreclose its security interest. U.C.C. §§ 9–601, 9–610. Debtor plans to keep operating its business in chapter 11, and hopes and intends to keep using the Zambonis. Creditor requests adequate protection. How should this motion be resolved?

The baseline protection for Creditor is to maintain a value package of $500,000, the value the collateral had at the time the Debtor filed chapter 11. It is common ground that Creditor must at the very least receive adequate protection to compensate

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[236] Id.

[237] Bankers Life Ins. Co. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.), 12 B.R. 803, 805 (Bankr. D. Utah 1981).

[238] See United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372 (1988).

it for any *depreciation* in the value of its collateral.[239] For example, if the rate of depreciation were $5,000 per month, Creditor would have to receive adequate protection compensation of $5,000 per month for that decline. That compensation would preserve the $500,000 collateral value. If such protection were not forthcoming, Creditor would be entitled to relief from the stay to proceed with foreclosure of its security interest, and Debtor would be prohibited from using the Zambonis.

A significant preliminary difficulty should be noted: where did the figures of $500,000 in total collateral value, and a rate of depreciation of $5,000 per month come from? These initial factual determinations will largely drive the Creditor's "adequate protection." As one might perceive, reasonable people can differ over such things as the value of property and the rate of depreciation of that property. In real cases, expert testimony is utilized; indeed, these cases often boil down to "dueling experts" on the two sides.

Even the appropriate legal *standard* of valuation is left undecided. Congress intentionally chose not to require courts to use either forced sale liquidation value, on the one extreme, or full going concern value, on the other extreme.[240] Room is afforded for the parties to negotiate and for the court to invoke equitable considerations based on the particular facts of the case.

Assuming that valuation issues are resolved, the question then becomes, by what *means* will the adequate protection be effected? As noted above, § 361 describes three nonexclusive means for providing protection. First, the trustee or debtor in possession may make *cash payments* to the affected creditor. § 361(1). In the hypothetical, the amount of the payment required would be $5,000 per month, to make up for the depreciation. Note that the amount of the adequate protection payment is *not* necessarily the same as the monthly payments that Debtor would have owed to Creditor under the original terms of the loan.[241] Adequate protection is tied to changes in the value of the *collateral*, not to the amount of the *debt*.[242] Indeed, if the collateral is not depreciating in value at all, or if the collateral is worth more than the debt, it is possible that no adequate protection payment would have to be made.

A second possible means of providing adequate protection is to grant the affected Creditor additional or replacement *liens* on other collateral to make up for the decrease in value of the original collateral. § 361(2). As the Supreme Court has made clear, the secured creditor is entitled only to protection of the *value* of its collateral, not to its rights in any specific items of collateral.[243] In our hypothetical, assume that Debtor also owned real estate worth $800,000, which was subject to a single mortgage that secured a $600,000 debt. Adequate protection could be provided to the Creditor with the security interest in the Zambonis by giving it a second mortgage on the real estate. The $200,000 in equity remaining after recognition of the first mortgage would afford

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[239] See id. at 370.

[240] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

[241] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54 (1978) ("The periodic payments would be to compensate for the depreciation and might, but need not necessarily, be in the same amount as payments due on the secured obligation.").

[242] See *Alyucan*, 12 B.R. at 808.

[243] See *Wright*, 311 U.S. at 273.

ample protection for Creditor for the $5,000 monthly depreciation of the Zambonis for a considerable time.

The third means of adequate protection identified in the Code is to grant the affected Creditor other, unspecified relief that will result in the Creditor realizing the "*indubitable equivalent*" of its secured interest. § 361(3). This rather quaint language is taken from Learned Hand's opinion long, long ago in the case of *In re Murel Holding Corp.*[244] As will be seen below, the adoption of this phrase perhaps caused more harm than good in the early years of the Code.[245] Be that as it may, what Congress had in mind in § 361(3) was to include in the Code a flexible catch-all provision for adequate protection that courts could invoke. An example given in the legislative history is a guarantee by a financially responsible third party.[246] Thus, if Warren Buffet[247] were to guarantee the payment of Creditor's secured claim, Creditor probably could cease worrying about any risk of nonpayment resulting from the $5,000 per month in depreciation.

Could the Debtor offer Creditor as adequate protection the promise of an *administrative priority* for the $5,000 a month depreciation? Under the prior Bankruptcy Act, such a result was possible,[248] and the House included the provision of an administrative priority as a means of adequate protection.[249] The Senate, however, rejected the promise of an administrative priority as a means of adequate protection "because such protection is too uncertain to be meaningful."[250] The uncertainty is whether all priority claims will be paid in full, which they occasionally are not; the secured creditor would be asked to trade the certainty of full payment out of its collateral for the hope of payment as an unsecured priority creditor. In the final compromise the Senate position prevailed.[251] Thus, § 361(3) specifically excludes the grant of an administrative priority under § 503(b)(1) as a permissible method of adequate protection.

Note that there is still one scenario in which the secured creditor could end up with a priority claim in lieu of its secured claim. That result could occur if adequate protection is provided initially, but later unfortunately proves to have been *inadequate*. § 507(b). To the extent of the inadequacy, the secured creditor is given a "superpriority" claim under § 507(b).[252] For example, in the hypothetical, assume that the Zambonis were sold for $410,000 ten months after Debtor commenced paying monthly adequate protection payments of $5,000. Creditor would have suffered an unexpected $40,000 loss: the actual loss in value of the collateral was $90,000 (a decline from $500,000 to $410,000), whereas the parties had expected and provided for only a $50,000 decline.

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[244] 75 F.2d 941 (2d Cir. 1935).

[245] See § 3.19.

[246] See H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 340 (1977).

[247] According to Forbes, while Buffett had been the richest person in the world in 2008, when I penned the Second Edition of this treatise, by this writing he has fallen from the top spot—but with a net worth of $67 billion as of July 2016, he's still probably a safe bet as a guarantor of a debt of a few thousand dollars.

[248] See In re Yale Express Sys., Inc., 384 F.2d 990 (2d Cir. 1967).

[249] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 340 (1977).

[250] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54 (1978).

[251] 124 Cong. Rec. H11,092 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

[252] See id. at H11,095.

The $40,000 shortfall would be entitled to superpriority (i.e., priority even over other second priority administrative expenses under § 507(a)(2)).[253]

The courts have struggled to give proper effect to § 507(b), which is not a model of precise draftsmanship. Among the problems with § 507(b) are that it appears to apply only if the trustee actually provides adequate protection, meaning that a creditor would be remediless if it were denied adequate protection altogether at the outset. In addition, § 507(b) seems to require as a predicate that the creditor have a claim that is independently valid as an administrative priority under § 507(a)(2) and § 503(b), raising the possibility that the creditor will not be protected if the debtor does not use the collateral at all.[254] Note also that the Code was amended in 2005, dropping § 507(b) superpriority claims behind newly established first priority claims for domestic support obligations. Now, under § 507(b), the superpriority is only over other priority claims under the now-demoted second priority, § 507(a)(2).

The catch-all provision in § 361(3) does give the court the ability to go beyond the mere provision of cash payments or replacement liens in approving the form of adequate protection that is best tailored to the situation before it. Indeed, a secured creditor would rarely be content *only* with either cash or liens, because there are other risks besides depreciation to the maintenance of the value of its security. For example, in our hypothetical, the Creditor would insist that the Zambonis be insured, that they be properly maintained and used, that all taxes be paid, and so forth. Otherwise the Creditor's collateral would be at risk.

During the first decade the Code was in place, the raging debate was whether the creditor's protectable "interest in property" under § 361 *also* included the right to immediate foreclosure. In practical terms, the issue was whether the secured creditor was entitled to compensation for the *time value* of its lien interest. This question arose in two contexts.

First, for an "*oversecured*" creditor, the issue was whether adequate protection gave the creditor the right to maintain the "*equity cushion*." The equity cushion is simply the amount by which the value of the collateral exceeds the total debt. For example, assume in our hypothetical that the Zambonis were worth $600,000, rather than $500,000, and that the debt at the time of filing was $500,000. Creditor would have an equity cushion of $100,000. As time passes, and the Creditor is stayed from foreclosing, that cushion will erode from both ends: the collateral will depreciate, and the debt will increase as interest accrues. Eventually, the cushion will disappear altogether. Does adequate protection mandate the preservation of the cushion? This question is explored in more depth below.[255] The short answer is "no," i.e., the equity cushion does not have to be maintained.

Note, however, that an equity cushion alone can serve to provide adequate protection for a limited period of time. In the hypothetical just described ($600,000 collateral value, $500,000 debt), Creditor will be fully protected and assured of full payment on its claim for several months, even if no payments, additional liens, or other

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[253] See, e.g., In re Scopac, 624 F.3d 274 (5th Cir. 2010); Grundy Nat'l Bank v. Rife, 876 F.2d 361 (4th Cir. 1989).

[254] See, e.g., Ford Motor Credit Co. v. Dobbins, 35 F.3d 860 (4th Cir. 1994).

[255] See § 3.20.

"indubitable equivalents" are provided. Assuming depreciation of $5,000 per month, and interest accrual of $4,000 per month, the $100,000 cushion will not erode for eleven months. If Debtor plans to complete the reorganization process in six months, for instance, the $100,000 cushion by itself should afford Creditor adequate protection. Courts do not, however, allow the equity cushion alone to constitute adequate protection until the last dollar of the cushion is exhausted, but require some buffer, For example, one case held that a 9% cushion did not suffice,[256] while another found 38% to be enough.[257]

The second major battlefield in which the "time value" dispute was fought during the Code's first decade was in the case of an "*undersecured*" creditor.[258] In our hypothetical, assume now that the value of the Zambonis at the time of bankruptcy was $400,000, with the debt still $500,000. Now Creditor faces a shortfall of $100,000. Outside of bankruptcy, since Debtor is in default, Creditor would be entitled to foreclose soon, meaning that Creditor would gain relatively prompt access to the $400,000, as soon as it could complete the state law foreclosure process. Presumably Creditor then could earn an appropriate market return on that $400,000. In bankruptcy, however, Creditor will be stayed from foreclosing, and while stayed will not be able to realize the time value of that $400,000. Does adequate protection entitle Creditor to that time value? In 1988 the Supreme Court definitively answered that question in the negative, holding in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*[259] that an undersecured creditor is not entitled to compensation for delay in foreclosing as part of adequate protection. It is to a fuller discussion of that problem that I now turn.

§ 3.19 Adequate Protection: *Timbers* and Opportunity Cost

Perhaps the most hotly debated topic during the first decade the Code was in effect was whether adequate protection entitled an undersecured creditor to compensation for the opportunity cost incurred because of delay in foreclosing during the pendency of a bankruptcy case.[260] In substance, the undersecured creditor wanted to be paid postpetition interest, albeit computed with respect to the value of the collateral rather than the principal debt. The question assumed enormous importance in reorganization cases, where the secured creditor's principal debt and the collateral value could be quite large, and the delay suffered during the reorganization might continue for many months or even years. The issue was settled by the 1988 decision of

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[256] In re JER/Jameson Mezz Borrower II, LLC, 461 B.R. 293, 306 (Bankr. D. Del. 2011).

[257] In re Hefty, No. 11-60039-11, 2011 WL 2470686, at *14 (Bankr. D. Mont. June 20, 2011).

[258] See § 3.19.

[259] 484 U.S. 365 (1988).

[260] Dozens of law review articles were written on the issue. Perhaps the most heard (although ultimately unheeded) voices were those of Professors Baird and Jackson. See Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97 (1984). Baird and Jackson argued that secured creditors should be compensated for the time value of their interests. For a sampling of other articles, see H. Miles Cohn, Protecting Secured Creditors Against the Costs of Delay in Bankruptcy: Timbers of Inwood Forest and Its Aftermath, 6 Bankr. Dev. J. 147 (1989) (Cohn represented the losing petitioning creditor before the Supreme Court); Raymond T. Nimmer, Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness, 68 Minn. L. Rev. 1 (1983); Note, 'Adequate Protection' and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy, 100 Harv. L. Rev. 1106 (1987).

the Supreme Court in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,[261] holding that adequate protection does not require the payment of opportunity costs or postpetition interest to undersecured creditors.

The basic facts in *Timbers* neatly illustrate the paradigmatic fact situation in which the issue arose.[262] The debtor operated an apartment project in Houston, Texas; the bank loaned the money and held a lien on the apartments, along with an assignment of rents. The debtor filed chapter 11 in March 1985, and the bank moved for relief from stay two weeks later, arguing that it was not adequately protected.[263] The total amount of the debt was just over $4.3 million; the value of the collateral was between $2.65 and $4.25 million, depending on whose appraiser was to be believed. The courts used the higher $4.25 million figure. The collateral was not depreciating in value; if anything, it was appreciating, if only slightly. Presumably taxes and insurance were being paid. The debtor had agreed to pay the postpetition rents from the project to the bank. Apart from the time-value/opportunity-cost issue, then, the bank was adequately protected—its collateral was safe and was not declining in value.

The bank argued, however, that it was *not* adequately protected, on the ground that it was being denied the time value of its money. Outside of bankruptcy, the bank asserted, it would have the right to proceed immediately with foreclosure of its lien. Once it had completed foreclosure, the bank would have the $4.25 million in proceeds from the sale of the collateral, which it then could reinvest and earn a market return. The market rate of return was about 12% per annum at the time. At that rate, the bank was losing $42,500 per month ($510,000 per year) due to the imposition of the automatic stay and the delay in foreclosing due to bankruptcy.

The bank argued that adequate protection under § 361 was designed to protect the secured creditor's "interest in property," and that the right to proceed with foreclosure upon the debtor's default was one of the bundle of sticks comprising the bank's "interest." That the full value of the bank's "interest" deserved protection under § 361 was underscored, the bank claimed, by the passage in the legislative history that secured creditors are to receive the "benefit of their bargain."[264] Its bargain included the right to immediate foreclosure. Not only that, the use of the term of art "indubitable equivalent" in § 361(3) connoted that adequate protection has a time value component, since the phrase was lifted from the plan confirmation setting, where it undeniably requires payment of time value. Furthermore, the bank asserted that the Bankruptcy Code as a general principle does not impose the costs of reorganization on secured creditors.

As a normative matter, the argument made in support of the view that compensation for delay should be paid[265] rested on the premise that a reorganization is run for the potential benefit of the residual claimants, *viz.*, the unsecured creditors and equity holders. Secured creditors have their collateral; they do not care about the

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[261] 484 U.S. 365 (1988).

[262] The facts are discussed at id. at 368–69.

[263] Note that the bank did not seek relief under § 362(d)(2).

[264] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 53 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

[265] This position was argued most forcefully by Professors Baird and Jackson, supra note 260.

reorganization and will not share in the upside if the reorganization succeeds. Fundamentally, then, it is unfair to burden them with reorganization costs. Furthermore, the bank argued that it was inefficient to impose reorganization costs on the secured creditors, because doing so would skew the resolution of the issue of how best to deploy the debtor's assets in favor of attempting reorganization. The reason for this inherent pro-reorganization bias is that the residual owners of the business would not have to pay all costs normally incident to the chosen asset deployment. If time-value compensation is denied, the debtor in effect has an interest-free loan for the duration of the bankruptcy reorganization. The inefficiency and inequity of denying compensation to an undersecured creditor is highlighted by the fact that a chapter 11 debtor *would* have to pay current expenses for rent, if it had leased the property instead of purchasing it, and would have to pay current debt if it were to purchase property *during* the reorganization. In effect, proponents of time-value compensation urged viewing that compensation as a form of administrative expense that should be paid in return for the use of property.

The bankruptcy court agreed with the bank's position, which reflected the growing trend in the courts.[266] The bankruptcy court conditioned the continuance of the stay on the debtor's payment to the bank of monthly payments of 12% per annum on the projected realizable foreclosure value of the collateral of $4.25 million, beginning in six months (the approximate time it would take to foreclose outside of bankruptcy). The court ruled that the postpetition rents could be applied toward this payment of $42,500 per month. The district court affirmed the bankruptcy court, but the Fifth Circuit, sitting en banc, reversed.[267]

The Supreme Court granted certiorari to resolve the split in the circuits. The Court had to determine "whether undersecured creditors are entitled to compensation under 11 U.S.C. § 362(d)(1) for the delay caused by the automatic stay in foreclosing on their collateral."[268] Affirming the Court of Appeals, the Supreme Court unanimously held that undersecured creditors are not entitled to such compensation.[269]

Writing for the Court, Justice Scalia focused on the precise meaning of the secured creditor's "interest in property" for purposes of adequate protection. The fundamental issue is whether the secured creditor has a protectable property interest in the right to take immediate possession of the collateral and foreclose.[270] If it does, then obviously compensation must be paid if the secured creditor is restrained and delayed from exercising that property right.[271] Justice Scalia began by noting that the term "interest in property" does not normally conjure up the idea of "right to immediate foreclosure," but acknowledged that such a meaning is at least conceivable.[272] Viewed in isolation, then, the phrase lacks a dispositive "plain" meaning.

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[266] The leading case at the time requiring payment of time value to undersecured creditors was *In re Am. Mariner Indus., Inc.*, 734 F.2d 426 (9th Cir. 1984).

[267] 808 F.2d 363 (5th Cir. 1987), aff'd, 484 U.S. 365 (1988).

[268] *Timbers*, 484 U.S. at 369.

[269] Id. at 382.

[270] See Charles Jordan Tabb & Robert M. Lawless, Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court, 42 Syracuse L. Rev. 823, 835 (1991).

[271] *Timbers*, 484 U.S. at 370–71.

[272] Id. at 371.

That ambiguity is clarified, however, by consideration of the rest of the Bankruptcy Code. Justice Scalia observed that "[s]tatutory construction is a holistic endeavor."[273] The other terms of the Code affecting the rights of a secured creditor pointed the Court emphatically towards the conclusion that time-value compensation is not provided for undersecured creditors.

First, the term "interest in property" is used elsewhere in the Code, including in § 506(a), where it defines the amount of a creditor's allowed secured claim. In that context, the term obviously means the value of the creditor's lien *without* taking into account the right to immediate foreclosure. The Court thought it likely that the same term would have the same meaning in § 361 as well.[274]

This suspicion was raised almost to a certitude by consideration of the Code's rules governing the allowance of postpetition interest on claims. The general rule is that creditors are denied postpetition interest. § 502(b)(2). Secured creditors are expressly excepted from this general rule *only* to the extent that they are *over*secured.[275] § 506(b). To grant an *under*secured creditor postpetition compensation for lost time value would in essence have the same economic effect as allowing interest. Doing so would render the Code's carefully drawn postpetition interest rules largely superfluous. The Court found such an outcome "implausible even in the abstract, but even more so in light of the historical principles of bankruptcy law," which denied postpetition interest to undersecured creditors.[276] Allowing a *de facto* interest claim for undersecured creditors also would be structurally inconsistent with § 552, which recognizes a secured creditor's lien against property acquired postpetition only in the limited circumstance in which that property represents proceeds or rents of the prepetition collateral.[277]

The Court also found persuasive the interaction between § 362(d)(1) and (d)(2), and stated that the bank's proffered reading "makes nonsense" of the latter.[278] Under § 362(d)(2), stay relief is warranted if the debtor lacks equity in the property (subsection (A)), and the "property is not necessary to an effective reorganization" (subsection (B)). Justice Scalia opined that giving relief from the stay to an undersecured creditor under § 362(d)(1) simply because of the lack of equity and the nonpayment of postpetition interest "renders § 362(d)(2) a practical nullity and a theoretical absurdity."[279] The occasion to prove the necessity of the property to an effective reorganization would disappear, except in cases where the secured creditor's collateral was not depreciating and the creditor was being paid postpetition interest, but still wanted to foreclose. The Court could not imagine "why Congress would want to provide relief for such an obstreperous and thoroughly unharmed creditor."[280]

On this point, the Court may have misperceived the focus of § 362(d)(2). The question under that section is not *why* relief should be given to the secured creditor,

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[273] Id.

[274] Id. at 371–72.

[275] See § 7.31.

[276] *Timbers,* 484 U.S. at 372–74.

[277] Id. at 374.

[278] Id. at 374–75.

[279] Id. at 375.

[280] Id.

but *why not*. Outside of bankruptcy the creditor would have the right to foreclose on the debtor's default. Section 362(d)(2) asks if there is a bankruptcy reason to interfere with the creditor's non-bankruptcy law entitlements. If the debtor has no equity, and if the property is not needed for an effective reorganization, there is no such reason, and foreclosure should be allowed, irrespective of whether the creditor is harmed or not.

One of the most significant passages in the Court's opinion with respect to the practical impact of the decision came in dictum in connection with the Court's musings about the application and role of § 362(d)(2). Given its holding that a chapter 11 debtor did not have to pay anything to undersecured creditors for the privilege of delay, the Court apparently felt the need to rebut the charge "that undersecured creditors will face inordinate and extortionate delay."[281] The answer came in the Court's perception (or perhaps admonition) that bankruptcy courts can, do and should aggressively manage their chapter 11 cases, and light a fire under debtors to move the case forward to conclusion.[282] Interpreting the provision in § 362(d)(2)(B) regarding whether the "property is necessary to an effective reorganization," the Court suggested that the showing required is "that the property is essential for an effective reorganization *that is in prospect*."[283] In other words, the debtor must prove that there is "a reasonable possibility of a successful reorganization within a reasonable time."[284]

The Court found the bank's remaining arguments unpersuasive as well. The reference to "indubitable equivalent" in § 361(3) does not require payment of interest, as the bank suggested, just because that term is also used in the plan confirmation context, where interest undeniably is mandated. The Court explained that the contexts are different; rights are finally fixed on confirmation, whereas adequate protection is only a temporary measure. Furthermore, interest is required at confirmation not because of the "indubitable equivalent" phrase, but because of the language in § 1129(b)(2)(A) requiring the calculation of the present value of the stream of payments to the secured creditor as of the "effective date" of the plan.[285]

Nor did the Court agree that the Code contained a "general principle" excusing secured creditors from having to bear any of the costs of the reorganization.[286] It is true that administrative expenses do not have priority over secured claims, and cannot be paid out of the secured creditor's collateral.[287] § 506(c). But, the Court explained, "[t]hat secured creditors do not bear one kind of reorganization cost hardly means that they bear none of them."[288] Instead, the Court reaffirmed the continuing validity of the general historical approach to the treatment of secured creditors, whereby postpetition interest is allowed only to the extent the creditor is oversecured. Under pre-Code law, undersecured creditors did not receive compensation for lost opportunity costs. The Court implicitly ratified this partial allocation of reorganization costs to secured

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[281] Id.

[282] Id. at 375–76.

[283] Id. at 376 (emphasis in original).

[284] Id.

[285] Id. at 377–78.

[286] Id. at 378–79.

[287] See § 7.31.

[288] *Timbers*, 484 U.S. at 379.

creditors, largely ignoring in the process the normative arguments outlined earlier that it is unfair and inefficient to cast those burdens onto secured creditors.

The Court found the legislative history insufficient to countermand the statutory language, the structure of the Code, and the history of non-compensation.[289] The bank relied almost entirely on the "benefit of their bargain" language in the House and Senate Reports. Dismissing those references as "generalizations," Justice Scalia pointed out that the legislative history actually worked against the bank, since it did not contain even a hint that Congress intended to change the well-settled pre-Code law that denied compensation to undersecured creditors.[290]

After *Timbers*, then, a secured creditor is not entitled as part of adequate protection to compensation for lost opportunity costs resulting from a delay in foreclosure. As noted above, this outcome results in a chapter 11 debtor gaining the interest-free use of the creditor's collateral during the pendency of the reorganization. Obviously, such a benefit enhances the debtor's chances of reorganizing. At the same time, debtors must reckon with the Court's dictum that debtors must prove a "reasonable possibility of a successful reorganization within a reasonable time."[291] Bankruptcy judges, aware that secured creditors are in economic terms unquestionably being harmed by the delay ensuing from the pendency of the chapter 11 case, may be less patient with debtors, and demand a stronger showing of feasibility at an earlier stage of the case than otherwise might have been true.[292]

In some situations, the "no compensation" rule of *Timbers* will not be fully operative. For cases involving *"single asset real estate,"* stay relief will be granted unless the debtor within 90 days after the bankruptcy filing (or, if later, 30 days after the court determines that subsection (d)(3) applies) either files a feasible plan or begins making monthly interest payments.[293] § 362(d)(3). In chapter 12 cases involving family farmers, § 1205 governs the provision of adequate protection, rather than § 361.[294] Under § 1205(b)(3), the debtor may have to pay "reasonable rent" for the use of the farmland.

§ 3.20 Adequate Protection: Equity Cushion

The Supreme Court's decision in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*[295] examined the question of whether an *under*secured creditor is entitled to compensation for the time value of money as a component of adequate protection. The Court said no. A related but factually converse situation concerns whether adequate protection entitles an *over*secured creditor to preserve its *equity cushion* during the pendency of the bankruptcy case.

An "equity cushion" is the amount (judged either in dollar or percentage terms) by which the value of the collateral exceeds the amount of the debt. For example, assume

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[289] Id. at 379–82.

[290] Id. at 380.

[291] Id. at 376.

[292] See Tabb & Lawless, supra note 270, at 838.

[293] See § 3.25.

[294] See § 13.13.

[295] 484 U.S. 365 (1988). See § 3.19.

that Creditor is owed a debt of $500,000, with interest of 12% per annum. Simple interest thus is accruing at a rate of $5,000 per month. Assume further that the collateral securing the debt is valued at $600,000, and is not declining in value. Creditor has an equity cushion of $100,000 in dollar terms ($600,000 minus $500,000) and a cushion of 20% in percentage terms ($100,000 cushion versus $500,000 debt). Viewed another way, the collateral-to-debt ratio is 1.2 to 1 ($600,000 to $500,000).

The problem is this: as time elapses, interest will accrue on the debt, and the debt accordingly will get larger. To the extent the creditor is oversecured, the postpetition interest that accrues on the debt will become part of the secured claim itself.[296] § 506(b). Eventually, the "equity cushion" will disappear altogether. In the hypothetical, the $100,000 cushion will be gone entirely in 20 months, with interest accruing at $5,000 per month. The legal question is: may the creditor insist that postpetition interest be paid in order to prevent the cushion from evaporating? Although the equity cushion question obviously is a spiritual cousin to the *Timbers* issue, since each implicates the time value of money as applied to secured creditors in bankruptcy, the *Timbers* holding does not directly dispose of the factually distinguishable equity cushion situation.

In the early years that the Code was in place, the bankruptcy courts routinely held that secured creditors *were* entitled to adequate protection of their equity cushion. The basic theoretical justification for that result was that (1) adequate protection should afford the secured creditor the "benefit of their bargain,"[297] and (2) an integral part of that "bargain" was the equity cushion itself. In other words, the secured creditor did not just bargain for certain collateral; the creditor also bargained for the value of that collateral to remain a safe percentage above the amount of the debt.

Creditors do not want to risk any possibility of a collateral shortfall, and thus intentionally build in a margin for error. Many secured lending agreements do provide that if the amount of the debt gets "out of ratio" to the collateral value, the obligation is in default and the creditor has the right to call the loan and foreclose immediately. For example, in our hypothetical, the Creditor's agreement with Debtor might provide that if the collateral-to-debt ratio falls below 1.2 to 1, Creditor could declare a default and foreclose. Thus, with a collateral value of $600,000, any debt amount over $500,000 would be a default situation. But is this aspect of the credit agreement part of the creditor's "interest in property" that is deserving of adequate protection in bankruptcy?

The leading case that reversed the trend and rejected the view that an oversecured creditor is entitled to preserve its equity cushion as part of adequate protection was the decision of Judge Ralph Mabey in *Bankers Life Insurance Co. v. Alyucan Interstate Corp. (In re Alyucan Interstate Corp.)*.[298] In *Alyucan*, the secured creditor's collateral was valued at $1.425 million, securing a debt of just under $1.3 million on the date bankruptcy was filed. Thus, on the date of the petition, the creditor had an equity cushion of $127,000. Interest was accruing at about $8,000 per month; by the time of the hearing on the creditor's motion for relief from stay, the debt had

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[296] See § 7.31.

[297] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 53 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 339 (1977).

[298] 12 B.R. 803 (Bankr. D. Utah 1981).

increased by $33,000, reducing the cushion to $94,000. The collateral value was stable. If no adequate protection payments were made, the equity cushion would disappear in just under a year. The issue was whether the chapter 11 debtor had to make those postpetition interest payments. Judge Mabey said no.

The core reason that the *Alyucan* court rejected a cushion analysis was that such an approach misperceives the proper focus of adequate protection. Fundamentally, "the 'interest in property' entitled to protection is not measured by the amount of the debt, but by the value of the lien."[299] If the value of the creditor's collateral position is not threatened, adequate protection is not necessary. The pro-cushion courts, by comparison, included the right to maintain a certain collateral-to-debt ratio as part of the creditor's protectable property interest.

The rationale of *Timbers*, decided seven years after *Alyucan*, is consistent with that of *Alyucan*. In each instance the basic issue is whether the secured creditor, be it undersecured or oversecured, should be protected against delay. Money does have time value. A secured creditor who is forced to wait until the close of the bankruptcy case to get its money is in an economic sense indisputably worse off than a secured creditor who gets paid at the outset of the case. The payment of postpetition interest would rectify that loss. The bankruptcy concept of "adequate protection," however, was not intended by Congress and has not been interpreted by the Supreme Court to make such amends to the delayed secured creditor. Instead, adequate protection focuses only on preservation of the value of the creditor's collateral throughout the case. The only concession made to the secured creditor with regard to the time value of money is that if the creditor is oversecured, its allowed secured claim will include postpetition interest, to the extent of the excess security. § 506(b). Apart from that express exception, however, the secured creditor must suffer the pangs of bankruptcy delay, just like all other creditors. Adequate protection for that delay is not required.[300]

Note, though, that this does not mean that an equity cushion might not, standing alone, itself constitute adequate protection. It can.[301] It means that the failure to preserve the cushion is not a basis for stay relief.

§ 3.21 Stay Relief Under § 362(d)(2): Overview

Relief from the stay may be granted even in cases where the creditor is adequately protected, and thus "cause" cannot be established under § 362(d)(1).[302] An alternative ground for relief from the stay, applicable *only* "with respect to a stay of an act against property," is found in § 362(d)(2). In other words, a creditor who is seeking stay relief in order to proceed with an act against property may obtain the desired relief if it proves *either* that it is not adequately protected (under (d)(1)), *or* that it is entitled to relief on the grounds stated in § 362(d)(2).

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[299] Id. at 808.

[300] See, e.g., Orix Credit Alliance, Inc. v. Delta Res., Inc. (In re Delta Res., Inc.), 54 F.3d 722, 730 (11th Cir. 1995).

[301] See, e.g., In re Hefty, No. 11-60039-11, 2011 WL 2470686, at *14 (Bankr. D. Mont. June 20, 2011) (cushion of 38% constituted adequate protection).

[302] See §§ 3.18–3.20.

Under § 362(d)(2), two things must be established in order for the creditor to prevail. First, the creditor must prove that "the debtor does not have an equity in such property."[303] § 362(d)(2)(A). The creditor bears the burden of proof on this issue. § 362(g)(1). Second, even if the creditor does prove that the debtor lacks equity, stay relief will not be granted unless "the property is not necessary to an effective reorganization." § 362(d)(2)(B). The party opposing stay relief, who typically would be either the trustee or, in a reorganization case, the debtor in possession, bears the burden of proof under § 362(d)(2)(B). § 362(g)(2). In effect, if the creditor can prove the debtor's lack of equity, the burden shifts to the debtor in possession or trustee to justify continuance of the stay on the ground that the estate needs to retain the collateral in order to be able to successfully reorganize. This second test itself has two components: first, that the debtor actually *needs* the collateral in question;[304] and second, that a successful reorganization is *feasible*.[305]

The emphasis in subsection (1) of § 362(d) is on whether the interests of the creditor are being unfairly put at risk by the continuation of the bankruptcy case. In subsection (2) of § 362(d) the focus is exactly the opposite. Here, a valid reason must be given for interfering with the creditor's nonbankruptcy rights. The right the creditor usually is interested in enforcing is the right to foreclose its lien. The reason for continuing to stay the creditor from foreclosure could be that some equity could be realized in the property, or it could be that the property will aid in the achievement of a successful rehabilitation. Absent either justification, though, the stay should be lifted, and the creditor should be allowed to go forward with foreclosure.

Section 362(d)(2) was designed specifically "to solve the problem of real property mortgage foreclosures of property where the bankruptcy petition is filed on the eve of foreclosure."[306] In its application, though, § 362(d)(2) extends to a request for relief from stay with respect to an act against any type of property, real or personal. For example, a creditor with a security interest in personal property could invoke § 362(d)(2).

§ 3.22 Stay Relief Under § 362(d)(2): Lack of Equity in the Property

The first element that must be established for a secured creditor to obtain relief from the stay under § 362(d)(2) is that the "debtor does not have an equity in such property." § 362(d)(2)(A). The creditor who is seeking relief bears the burden of proof on the equity issue. § 362(g)(1).

The rationale behind this test is that a bankruptcy purpose would be served by denying the creditor relief from stay if the debtor has equity. If the bankruptcy trustee were to sell the property in which the debtor has equity, by definition there would be something left over for the estate. This surplus then could either be distributed to the general creditors of the estate, in a liquidation, or used by the debtor in its business, in a reorganization. Indeed, in a reorganization the debtor could simply retain the property and provide the secured creditor with adequate protection. Accordingly, it is

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[303] See § 3.22.

[304] See § 3.23.

[305] See § 3.24.

[306] 124 Cong. Rec. H11,092–93 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

worth having the trustee (or debtor in possession) conduct the sale (or forgo the sale), in order to enhance the likelihood of maximizing the return to the estate. If the sale were left to the secured creditor, by comparison, that creditor would have no incentive to attempt to obtain a sale price over and above the creditor's own debt. Having the trustee conduct the sale will not harm the fully secured creditor, who will be paid in full.

How is the issue of the debtor's equity computed? A simple mathematical comparison must be made between:

(1) the value of the *debtor's interest* in the property,

and

(2) the total dollar value of *all liens* on the property securing claims against the debtor.

If (1) is greater than (2), the debtor has equity, and the creditor cannot get stay relief under § 362(d)(2). However, if (2) is greater than (1), then the movant creditor has successfully carried its burden of proof under subsection (d)(2)(A), and will be entitled to stay relief if it also prevails under subsection (d)(2)(B).

An example will illustrate the point. Assume that Debtor has Property, which has a value of $100,000. Creditor One has the senior lien against the Property, securing a debt of $80,000. Creditor Two has a junior lien against the Property, securing a debt of $30,000. Creditor One moves for relief from the stay. Is § 362(d)(2)(A) satisfied? The answer is yes. The two secured debts of $80,000 and $30,000 together total $110,000 and thus are greater than the $100,000 value of the Property. Debtor has no equity in the Property. If Creditor can also win under subsection (d)(2)(B), it will get stay relief. If, however, the Property were valued at $120,000, for example, Debtor would have equity, and Creditor would lose its stay relief motion under subsection (d)(2).

Note that equity is computed from the perspective of the *debtor*, not from the perspective of the creditor who is petitioning for relief.[307] Indeed, under the original hypothetical, as to Creditor One, there is equity of $20,000 ($100,000 value versus $80,000 debt). That, however, is not the point of subsection (d)(2). Concerns about protecting the creditor are addressed in subsection (d)(1). Indeed, the $20,000 cushion above Creditor One's debt would be relevant to establishing that Creditor One was adequately protected.[308] Instead, the focus under subsection (d)(2) is to ask if it would be of any benefit *to the estate* to keep the stay in place, and if the *debtor* has no equity, the answer is no, for the reasons explained above.

Law students tend to share a misconception that a debtor must have "equity" in property to the extent that the debtor has made payments on the secured debt. Wrong. Not true. Why not? The reason this logic is fallacious is that it ignores the facts (1) that the value of the collateral may have declined and (2) that interest will have accrued on the debt, in a combined amount that exceeds the amount of payments made. A debtor who puts $1,000 down to purchase property, and makes principal payments of $4,000,

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[307] See, e.g., In re Dowding, 124 Fed.Appx. 921 (6th Cir. 2005); Nantucket Investors II v. Cal. Fed. Bank (In re Indian Palms Assocs.), 61 F.3d 197 (3d Cir. 1995); Stewart v. Gurley, 745 F.2d 1194 (9th Cir. 1984).

[308] See, e.g., *Indian Palms Assocs.*, 61 F.3d at 197; In re Mellor, 734 F.2d 1396 (9th Cir. 1984).

will not have any equity if the property has declined more than $5,000 in value. Also, it is possible that the property may have become encumbered by other liens, including involuntary liens such as judicial liens or tax liens.

In the hypothetical above, a value of $100,000 for the property was assumed. As one might imagine, in the real world arriving at the proper valuation of property is not so easy. Each party will bring their own expert appraiser in to testify, and the bankruptcy judge will have to weigh the competing evidence (sometimes they simply split the difference!). The Code does not even specify a particular standard of valuation that courts must apply in every instance. The only statutory guidance is in § 506(a)(1), which vaguely admonishes courts to determine value "in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use . . . affecting such creditor's interest." The legislative history emphasizes that the bankruptcy court should not always adopt either a forced sale liquidation value or a full going concern value; rather, the court should assess the equities of the particular case in determining how to allocate the difference between the polar extremes.[309]

One modification in the approach to valuation of property was made in 2005. If the debtor is (1) an individual; (2) the case is under chapter 7 or chapter 13; and (3) the property is personal property, then the value of the creditor's secured claim is based on "replacement value" (as of the date of the petition), "without deduction for costs of sale or marketing."[310] § 506(a)(2). The intent was to give the secured creditor the benefit of the higher replacement value, rather than a lower liquidation value. While using a higher valuation does benefit a secured creditor if a debtor is trying to keep property by paying off the secured creditor (either pursuant to a reorganization plan or by redemption), the secured creditor actually might be worse off in the stay relief context. The reason that this amendment could hurt a secured creditor moving for relief under § 362(d)(2) is that if the collateral has a higher valuation, that accordingly increases the possibility that the debtor will have equity, thus defeating the stay relief motion under subsection (d)(2)(A).

In making the valuation assessment (under § 506(a)(1), where the court still enjoys discretion), courts tend to give considerable weight to the "proposed disposition or use" of the property. As just discussed, if § 506(a)(2) applies, courts must use replacement value. Otherwise, though, they remain free to value property under the broader guidelines of subsection (a)(1). How do courts exercise this discretion in practice? If the property will be sold, there is a greater tendency to use a liquidation value.[311] If, however, the debtor plans to retain the property and use it in its business, courts gravitate more to going concern value.[312] Some concern has been expressed that valuing the property at the higher going concern level is unfair to secured creditors, because it ignores the fact that from the perspective of the secured creditor, collateral is only important if the creditor has to foreclose—in which case only the lower

[309] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54, 68 (1978).

[310] Furthermore, if the property is acquired for "personal, family, or household purposes," then replacement value is specified to be "the price a retail merchant would charge."

[311] See, e.g., In re McElwee, 449 B.R. 669 (Bankr. M.D. Pa. 2011).

[312] See, e.g., In re Residential Capital, LLC, 501 B.R. 546 (Bankr. S.D.N.Y. 2013); In re SK Foods, L.P., 487 B.R. 257 (Bankr. E.D. Cal. 2013); In re Pelham Enters., 376 B.R. 684 (Bankr. N.D. Ill. 2007).

liquidation value will be meaningful. Forceful though that argument may be in som contexts, it forgets the point that the role of § 362(d)(2) is to ask why the estate need to resist stay relief, not whether the creditor is protected. If the focus is on the estate need, then it is perfectly logical to use a value that mirrors the estate's projecte deployment of the collateral. Whether the creditor is adequately protected is th bailiwick of § 362(d)(1).

Note that a value determination at the stay relief hearing will not be binding an given *res judicata* effect later in the case.[313] Having said that, the parties must b sensitive to the reality that judges have memories. Even if the judge is not legall bound to follow her earlier determination of value, a party arguing for a different valu than it argued for earlier in the case will have to do some serious explaining to th judge. Bearing this in mind, each side has to weigh competing considerations. For th secured creditor, a low valuation might be preferred early in the case at the stay relie hearing, because a low value might help prove the debtor's lack of equity. In addition, i the property has a low value, the debtor may not be able to prove the existence of a equity cushion that would suffice as adequate protection. But, at the conclusion of a reorganization case, the secured creditor inevitably will want a high value, because th creditor is entitled in the plan to be paid the value of its collateral.

For the trustee or debtor in possession, the incentives are, of course, exactly reversed. The trustee or DIP will want a high value at the stay hearing, both to show the presence of equity under § 362(d)(2)(A) and to establish adequate protection via a cushion under § 362(d)(1). At the end of the case, at confirmation, the DIP would prefer a lower collateral valuation, thereby allowing the plan to be confirmed with lower payments to the secured creditor.

Proof by a secured creditor that a debtor lacks equity in the property is not necessarily dispositive of the lift stay issue. Even if the debtor lacks equity, stay relief will be denied if the debtor needs the property for a successful reorganization.[314] In other words, proof of a lack of equity is a necessary but not sufficient condition to obtaining relief from the stay under § 362(d)(2) in a reorganization or debt adjustment case. In a chapter 7 liquidation case, however, equity will be the only real issue, because by definition there is not going to be a reorganization.

§ 3.23 Stay Relief Under § 362(d)(2): Necessity

If a party who is seeking relief from the stay under § 362(d)(2) with respect to an act against property can prove that the debtor does not have an equity in that property,[315] the requested relief will be granted unless the opponent can show that the property is "necessary to an effective reorganization." § 362(d)(2)(B). The burden of proving necessity to an effective reorganization is on the trustee (or debtor in possession). § 362(g)(2). This issue almost always arises in the context of a secured creditor's attempt to obtain permission from the bankruptcy court to proceed with foreclosure of its lien. The usual opponent is the debtor in possession in a chapter 11 case, who typically plans to retain and use the collateral in its business.

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[313] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 54, 68 (1978).

[314] See §§ 3.23–3.24.

[315] See § 3.22.

In chapter 7 liquidation cases, § 362(d)(2)(B) by definition is not in issue. If the secured creditor in a chapter 7 case proves the debtor's lack of equity, stay relief should be granted. Some question has arisen in the courts as to whether § 362(d)(2)(B) is applicable to debt adjustment cases under chapter 12 or chapter 13. Although a few decisions hold that it is not applicable, narrowly reading the reference to "reorganization" in subsection (d)(2)(B), the majority and better view is that (d)(2)(B) does apply in chapter 12 and chapter 13 cases.[316] The debtor in those chapters normally retains possession and control of its property, and may need to use that property in order to perform under the plan. Indeed, it is even possible that § 362(d)(2)(B) will apply in a chapter 11 *liquidation*, because one form of "reorganization" that is permitted under chapter 11 is to liquidate the debtor's assets.

The test in § 362(d)(2)(B) has two components: *necessity* and *feasibility*.[317] Each spears to the larger question of whether any bankruptcy purpose would be served in forestalling the secured creditor from proceeding with foreclosure. In order to retain the benefit of the stay and keep the secured creditor at bay, the resisting debtor in possession must show *both* prongs. In other words, if the debtor fails to show either that the property is necessary or that a successful reorganization is a realistic possibility, the secured creditor should be given permission to foreclose (assuming of course proof of the "no equity" ground under subsection (d)(2)(A)).

The *necessity* prong is almost never an issue in reorganization cases. In virtually every chapter 11 case, the debtor in possession obviously needs to retain and use its property if it is to have any chance of reorganizing. While "feasibility" may be and virtually always is debated,[318] the "necessity" of the property usually is self-evident. Indeed, the very fact that the debtor in possession is opposing the secured creditor's motion for stay relief suggests rather strongly that the debtor at least believes that the property is necessary. The debtor may be mistaken, of course, and the ultimate determination of need is for the court.

In some situations, however, necessity may not be a foregone conclusion. One such case could be where the property that is subject to the creditor's lien is fungible, at least in the sense of being readily replaceable and available. To give an example, for a considerable period of time in the 1980s the available supply of oil rigs greatly exceeded the demand. Anyone who wanted an oil rig could readily obtain one, and at a substantial discount price. In such a setting, assume that a debtor has an oil rig that is subject to a creditor's security interest. Is *that* rig really necessary to the debtor? The secured creditor could make a plausible argument that the particular rig in which it has a security interest is not necessary to the debtor, and it therefore should be allowed to foreclose, because the debtor could purchase a replacement rig with no difficulty.

Notwithstanding the intuitive appeal of this reasoning, courts have not been receptive to the creditor's plea. For one thing, the debtor would incur transaction costs

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[316] See, e.g., In re Timmer, 423 B.R. 870 (Bankr. N.D. Iowa 2010); In re Huggins, 357 B.R. 180 (Bankr. D. Mass. 2006).

[317] Some courts have questioned whether § 362(d)(2)(B) includes a feasibility test, arguing that it should be read only to require proof of necessity. See Empire Enters., Inc. v. Koopmans (In re Koopmans), 22 B.R. 395 (Bankr. D. Utah 1982). This issue is explored in more detail in § 3.24. The overwhelmingly prevailing view, though, is that feasibility must be proven.

[318] See § 3.24.

in replacing the rig. However, in a market glut situation, those costs might be quite small. Much more important is the fact that the debtor would have to pay real money for the new rig, and if it did not pay cash, it would have to pay interest. By comparison, the debtor might not have to pay current dollars for the use of the old rig. If the old rig was not declining in value, and the rig was adequately insured and maintained, the secured creditor might be adequately protected. And, under the rule announced by the Supreme Court in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,[319] the secured creditor would not be compensated for the cost of delay. In this light, the "necessity" of the particular rig is that it alone can qualify for the special benefits flowing from the no-compensation *Timbers* rule.

Another situation in which the secured creditor might make a cogent argument that collateral is not "necessary" to an effective reorganization is where the debtor is not planning on actually using the property in its business operations. This might be the case, for instance, if the debtor is retaining the property simply as an investment. Examples might include undeveloped land or oil and gas reserves. In such a scenario, the secured creditor could argue that there is nothing special and unique about its collateral as an investment. Other investments are available to the debtor. Nor should the debtor be able to argue that this particular investment property has a unique value—even if the property is in fact unique. Economically, if the markets are working properly, the price for which the property could be sold should fairly reflect the property's fair market value. The courts have rejected arguments by the debtor that the secured creditor would not do anything more with the property; to resist relief from the stay under § 362(d)(2), the debtor must explain why it needs the property, not how the creditor is unharmed or what the creditor would or would not do with the property.[320]

Aside from these relatively rare circumstances, however, necessity usually is easily established in a reorganization or debt adjustment case. The fighting issue in those cases is almost always over the other prong of § 362(d)(2)(B)—feasibility of the reorganization effort. It is to that question that I now turn.

§ 3.24 Relief Under § 362(d)(2): Prospect of a Successful Reorganization

Relief will be granted with respect to a stay of an act against property under § 362(d)(2) if the debtor does not have an equity in the property,[321] § 362(d)(2)(A), and if the property is not necessary to an effective reorganization. § 362(d)(2)(B). Under subsection (d)(2)(B), the party opposing relief from the stay—usually the trustee or the debtor in possession—bears the burden of proving (§ 362(g)(2)) both the necessity of the property to the reorganization effort,[322] *and* that a successful reorganization is *feasible.* The latter element is examined in this section.

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[319] 484 U.S. 365 (1988). See § 3.19.

[320] See, e.g., In re Playa Dev. Corp., 68 B.R. 549 (Bankr. W.D. Tex. 1986); In re Greiman, 45 B.R. 574 (Bankr. N.D. Iowa 1984); In re BBT, 11 B.R. 224 (Bankr. D. Nev. 1981).

[321] See § 3.22.

[322] See § 3.23.

As a threshold matter, there has been some dispute in the courts over whether § 362(d)(2)(B) does in fact require the debtor in possession or trustee to prove feasibility at a stay relief hearing. The leading case holding that *only necessity* must be established is the early Code case of *In re Koopmans.*[323] The statutory language in (d)(2)(B) arguably is ambiguous: it provides that the property must be "necessary to an effective reorganization." While a superficial glance at this phraseology might suggest that the debtor in possession must prove both that the property is "necessary" and that an "effective reorganization" is possible, a closer examination of the language reveals another possible reading—that the DIP must prove only that if a reorganization is to be effective, this property will be necessary. Indeed, the statute says nothing in § 362(d)(2)(B) about proving the likelihood that the reorganization will succeed. This congressional silence in § 362 is all the more telling in light of the fact that elsewhere in the Code Congress demonstrated that it did know how to craft a feasibility test. In § 1112(b)(4)(A), Congress specified that a chapter 11 case could be dismissed or converted to chapter 7 on proof of "substantial or continuing loss to or diminution of the estate and the *absence of a reasonable likelihood of rehabilitation.*"

Judge Mabey argued in *Koopmans* that the differences in the language of § 362(d)(2)(B) and § 1112(b) were anything but accidental. To begin with, the history of stay litigation and the evolution of § 362(d)(2)(B) in the reform process leading up to the enactment of the Code in 1978 suggest that necessity and feasibility should not be linked.[324] But even more significant, perhaps, is the difference in the roles of and procedures governing stay relief under § 362(d) and dismissal or conversion under § 1112(b).[325] The stay relief section is essentially a two-party affair, between the secured creditor and the debtor in possession (or trustee). Although notice of a stay relief motion must be served on an official creditors' committee, Rule 4001(a), the hearing generally will only involve the creditor and the debtor. The issues at the hearing will be whether the creditor is protected and whether the debtor can demonstrate a good reason to interfere with the creditor's non-bankruptcy remedies. By contrast, a motion to dismiss or convert the case under § 1112(b) must be served on *all* creditors. Rule 2002(a)(4). The noticed creditors, whose interests obviously would be directly implicated by conversion or dismissal, have a right to be heard on the matter. The issue of the debtor's reorganization prospects is fair game for all interested parties, not just the one secured creditor. Yet, if relief effectively could be granted for the same reasons at a stay relief hearing, the affected creditors would not be heard.

The "necessity only" advocates of § 362(d)(2)(B) further support their position by pointing out that the chapter 11 process is designed only to put the debtor to its proof of reorganization prospects at the *conclusion* of the case, not at the outset. In the 1978 reforms, Congress abandoned the requirement under old chapter X that the debtor make a preliminary showing to the court of good faith, which was construed to carry with it the need to prove reasonable prospects of reorganization. Under the Code, even the power to dismiss or convert under § 1112(b) will only be triggered if the debtor's absence of reorganization prospects is accompanied by "substantial or continuing loss to or diminution of the estate." The negative inference is that the case should not be

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[323] Empire Enters., Inc. v. Koopmans (In re Koopmans), 22 B.R. 395 (Bankr. D. Utah 1982).

[324] Id. at 397–400.

[325] Id. at 400–01.

dismissed solely because a reorganization may not be likely, if there is no ongoing Instead, the only time the debtor must prove feasibility is at *confirmation*.[326] § 1129(a)(11).

Notwithstanding the considerable force of the arguments made in *Koopm* today the prevailing view is that the debtor in possession must prove u § 362(d)(2)(B) that there is "*a reasonable possibility of a successful reorganiza within a reasonable time*." In its 1988 decision in *United Savings Associatio Timbers of Inwood Forest Associates, Ltd.*,[327] the Supreme Court approved in dic the feasibility test of subsection (d)(2)(B) as just quoted.[328] According to the Co "what [§ 362(d)(2)(B)] requires is not merely a showing that if there is conceivably to an effective reorganization, this property will be needed for it; but that the propert essential for an effective reorganization *that is in prospect*."[329] In so proclaiming, Court did not even consider the powerful arguments outlined above that would supp reading subsection (d)(2)(B) to demand only proof of necessity. Instead, the Court w driven to its dictum as a means of defending its holding that an undersecured credi was not entitled to compensation for delay during the pendency of the case. The Cour point was that the harm to the delayed creditor would not be that great, since it wou not be held up for an inordinate amount of time. The Court observed that stay rel often is given within a year of the bankruptcy filing, and may even be granted in t first months of the case if there is a "lack of any realistic prospect" of reorganizati success.[330]

Assuming that lower courts will continue to follow the Supreme Court's dictum i *Timbers* and require the party opposing a stay relief request under § 362(d)(2) to pro feasibility as well as necessity, the question becomes how the feasibility test will b applied in practice. The first point of importance is that the nature and extent of th proof required of the debtor in possession will vary depending on the time frame. I chapter 11, the debtor in possession generally has the exclusive right to propose reorganization plan for the first 120 days of the case.[331] § 1121(b). In these first fev months of the case, bankruptcy courts tend to be very lenient to the debtor with regar to the quality of the proof of feasibility they will demand. Courts recognize that th debtor should be given at least some time to try to put a plan together. The Supreme Court in *Timbers* noted this tendency with apparent approval.[332] In these early days, the bankruptcy court is almost certain to give the debtor a chance; only if the court perceives that the situation is hopeless or that the filing was a bad faith attempt to forestall foreclosure will an early lift stay motion be granted. However, after the debtor has been in chapter 11 for many months, the court's patience may begin to wear thin, and the secured creditor's chances of obtaining a favorable ruling on the lift stay motion will increase steadily. At some point, the court will demand concrete and persuasive evidence of rehabilitation prospects. Note that the court's ruling against the

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[326] See § 11.28.

[327] 484 U.S. 365 (1988). See § 3.19.

[328] 484 U.S. at 376.

[329] Id. at 375–76 (emphasis in original).

[330] Id. at 376.

[331] See § 11.15.

[332] 484 U.S. at 376.

creditor early in the case will not be *res judicata* of a later stay relief motion, because the circumstances may have changed. As a tactical matter, the secured creditor thus is not harmed by bringing a lift stay motion early in the case. Even though the court is likely to deny the motion then, the issue of the debtor's reorganization prospects will have come to the judge's attention, and when the creditor renews the motion later, the judge at the subsequent hearing might be more sensitive to the creditor's plight and less forgiving of the debtor's failure to make tangible progress towards reorganization.

What sort of evidence will be relevant to the merits of the issue of the likelihood of a successful reorganization? To begin with, the bankruptcy court will insist on some actual evidence of reorganization prospects, rather than just the debtor's unsupported and self-serving assertions of vague hopes and dreams. Courts want to see verifiable research, documentation, sensible and realistic projections, and financial analysis.[333] Beyond this, the nature of the proof may depend more on the business practicalities of the case than on legalities. Factors the court might weigh in the balance include the general state of the economy, the trends in the debtor's particular industry, market conditions, competition, the ability of debtor's management, the availability of sufficient working capital, and so forth. Remember that the debtor does not have to prove that the reorganization definitely will succeed; at this point in the case it only must establish a "reasonable possibility" of success.[334]

Whether the debtor is likely to be able to turn around its business is not, however, always the only issue regarding feasibility. A secured creditor also might be able to prevail on the feasibility issue if it can prove that *legally* the debtor will never be able to confirm a plan of reorganization. This proof could be made if the secured creditor itself has the power to veto any reorganization plan proposed by the debtor by the expedient of voting against such a plan. For example, the secured creditor might have this power if it held a controlling interest in a class and could not be "crammed down" under § 1129(b).[335] Thus, in these cases the hearing on the motion to lift the stay under § 362(d)(2) may become a sort of preliminary confirmation hearing.

§ 3.25 Stay Relief Under § 362(d)(3) for Single Asset Real Estate

A third ground for relief from the automatic stay was added to the Code in the 1994 Amendments.[336] Section 362(d)(3) was added in response to the pleas of secured lenders. For years lenders had complained bitterly about what they perceived to be the abuses inflicted on them in bankruptcy cases involving "single asset real estate" ("SARE") debtors. As the name suggests, these debtors have only one major asset—real estate. For example, a limited partnership might be formed to purchase an apartment building, an office park, or the like. Often these single asset debtors are little more than investment vehicles, used to take advantage of various tax shelters. In many of the cases the secured lender is the only significant creditor. The debtor often files bankruptcy on the eve of foreclosure of the lender's mortgage or deed of trust, invoking the automatic stay. The only real dispute the debtor has is with this secured lender.

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[333] See, e.g., Pegasus Agency, Inc. v. Grammatikakis (In re Pegasus Agency, Inc.), 101 F.3d 882 (2d Cir. 1996); In re Teron Trace, No. 09-82889, 2010 WL 2025530, at *1, *4 (Bankr. N.D. Ga. Jan. 28, 2010).

[334] *Timbers*, 484 U.S. at 366.

[335] See §§ 11.30–11.34 for a discussion of cram down.

[336] Bankruptcy Reform Act of 1994, Pub. L. No. 103–394, § 218, 108 Stat. 4128 (1994).

Even though § 362(d)(2) was enacted in large part to deal with the problem of eve-of-foreclosure filings,[337] secured creditors found stay relief hard to obtain, with courts inclined to give the debtor a chance to reorganize. In the 1978 reforms, the Senate wanted to include a provision excluding "single asset real estate" from the property potentially necessary to an effective reorganization under § 362(d)(2)(B),[338] but that exclusion was not included in the final bill. And even worse, the creditor's relief might be delayed for many months or even years while the debtor wallowed in chapter 11.

This unpleasant situation for secured lenders became almost intolerable in 1988 when the Supreme Court held in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,[339] that an undersecured creditor was not entitled as part of adequate protection to compensation for the time value of their money lost due to bankruptcy delay. Because of *Timbers*, and because postpetition interest generally does not have to be paid, debtors did not even have to pay for the privilege of delay while they were in bankruptcy. The ability to squeeze lenders through lengthy uncompensated delays gave debtors leverage to coerce favorable reorganization agreements by lenders.

Section 362(d)(3) offers substantial succor to stayed secured creditors in single asset real estate cases. Within a few months of the petition date, in order to keep the stay in effect, the debtor is required *either* to file a feasible plan or start making monthly interest payments. The debtor is initially given 90 days to act (or, if later, 30 days after the court determines that the debtor is subject to § 362(d)(3)). For cause shown, the debtor can obtain an extension from the court.

The feasibility prong, § 362(d)(3)(A), tracks the dictum in *Timbers* on feasibility: the debtor must file a plan "that has a reasonable possibility of being confirmed within a reasonable time." The same considerations that go into a feasibility decision under § 362(d)(2)(B)[340] should be given effect under (d)(3) as well. Thus, the debtor must offer more than vague hopes or dreams, and must present some concrete evidence of why and how the plan could work. At the same time, all details do not have to be settled; the feasibility imperative is less onerous at this early stage of the case than it would be at the time of plan confirmation, at the end of the case.

If the debtor does not file a feasible plan within the required time period, it will have to pay the secured creditor for the privilege of further delay. § 362(d)(3)(B). It is this aspect of § 362(d)(3) that alters for secured creditors the result of the *Timbers* case. If a debtor is lingering in chapter 11, the secured creditor will be entitled to be paid monthly interest. Note that the interest payments required under § 362(d)(3)(B) are calculated based on the *collateral* value, not the debt, so an undersecured creditor will not necessarily receive full interest compensation. However, the only harm to the creditor from the bankruptcy stay is based on the collateral value, for it is only that value that the creditor could realize on foreclosure outside of bankruptcy. The rate of interest is to be pegged at the "then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate." § 362(d)(3)(B)(ii). Prior to the

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[337] See 124 Cong. Rec. H11,092–93 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

[338] See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 53 (1978).

[339] 484 U.S. 365 (1988). See § 3.19.

[340] See § 3.24.

2005 amendments, a "current fair market rate" of interest was used, rather than the contract rate.

The catch with regard to § 362(d)(3) is that it is not uniformly available. Only a creditor who is stayed from enforcing a lien against "single asset real estate" may take advantage of subsection (d)(3). Thus, ascertaining the meaning of "single asset real estate" assumes primary importance; indeed, almost all of the litigation under the new section has been to determine whether certain property falls within the definition. Section 101(51B) defines "*single asset real estate*" as

> real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.

Even a casual perusal of the single asset real estate definition reveals that it is a well-spring of uncertainty and ambiguity. What does "the business of operating the real property" entail? What is a "substantial" "other" business that is not "incidental"?[341] What is a "single property or project"? In putting flesh on these unsteady statutory bones, the courts have drawn on the considerable jurisprudence that developed prior to 1994 in cases in which the "single asset real estate" red flag was raised.[342] Many single asset real estate decisions addressed whether the case should be dismissed for "bad faith."[343] The concept of "single asset real estate" came to have a fairly well-understood meaning in bankruptcy parlance.

Courts (prior to 2005) identified four criteria for SARE that inhere in the statutory definition:

> First, real property constituting a single property or project, other than residential real property with fewer than 4 residential units, falls within the scope of section 101(51B). Second, that real property must generate substantially all of the income of the debtor. Third, the debtor must not be involved in any substantial business other than the operation of its real property and the activities incidental thereto. Fourth, the debtor's aggregate non-contingent liquidated secured debt must be less than $4,000,000.[344]

These criteria, developed in cases soon after the passage of the 1994 amendment, continue to influence courts today. The only exception is that the last criteria—the $4 million secured debt ceiling—was repealed in 2005. Today, a debtor will qualify as a SARE no matter how much debt it has, if it meets the three remaining criteria.[345] Another 2005 amendment excluded "family farmers" from the definition.

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[341] See Ad Hoc Grp. of Timber Noteholders v. Pac. Lumber Co. (In re Scotia Pac. Co.), 508 F.3d 214 (5th Cir. 2007); In re Alvion Props., Inc., 538 B.R. 527 (Bankr. S.D. Ill. 2015); Kara Homes, Inc. v. Nat'l City Bank (In re Kara Homes, Inc.), 363 B.R. 399 (Bankr. D.N.J. 2007).

[342] See *Scotia Pacific,* 508 F.3d 214; *Kara Homes,* 363 B.R. 399; In re CBJ Dev., Inc., 202 B.R. 467 (B.A.P. 9th Cir. 1996); In re Kkemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995).

[343] See, e.g., In re Costa Bonita Beach Resort, Inc., 479 B.R. 14 (Bankr. D.P.R. 2012).

[344] In re Philmont Dev. Co., 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995).

[345] See *Kara Homes,* 363 B.R. 399.

At a minimum, Congress meant to subject passive tax-shelter type real estate investments to the stay relief rule of subsection (d)(3). Courts give great weight to whether the core of the business is a "passive" real estate investment, where the debtor simply collects income.[346] If so, it is a SARE. The seminal and oft-cited case of *In re Kkemko, Inc.*, after looking closely at the history of the passage of the 1994 law, observed, "The drafters and promulgators of § 101(51B) were working in a bankruptcy context, and we have no doubt that their intention in using the phrase 'single asset real estate' grew out of the common usage of that term in bankruptcy. By it, they meant a building or buildings which were intended to be income producing, or raw land."[347]

Thus, if the debtor's only business is to collect rents from an apartment building or office park, and the property is not residential realty with less than 4 units, the special rule of § 362(d)(3) certainly will apply. Even if the debtor's only asset is undeveloped raw land, the courts generally find subsection (d)(3) applicable. A 2007 decision went so far as to hold that a debtor whose business consisted of purchasing real estate and then developing and selling single family homes and condominiums on that real estate was a SARE.[348] That decision, though, surely skates out on the thinnest interpretive ice. One could debate whether the non-passive acts of planning, developing, and selling the homes and condominiums was merely "operating the real property" and activities incidental thereto. § 101(51B). Just because the debtor's activities are based on and flow from the real estate itself does not necessarily mean that it will qualify, if the debtor is conducting a "substantial business" other than just owning and operating the real estate. Thus, a Fifth Circuit case held that a company that planned, grew, harvested, and sold timber was not a SARE.[349] The court found that the active, as opposed to passive, management of the timber operations took the debtor out of the SARE definition. Distinguishing the home development case discussed above, the court emphasized that such timber management activities could be conducted as a business independent of the ownership of the underlying real estate.

Many cases have grappled with the SARE issue when the debtor's "single asset" includes an active operating business, such as a shopping center, golf course, or hotel. Courts in such cases inevitably find that the debtor is doing more than merely "operating the real property and activities incidental" thereto, and will not force such a debtor to comply with the dictates of § 362(d)(3).[350] § 101(51B).

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[346] See, e.g., In re Prairie Hills Golf & Ski Club, Inc., 255 B.R. 228 (Bankr. D. Neb. 2000) (holding that golf and ski club was not SARE because was not simply a "passive" real estate investment); see also *Kara Homes*, 363 B.R. 399; In re Club Golf Partners, 2007 WL 1176010 (Bankr. E.D. Tex. Feb. 15, 2007).

[347] *Kkemko*, 181 B.R. at 51.

[348] *Kara Homes*, 363 B.R. 399.

[349] *Scotia Pacific*, 508 F.3d 214.

[350] See, e.g., In re Whispering Pines Estate, Inc., 341 B.R. 134 (Bankr. D.N.H. 2006) (hotel); In re Larry Goodwin Golf, Inc., 219 B.R. 391 (Bankr. M.D.N.C. 1997) (golf course); *Kkemko*, 181 B.R. 47 (marina).

Guam Society of CPAs
August 20, 2024
Law of Bankruptcy (including tax ramifications)

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2. Committee on Finance—Bankruptcy Tax Act of 1980
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30. Ball for Ball III by Appointment v. Commissioner of Internal Revenue, 742 F.3d 552 (2014; 3rd Cir.)—S corporations—electing small business trusts—shareholder liability—items of income—basis adjustments—QSub elections – unrecognized gain; gross income; liquidations
31. Clark v. Rameker, 573 U.S. 122 (2014—Inherited IRA as "retirement funds" within the meaning of bankruptcy exemption
32. Northern Pipeline Construction Co. v. Marathon Pipe Line Company, 458 U.S. 50 (1982)—A jaundiced view of bankruptcy
33. Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989)—Retrenchment extended from Article III to the 7th Amendment
34. Stern v. Marshall, 564 U.S. 462 (2011)—Marathon Consolidated
35. National Labor Relations Board v. Bildisco, 465 U.S. 465 (1984)—Bankruptcy versus Labor Law
36. Midlantic National Bank v. New Jersey Department of Environmental Protection, 474 U.S/ 494 (1986)—Bankruptcy versus Environmental Law
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CHAPTER VI

PROPERTY OF THE ESTATE

The filing of a bankruptcy petition not only triggers the automatic stay but also creates an estate and in effect transfers the debtor's rights in property to that estate, section 541(a).

A. WHY IS PROPERTY OF THE ESTATE AN IMPORTANT CONCEPT?

"Property of the estate" is one of the most important basic bankruptcy concepts. The filing of any bankruptcy petition automatically creates an "estate," and that estate includes the assets of the debtor as of the time of the bankruptcy filing, section 541(a).

In a Chapter 7 case, "property of the estate" is collected by the bankruptcy trustee and sold; the proceeds from the sale of the property of the estate are then distributed to creditors, sections 704, 726. In other words, the loss of property of the estate is the primary cost of Chapter 7 bankruptcy to the debtor; the receipt of the proceeds from the sale of property of the estate is the primary benefit creditors derive from a Chapter 7 bankruptcy.

In other kinds of bankruptcy cases, the importance of property of the estate is less obvious. Nonetheless, property of the estate is an important concept in cases filed under Chapter 11 or 13.

In most Chapter 11 cases, the debtor will remain in possession of "property of the estate" as "debtor-in-possession." However, the Chapter 11 debtor-in-possession's use of the property of the estate will be subject to bankruptcy court supervision.

Consider the example of Chapter 11 cases involving business debtors. Successful rehabilitation of a business generally requires continued operation of the business. Continued operation of the business generally requires continued possession and use of the business' property. A debtor will continue to operate its business in Chapter 11 as debtor-in-possession unless a request is made by a "party in interest" for the appointment of a trustee, and the bankruptcy court, after notice and hearing, grants the request.

Recall that since 2020, debtors that meet the requirements of section 1182 can elect to use Subchapter V of Chapter 11. In Subchapter V cases there is a trustee but the debtor will continue to operate the business as a debtor-in-possession.

When a trustee is appointed in a Chapter 11 case that is not a Subchapter V case, the trustee takes possession of property of the estate. Even if a trustee is not appointed in a Chapter 11 case, the debtor-in-possession's use and sale of the property of the estate is subject to the supervision of the bankruptcy judge as provided in section 363. Section 363 is considered later.

While Chapter 13 contemplates that there will be a trustee in every case, a Chapter 13 trustee does not

take possession of property of the estate. A debtor who files for Chapter 13 relief retains possession of his property. Again, however, the use and sale of "property of the estate" is subject to the supervision of the bankruptcy court as provided in section 363.

In Chapter 13 cases, the value of the property of the estate determines the minimum amount that must be offered to holders of unsecured claims in the debtor's plan of repayment, section 1325(a)(4). Chapter 11 imposes a similar requirement as to holders of unsecured claims, section 1129(a)(7)(A)(ii).

Finally, a number of general provisions in Chapters 3 and 5 that are applicable in all bankruptcy cases use the phrase "property of the estate." For example, the automatic stay bars a creditor from collecting a claim from property of the estate, section 362(a)(3), (4).

In short, in all bankruptcy cases and in all bankruptcy classes, it is necessary to be able to answer the question "what does property of the estate include?"

B. WHAT DOES PROPERTY OF THE ESTATE INCLUDE?

Section 541 is the primary section to turn to in answering the question "what does property of the estate include?" With only minor exceptions, property of the estate includes all property of the debtor as of the time of the filing of the bankruptcy petition.

1. WHAT IS INCLUDED IN THE PHRASE "INTERESTS OF THE DEBTOR IN PROPERTY AS OF THE COMMENCEMENT OF THE CASE"?

The seven numbered paragraphs of section 541(a) specify what property becomes property of the estate. Paragraph one is by far the most comprehensive and significant. Section 541(a)(1) provides that property of the estate includes "*all* legal or equitable *interests of the debtor* in property *as of the commencement of the case*" (emphasis added).

This is a very broad statement. Note first the word "all." Property of the estate thus includes both real property (such as a company's manufacturing facility or an individual's house) and personal property (such as a store's inventory or an individual's car), both tangible (the manufacturing facility, the car, etc.) and intangible property (such as an account receivable or a patent license), both property in the debtor's possession and property in which the debtor has an interest that is held by others.[1]

The language in section 541(a)(1) raises two important litigable issues. Please reread the statutory excerpt again. Focus on the italicized phrases.

First, note the phrase "interests of the debtor in property." If the debtor has a limited interest in some

[1] Third parties in possession of property in which the debtor has an interest are statutorily obligated to return such property to the trustee or debtor in possession, sections 542 and 543. When we consider these sections, we will consider the obligation of a secured creditor who has seized but not yet sold property that served as its collateral to return that property to the debtor.

asset, it is that limited interest that is property of the estate. Consider the following two examples:

(1) *A* and *B* own an island as tenants in common. If *A* files a bankruptcy petition, only *A*'s limited interest in the island would be property of the estate.[2]

(2) *X* owns a new Chevrolet Silverado. He borrowed the money to buy the truck from a bank which retained a security interest in the truck. Under Article 9 of the Uniform Commercial Code, that security interest or lien is a property interest in the Silverado truck. Outside of bankruptcy then, both *X* and the bank have property interests in the Silverado. Accordingly, if *X* files a bankruptcy petition, under section 541 of the Bankruptcy Code, only *X*'s property interest in the Silverado is property of the estate.[3]

Second, consider the phrase "as of the commencement of the case" in section 541(a)(1). "Commencement of the case" is synonymous with the filing of a bankruptcy petition, sections 301, 303. Thus, assets that the debtor acquired prior to the petition become property of the estate.

Generally, property acquired after the petition generally is not property of the estate. For example,

[2] While only A's interest in the island is property of the estate, the entire island can be sold under section 363(h).

[3] In the specific situations described in section 363(f), X's Silverado can be sold free and clear of the Colorado bank lien.

if *D* files for Chapter 7 bankruptcy on April 5, the money *D* earns from the work that *D* does after April 5 is not property of the estate, section 541(a)(1), (6) ("earnings from services performed by an individual after the commencement of a case" excepted from property of the estate).

2. WHAT ELSE IS INCLUDED IN PROPERTY OF THE ESTATE?

While property of the estate is determined primarily by section 541(a)(1)—"the interests of the debtor in property as of the commencement of the case," property of the estate also includes some property acquired after the commencement of the case:

#1 "Any interest in property that the trustee recovers," section 541(a)(3)

As we will see in Chapter XII of this book, the bankruptcy trustee (and the debtor in possession in a Chapter 11 case) is empowered by the Bankruptcy Code to recover certain payments and other transfers of the debtor's interest in property. The trustee's use of these avoidance powers increases the property of the estate.

Assume, for example, *D* pays $1,000,000 to one of his creditors, *C*, on January 10th and *D* then files for bankruptcy on January 15th. If the bankruptcy trustee is able use her avoidance powers under sections 547 and 550 to avoid that January 10th payment, then *C* would have to return the $1,000,000, and that $1,000,000 would become property of the estate.

#2 "Proceeds, product, offspring, rents or profits of or from property of the estate," section 541(a)(6)

Assume that Homer and Marge Simpson file a bankruptcy petition and the next day their house is destroyed by an explosion of the Springfield nuclear power plant. Any insurance proceeds would be property of the estate. Similarly, if *D* Realty Co. files for bankruptcy, both the buildings it owns as of the bankruptcy petition and the postpetition rents from the buildings would be property of the estate.

Reconsider the last sentence. The postpetition earnings of a corporation or any other "person" other than an "individual" are property of the estate under section 541(a)(6). The postpetition earnings of an individual from the services that they perform after the bankruptcy are excluded from property of the estate—unless the debtor has filed a petition for relief under Chapter 11 or 13.

#3 "Earnings from services" that an individual debtor acquires after filing a petition for relief under Chapter 11 or Chapter 13.

If an individual debtor files a petition for relief under Chapter 11 or Chapter 13, property of the estate will be determined not only by section 541 but also by section 1115 or 1306. Under these provisions, postpetition earnings are property of the estate.

#4 Property that the debtor acquires or becomes entitled to within 180 days after the filing of the petition by (a) bequest, devise, or inheritance; (b) property settlement or a divorce decree; or (c) as beneficiary of a life insurance policy, section 541(a)(5).

3. WHAT IS EXCLUDED FROM PROPERTY OF THE ESTATE?

There are some very specific exclusions from property of the estate in section 541(b) and 541(c). For example, section 541(b)(5), provides that funds placed in an educational retirement account at least 365 days prior to a bankruptcy filing, within limits established by the Internal Revenue Code and for the benefit of the debtor's children or grandchildren, are excluded from the debtor's estate.

If your professor is going to test you on insignificant stuff like that, even this book is not going to help.

The most significant section 541(b) or section 541(c) exclusion from property of the estate is section 541(c)(2). Even though neither the words "spendthrift trust" nor "ERISA" appear in section 541(c)(2), it has been read to exclude traditional spendthrift trusts and ERISA accounts from property of the estate, Patterson v. Shumate, 504 U.S. 753 (1992). Since most bankruptcy law professors do not understand ERISA, you probably do not need to understand more about section 541(b) and (c).

In both law school classes and bankruptcy cases, the most significant exclusions from property of the estate are not based on section 541(b) or (c). Rather, the most significant exclusions are exemptions which will be considered in the next chapter.

CHAPTER XIV

CHAPTER 13

A. COMMENCEMENT OF THE CASE

Chapter 13 of the Bankruptcy Code replaced Chapter XIII of the Bankruptcy Act of 1898. Chapter XIII was limited to a "wage earner," i.e., "an individual whose principal income is derived from wages, salary, or commissions."

Chapter 13 is open to more debtors. Subject to limited exceptions,[1] the source of income is not an eligibility test. A debtor may file for Chapter 13 relief if the debtor

(1) *is an individual, and*

[Chapter 13 is not available to corporations or other business entities.]

(2) has a "regular income," and

[The phrase "individual with a regular income" is statutorily defined in section 101(30) as "an individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under Chapter 13 of this title."]

[1] Neither a stockbroker nor a commodity broker may file a petition under Chapter 13, section 109(e).

(3) has noncontingent, liquidated unsecured debts of less than $419,725 and noncontingent, liquidated secured debts of less than $1,257, 850, section 109(e)[2].

[Note that the debt limitation only includes "fixed" debts. For example, Jimmy McGill is sued for $25,000,000 for malpractice on April 4. He could still file a Chapter 13 petition on April 5 The $25,000,000 unsecured claim is unliquidated and so does not affect Chapter 13 eligibility.]

While the means testing requirements of section 707 can and will prevent some individuals from filing for Chapter 7 relief, there is nothing in section 707 or section 109 or anywhere else in the Code that expressly requires anyone to file a Chapter 13 petition. Failing the means test simply means that an individual cannot use Chapter 7; it does not mean that they must use Chapter 13.

Obviously, failing the section 707 means test will mean that some debtors will file for Chapter 13 relief because they feel that they have no meaningful alternative: no protection from creditors under state law, no possibility of filing for Chapter 7 protection.

B. CO-DEBTOR STAY

An advantage of Chapter 13 over Chapter 7 is the co-debtor stay which is available only in Chapter 13 cases. Section 1301 restrains a creditor from attempting to collect a debt from the co-debtor of a Chapter 13 debtor.

2 The amounts are inflation indexed under section 104.

The following hypothetical illustrates the application of section 1301's co-debtor stay: *D* borrows money from *C* to buy a pair of contact lenses. *D*'s mother, *M*, signs the note as a co-maker. *D* later incurs financial problems and files a Chapter 13 petition. Section 362 stays *C* from attempting to collect from *D*; section 1301 stays *C* from attempting to collect from *M*.

Section 1301's stay of collection activities directed at co-debtors is applicable only if

(1) the debt is a consumer debt; and

(2) the co-debtor is not in the credit business.

This co-debtor stay automatically terminates when the case is closed, dismissed, or converted to Chapter 7 or 11.

Section 1301(c) sets out three grounds for relief from the co-debtor stay. Section 1301(c) requires notice and hearing and requires the court to grant relief if any of the three grounds are established.

First, the stay on collection from the co-debtor will be lifted if the co-debtor, not the Chapter 13 debtor, received the consideration for the claim, section 1301(c)(1). For example, if in the above hypothetical, *M*, not *D*, filed for Chapter 13 relief, *C* could petition for relief under section 1301(c)(1) so that it could attempt to collect from *D*. Section 1301(c)(1) also covers the situation in which the Chapter 13 debtor is merely an accommodation endorser.

Second, when the Chapter 13 plan has been filed, a creditor may obtain relief from the co-debtor stay to

the extent that "the plan filed by the debtor proposes not to pay such claim," section 1301(c)(2). Assume, for example, that *D* still owes *C* $200. *D*'s Chapter 13 plan proposes to pay each holder of an unsecured claim 70¢ on the dollar. *C* will thus be paid $140 under the plan. As soon as such a plan is filed, *C* can obtain relief from the stay so that it can obtain $60 from *M*, the other 30¢ on the dollar. A motion to lift the stay under section 1301(c)(2) is deemed granted unless the debtor or co-debtor files a written objection within 20 days, section 1301(d).

Third, section 1301(c)(3) requires the court to grant relief from the co-debtor stay to the extent that "such creditor's interest would be irreparably harmed by continuation of such stay." The running of a state statute of limitations is not a basis for relief under section 1301(c)(3). Section 108(c) guarantees the creditor at least 30 days after the termination of the stay to file a state collection action against the co-debtor.

C. TRUSTEES

There will be a trustee appointed in every Chapter 13 case, section 1302(a). In almost all districts, the United States trustee appoint a standing trustee who serves as trustee in every Chapter 13 case, section 1302(d).

Being a Chapter 13 standing trustee is a full-time job, but it is not a government job. The Chapter 13 trustee is not a government employee. Rather, the Chapter 13 trustee operates a private business. The Chapter 13 trustee does not receive a salary from the

government. Rather, they receives a percentage of the funds disbursed to creditors under the Chapter 13 plans in their district.

The trustee in a Chapter 13 case is an active trustee. Section 1302 imposes a number of duties on a trustee in a Chapter 13 case.

Section 1302 does not clearly indicate whether a Chapter 13 trustee can assert the avoidance provisions. The statutory arguments for a Chapter 13 trustee being able to avoid preferences and other prebankruptcy transfers are

(1) section 103 which indicates that provisions in chapter 5 such as section 547 are applicable in Chapters 7, 11, and 13;

(2) use of the word "trustee" in section 547 and the other avoidance provisions.

The statutory argument for a Chapter 13 trustee *not* being able to avoid preferences and other prebankruptcy transfers focuses on section 1302(b)'s exclusion of section 704(1). If a Chapter 13 trustee is not empowered to "collect the property of the estate," she should not be able to avoid prebankruptcy transfers.

Operation of the debtor's business is *not* one of the duties there enumerated. If a debtor engaged in business files a Chapter 13 petition, section 1304(b) contemplates that the business will be operated by the debtor, not by the trustee, "unless the court orders otherwise."

While a Chapter 13 trustee's duties are listed in section 1302, the exact role of a Chapter 13 trustee varies from district to district. And, while a Chapter 13 trustee does not collect property of the estate or bring avoidance actions or operate businesses, most Chapter 13 trustees play the leading role in most Chapter 13 cases.

Think about Chapter 13 in terms of amounts. First, the dollar amount of most claims. The amount owed by most Chapter 13 debtors to most of their creditors is too low for creditors to hire attorneys to represent them in the Chapter 13 case. Second, the amount of cases. The amount of cases handled by the typical bankruptcy judge is too high for the judge to be able to spend significant time on Chapter 13 cases.

Accordingly, creditors and the bankruptcy judges generally rely on the Chapter 13 trustee to (i) review the debtor's Chapter 13 plan, (ii) raise plan issues, if any, with the debtor's attorney and (iii) resolve those plan issues with the debtor's attorney. Most Chapter 13 plans are presented to the judge without any objection. And, to the extent that there is a plan confirmation objection, the objection is generally raised by the Chapter 13 trustee. After the plan is confirmed by the court, it is the Chapter 13 trustee's office that distributes the plan payments.

D. PREPARATION OF THE CHAPTER 13 PLAN

Only a debtor may file a Chapter 13 plan, section 1321. The court may dismiss a Chapter 13 case or convert it to Chapter 7 for "failure to file a plan *timely* under section 1321 of this title," section 1307(c)(3).

The Code leaves the question of the meaning of "timely"—how many days the debtor has to file such a plan—to the Rules. It's within 15 days after filing the petition, Bankruptcy Rule 3015.

The two most important plan preparation questions are (1) how much does the debtor have to pay under the plan and (2) how much do the various creditors get paid under the plan? To answer these questions, look primarily to sections 1322 and 1325.

Section 1322 governs the contents of a Chapter 13 plan. Section 1325 sets out the requirements for confirmation (court approval) of a plan. Since confirmation is a Chapter 13 debtor's objective, the debtor's attorney will want to look to both section 1322 and section 1325 in formulating the plan.

In looking at section 1325(b)(1)(B), you will see that the amount of a debtor's monthly plan payments depends on their "disposable income." In looking at section 1325(b)(2), section 1325(b)(4) and section 1322(d), you will see that the number of a debtor's monthly payments depends upon a debtor's "current monthly income" and "median family income." Generally, a debtor whose "current monthly income" multiplied by 12 is less than the "median family income" for the state for a family of the same size will make plan payments for three years, and a debtor whose "current monthly income" multiplied by 12 is more than the "median family income" for the state

for a family of the same size will make plan payments for five years.

Looking more closely first at section 1322, notice that subsection (a) of section 1322 specifies what the plan must provide; subsection (b) specifies what the plan may provide. Generally, a Chapter 13 plan must provide for the full payment in cash of all claims entitled to priority under section 507 unless the holder of the claim otherwise agrees, section 1322(a)(2). There is a limited exception for assigned domestic support obligations, section 1322(a)(4).

A Chapter 13 plan may provide for less than full payment to other unsecured claims. It may not, however, arbitrarily pay some holders of unsecured claims less than others. Rather, the plan must either treat all unsecured claims the same or classify claims and provide for the same treatment of each unsecured claim within a particular class, sections 1322(a)(3), 1322(b)(4).

Section 1322(b)(2) indicates that a Chapter 13 plan can also modify the rights of most holders of secured claims.[3] The plan may modify the rights of creditor *A* who has a security interest on the Chapter 13 debtor's consumer goods, equipment, and inventory. The plan may modify the rights of Creditor *B* who has a mortgage on the Chapter 13 debtor's store.

[3] Section 1322(a)(2) needs to be read together with the 2005 amendments to section 1325(a)(5) which in essence modify or limit the extent to which a Chapter 13 plan can modify the rights of holders of most automobile secured claims. We will read about section 1325(a)(5) elimination of most Chapter 13 "strip downs" of car loans.

A Chapter 13 plan may not, however, modify the rights of Creditor *C* who has a mortgage *only*[4] on the Chapter 13 debtor's principal residence, section 1322(b)(2). If, for example, before bankruptcy, *D*'s home mortgage provided for a principal balance of $100,000, interest at 10% and monthly payments of $625, the debtor has exactly the same home mortgage obligation in Chapter 13. No plan modification of mortgages on the debtor's principal residence.

While a Chapter 13 plan cannot modify a claim secured only by the debtor's principal residence, it can cure defaults with respect to such a claim, section 1322(a)(3), (5). If, for example, *D* missed four home mortgage payments of $625 each before filing for Chapter 13 relief, *D*'s Chapter 13 plan can provide for periodic payments over the duration of the plan to "cure" that $2,500 default. We will do more examples of curing defaults on secured claims and do examples of modifying secured claims when we do more with confirmation of Chapter 13 plan provisions relating to claims secured by houses and other secured claims later in this chapter.

In the typical Chapter 13 case, the source of the payments proposed by the plan will be the debtor's wages. This is not, however, a statutory requirement. Payments under the plan may also be funded by other income such as social security benefits or even the sale of property of the estate, section 1322(b)(8). Section 1322(a)(1) only requires that the plan provide

[4] Note the word "only" in section 1322(b)(2). If *C* loaned *D* $100,000 and obtained a mortgage on both *D*'s residence and *D*'s store, the plan could modify *D*'s rights.

for submission of "such portion of future earnings . . . of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan." Section 1322(a)(1) needs to be read together with section 1325(b) which makes the commitment of disposable income necessary for the confirmation of the plan.

Again, in formulating a Chapter 13 plan or dealing with a law school exam question on a Chapter 13 plan look not only at section 1322 which deals with the contents of the plan but also at section 1325 which covers confirmation of a plan. Section 1325 is covered below.

E. CONFIRMATION OF THE CHAPTER 13 PLAN

In Chapter 13, creditors do not vote on the plan. Chapter 13 requires only court approval. The standards for judicial confirmation of a Chapter 13 plan are set out in section 1325.

Section 1325(a)(1) requires that the plan satisfy the provisions of Chapter 13 and other applicable bankruptcy law requirements. Section 1325(a)(2) conditions confirmation on payment of the filing fee. Section 1325(a)(3) sets out a "good faith" standard.

Dicta in appellate court cases on section 1325(a)(3) (good faith) tend to list numerous factors. Holdings in bankruptcy court cases on section 1325(a)(3) tend to focus on the debtor's financial condition and the amount of payments proposed by the plan. Section 1325(a)(4) and section 1325(b) more directly address the adequacy of the plan payments.

Section 1325(a)(4) protects the holders of unsecured claims by imposing a "best interests of creditors" test: the present value of the proposed payments to a holder of an unsecured claim must be at least equal to the amount that the creditor would have received in a Chapter 7 liquidation. The following hypothetical illustrates the practical significance of the "present value" language in section 1325(a)(4). Assume the following four facts:

(1) *D* owes *C* $1,000;

(2) *D* files a Chapter 13 petition;

(3) If *D* had filed a Chapter 7 petition, the sale of the property of the estate would have yielded a sufficient sum to pay all priority creditors in full and pay unsecured creditors like *C* 36¢ on the dollar so that *C* will receive $360 in cash at the close of the Chapter 7 case;

(4) *D*'s Chapter 13 petition proposes to pay *C* $10 a month for 36 months.

This plan does not satisfy the requirement of section 1325(a)(4). Payment of $360 over a 36-month period does not have a "present value" of $360.

This hypothetical is probably somewhat unrealistic. In the typical Chapter 7 case, an unsecured creditor would receive little if anything. Accordingly, in the typical Chapter 13 case, section 1325(a)(4) will be easily satisfied.

Section 1325(a)(3) and (4) needs to be read together with section 1325(b). Section 1325(b) imposes a "best efforts" kind of requirement. More specifically, section 1325(b) requires either that the plan pay unsecured claims in full with interest or commit all of the debtor's "disposable income" to such payments for the "applicable commitment period" as defined in section 1325(b)(4).

Section 1325(b)(2) also defines "disposable income" as "current monthly income," other than child support income, that is not necessary to provide support for the debtor or the debtor's dependents. If (and only if) the Chapter 13 debtor's income is greater than the applicable "median family income," then it is necessary to read section 1325(b)(2) together with section 1325(b)(3) and necessary to limit the debtor's support needs by the Internal Revenue Service expense standards referenced in section 707(b)(2)(A)(ii)(I).

Section 1325(a)(5) protects the holders of secured claims "provided for by the plan" by requiring one of the following:

(1) Acceptance of the plan by such a creditor; or

(2) Continuation of the lien and proposed payments to such a creditor of a present value that at least equals the value of the collateral; [this "cram down" provision will be considered in Part F of this chapter]

(3) Surrender of the collateral to the creditor.

Section 1325(a)(6) requires a determination of ability to perform; it requires that the debtor "will be able to make all payments under the plan and to comply with the plan."

A confirmed Chapter 13 plan is binding on the debtor and all of his creditors, section 1327(a). Unless the plan or the order confirming the plan otherwise provides, confirmation of a plan vests all of the "property of the estate" in the debtor free and clear of "any claim or interest of any creditor provided for by the plan," section 1327(c).

After confirmation, the plan is put into effect with the debtor generally making the payments provided in the plan to a Chapter 13 trustee who acts as a disbursing agent.

A Chapter 13 plan can be modified after confirmation. Section 1329 expressly provides for post-confirmation modification on request of the debtor, the trustee, or the holder of an unsecured claim.

F. CRAMDOWN (OR CRAM DOWN) OF SECURED CLAIMS IN CHAPTER 13

A Chapter 13 plan can propose modifications of a secured claim to which the holder of the claim consents. For example, the creditor might agree to wait longer for payment if the payment is increased. If the modification is acceptable to the holder of the secured claim, it will be acceptable to the court, section 1325(a)(5)(A). No secured claim plan confirmation issue.

Alternatively, a Chapter 13 plan can propose to surrender the encumbered property to the holder of a secured claim. Assume, for example, that *D* owes *S* $200,000, secured by a first mortgage on Redacre. If *D*'s Chapter 13 plan surrenders Redacre to *S*, then *S* no longer has a secured claim. If Redacre's value is less than $200,000, then after S obtains Redacre, *S* might still have a claim. Just not a secured claim. Accordingly, a plan that "surrenders the property securing such claim" will be acceptable to the court, section 1325(a)(5)(C). Again, no secured claim plan confirmation issue.

Secured claim plan confirmation issues arise only if the plan proposes that (i) the debtor retain the encumbered property and (ii) the secured claim be modified and (iii) the holder of the secured claim does not agree. These issues are called cram down issues (or cramdown issues).

It's not the Bankruptcy Code that uses the phrase "cram down." Neither "cram down" (nor "cramdown") appears anywhere in the Bankruptcy Code. Rather it is the bankruptcy lawyers, judges and law professors who have come to use the term cram down to describe court approval of a plan provision that effects changes in the payment of a claim without claim holder approval.

In order to cram down a Chapter 13 modification of a secured claim, the bankruptcy court must apply section 1325(a)(5)(B). And, in order to apply section 1325(a)(5)(B), it is necessary to determine the nature of the proposed modification.

One form of cram down is a "strip down," i.e., reducing the amount that was to be paid to the holder of the secured debt to the value of its collateral. In applying section 1325(a)(5)(B) to a "strip down," the bankruptcy court makes the following two determinations:

(1) What is the value of the collateral?[5]

(2) Is the present value of the plan payments at least equal to the value of the collateral?[6]

To illustrate, *D*, an independent trucker, owes *S* $60,000. *S* has a security interest in *D*'s tractor and trailer rig. *D* files a Chapter 13 plan that proposes to pay *S* $1,000 a month for 36 months. *S* does not consent.

In applying section 1325(a)(5)(B) to this proposed strip down, the court would first have to determine the value of the collateral, i.e., the value of the tractor and trailer rig. Looking to *Associates Commercial Corp. v. Rash*, discussed in Chapter X, the court would look to the replacement value of the tractor and trailer rig.

If the replacement value of the tractor and trailer rig was $36,000, then the proposed plan payments must have a present value of $36,000. Obviously, a

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5 The relevant language in section 1325(a)(5) is "allowed amount of SUCH CLAIM." The antecedent of "such claim" is "secured claim." Section 506 ties the amount of the secured claim to the value of the collateral.

6 The relevant language in section 1325(a)(5) is "value, as of the effective date of the plan, of property to be distributed under the plan . . . ."

Chapter 13 debtor's promise to pay $1,000 a month for 36 months has a present value significantly less than $36,000. The debtor would also have to pay cram down interest as measured by the "formula approach" of *Till v. SCS Credit Corp.*, discussed in Chapter X.

No strip down is allowed on a purchase money loan incurred within 910 days before the bankruptcy filing if it is secured by a motor vehicle acquired by the debtor for her personal use. Thus, a D, Chapter 13 debtor who owes $33,000 on a recently purchased personal car that *D* wants to keep will now have to make payments with a present value of $33,000.

While *D* cannot cram down a change in the principal to be paid, *D* can, consistent with *Till*, cram down a change in the interest rate, and *D* can, consistent with the requirements of section 1325(a)(5)(B)(iii)[7] change the number of payments and the amount of each payment.

Remember that strip down is simply one form of cram down. A cram down is any change in the payment obligation approved by the court over the creditor's objection. The change can be changes in the interest rate, changes in the number of payments, changes in the amount of payments, etc. Or the change can be a change in the amount to be paid, i.e., a strip down.

And, remember a strip down is still possible in a case with the same facts as *Rash*. A strip down of a

[7] Section 1325(a)(5)(B)(iii) requires that the payments be monthly and be adequate to provide "adequate protection."

motor vehicle loan is still possible so long as the collateral is not a personal use automobile.

G. TREATMENT OF HOME MORTGAGES IN CHAPTER 13 PLANS

Most home mortgages are protected from strip down or any other form of cram down. Section 1322(b) excepts from cramdown claims "secured only by a security interest in real property that is the debtor's principal residence" from plan modification.[8]

So, if *D* owes $100,000 on their home mortgage to *M* at the time that *D* files for Chapter 13 and her payments are $625 a month and the mortgage interest rate is 10%, *D* cannot use section 1322(b) to change the mortgage payment schedule or interest rate. Nor can *D* use section 1322 to reduce the amount of that secured claim, regardless of the value of the home. If, for example, the value of the home is only $70,000, *D* cannot use a Chapter 13 plan to "strip down" *M*'s secured claim to $70,000. Nobleman v. American Savings Bank, 508 U.S. 324 (1993).

[8] Reread the quoted language and identify the three "litigable" (i.e., "law school test-able") issues. First, is the residence the only security for the loan, or did the creditor take a lien on some other collateral such as the debtor? What if the home loan is secured not only by a mortgage on the home but also a lien on the debtor's bank account? By a credit life insurance policy? By fixtures or furniture? Second, is the double-wide mobile home that the debtor lives in "real property"? Third, is a mixed use property such as a combination home/business office protected?

In practice, a judge expects a lawyer to know how they have ruled on each of these questions. In law school, a law professor expects a student to "spot" and raise each of these questions.

Courts have distinguished between a "strip down" and a "strip off." Assume again that *M* has a $100,000 first mortgage on *D*'s $70,000 home. Now also assume that *S* has a $25,000 second mortgage. As noted above, *D* cannot use section 1322(b)(2) to strip down *M*'s secured claim to $70,000. How is *S*'s claim different from *M*'s? Under section 506, the amount of *S*'s secured claim is zero—the value of SUCH creditor's interest (i.e., the second mortgage interest) in the house. If *S* has a "zero" secured claim in *D*'s principal residence, courts reason that *S* gets "zero" protection from strip off from section 1322(b)(2).

In sum, no "strip down," i.e., no reduction of a first or second mortgage where that mortgage has some value but possibly a "strip off," an elimination of a second or third mortgage where the house has a value less than the amount of the mortgage(s) with priority, has no value.

Section 1322(b)(2) general prohibition against Chapter 13 plans making nonconsensual changes to mortgages on the debtor's principal residence is subject to an important statutory exception.

Section 1322(b)(5) permits a Chapter 13 plan to cure defaults on all home mortgages. Assume for example that *D* missed three home mortgage payments of $700 a month before *D* filed a Chapter 13 bankruptcy petition and under the terms of the mortgage D's default in making these three payments triggered an acceleration which made the entire loan balance immediately due. *D* can use their Chapter 13 plan to cure these defaults "within a reasonable time" and maintain the mortgage by

continuing to make the usual monthly payments, section 1322(b)(5).

H. CLASSIFICATION OF UNSECURED CLAIMS

A Chapter 13 debtor often wants to make certain that some creditors are paid in full by their Chapter 13 plan. Especially debts guaranteed by a family member or friends and debts excepted from the Chapter 13 discharge.

To get credit, the debtor may have had to get someone more creditworthy—a relative or close friend[9]—to guarantee payment of the obligation. To the extent that the Chapter 13 plan does not pay that obligation, the creditor can and will collect from the co-debtor. Cf. section 1301(c)(2).

And, some debts such as student loans are not covered by a Chapter 13 discharge. The debtor will, of course, want to pay all such nondischargeable debts in full in her Chapter 13 plan; otherwise the debtor will have to pay the balance after completing the Chapter 13 plan payments.

A Chapter 13 debtor can use claim classification to pay one or more of their creditors in full even though they does not have sufficient disposable income to pay all of their creditors in full.[10] Under section

[9] There is no requirement that the guarantor be a relative or friend but. . . . How many of your loans have been guaranteed by strangers? How many loans have you guaranteed for strangers?

[10] A Chapter 13 debtor can also use section 1322(b)(5) to make preferential plan payments on long-term debts. Section 1322(b)(5) only applies if the last payment on the debt is due after

1322(b)(1), a Chapter 13 plan can divide unsecured claims into more than one class and treat the various classes differently.

The primary limitation on this discrimination in the plan treatment of unsecured claims is that the classification may not "discriminate unfairly." The key word is, of course, "unfairly": any classification discriminates—what is required is that the discrimination not be unfair.

Most reported opinions under section 1322(b)(1) set out some sort of multi-factor test. The factor that seems most important is the difference in the amount of payment to the various classes. Obviously, it will be easier to get court approval of a plan that pays Class 2 100% and all other classes 90% than a plan that pays Class 2 100% and all other classes 10%.

Put Chapter 13 plan classification in context. All Chapter 13 plans must meet the "best interests" test of section 1325(a)(4) with respect to all classes of unsecured claims. In other words, even the creditors in the class receiving least favorable Chapter 13 plan treatment are still receiving at least as much as they would have received if the debtor had filed for Chapter 7 relief instead of Chapter 13.

the last plan payment. With respect to such debts, a Chapter 13 debtor can simply make payments according to the contractual terms. The advantage to this approach is that more of the debt can be paid during the Chapter 13 case. The disadvantage to this approach is that, even if the debt was otherwise dischargeable, the debtor will have to complete the payments under the contract notwithstanding any Chapter 13 discharge. Cf. section 1328(a).

I. DISCHARGE

A Chapter 13 debtor will be denied a discharge because of their bankruptcy history. More specifically, a Chapter 13 debtor will be denied a discharge if they received a discharge in another Chapter 13 case in the two-year period preceding the filing of this Chapter 13 case, section 1328(f)(2). Similarly, a Chapter 13 debtor will be denied a discharge if they received a discharge in a Chapter 7, 11 or 12 case in the four years preceding the filing of this Chapter 13 case, section 1328(f)(1). And, any Chapter 13 discharge will be delayed until the debtor completes an "instructional course concerning personal financial management," sections 111, 1328(g).

Section 1328 contemplates that a Chapter 13 debtor will complete all plan payment obligations and certify that he has paid all postpetition domestic support obligations and then receive a discharge, section 1328(a). A section 1328(a) discharge is subject to most but not all of the exceptions to discharge in section 523. For example, a section 1328(a) discharge, unlike a discharge in a Chapter 7 case, will cover debts for willful and malicious injury to property and debts for divorce or separation property settlements. Cf. section 1328(a)(2), (4).

The bankruptcy court may grant a discharge in a Chapter 13 case even though the debtor has not completed payments called for by the plan. Section 1328(b) empowers the bankruptcy court to grant a "hardship" discharge if:

(1) the debtor's failure to complete the plan was due to circumstances for which she "should not justly be held accountable;" and

(2) the value of the payments made under the plan to each creditor at least equals what that creditor would have received under Chapter 7; and

(3) modification of the plan is not "practicable."

A section 1328(b) "hardship" discharge is not as comprehensive as a section 1328(a) discharge. A "hardship" discharge is limited by all of the section 523(a) exceptions to discharge, section 1328(c)(2).

J. DISMISSAL AND CONVERSION

Most Chapter 13 cases do *not* end in a discharge. Most bankruptcy cases filed as Chapter 13 cases are either dismissed or converted to Chapter 7 cases. A debtor who files a Chapter 13 petition may at any time request the bankruptcy court to dismiss the case or convert it to a case under Chapter 7, section 1307(a), (b).

The bankruptcy court may also dismiss a Chapter 13 case or convert it to a case under Chapter 7 on request of a creditor. The statutory standard for such creditor-requested conversion or dismissal is "for cause." Section 1307(c) sets out eight examples of "cause."

Section 1307(d) gives a bankruptcy court the power to convert from Chapter 13 to Chapter 11 before confirmation of the plan on request of a party in

interest and after notice and hearing. There is no statutory standard to guide the court in deciding whether to convert from 13 to 11.

K. COMPARISON OF CHAPTERS 7 AND 13

Remember that in a Chapter 7 case, a debtor's unencumbered nonexempt property as of the time of the bankruptcy petition is sold by the Chapter 7 trustee and the proceeds are distributed to the holders of unsecured claims, What unencumbered nonexempt property do you have? Most individuals do not have much if any unencumbered nonexempt property. For most individuals, the only real costs of Chapter 7 bankruptcy are (i) the filing fee and (ii) their attorney's fee. And most Chapter 7 debtors receive a discharge within a few months of filing for bankruptcy.

Chapter 13 on the other hand puts the debtor on a strict budget and takes their "disposable income" for as long as five years. And, most Chapter 13 debtors do not receive a discharge until they complete their plan payments.

Accordingly, real lawyers will rarely be asked by clients to compare Chapters 7 and 13. For most individuals who pass the means test, Chapter 7 provides more immediate relief at a much lower cost than Chapter 13.

Nonetheless, law students will continue to be asked by law professors to compare Chapters 7 and 13 and so you might want to review the following chart:

		Chapter 7	Chapter 13
1.	**Automatic Stay**	Automatic stay of section 362 protects the debtor from creditors' collection efforts	Automatic stay of section 362 protects the debtor from creditors' collection efforts. Automatic stay of section 1301 protects certain co-debtors
2.	**Loss of Property**	"Property of the estate" as described in section 541 is distributed to creditors	Except as provided in the plan or in the order of confirmation, debtor keeps "property of the estate"
3.	**Availability of Discharge**	Section 727(a) lists grounds for objection to discharge	Section 727 is inapplicable. Discharge depends on completing payments required by the plan, section 1328(a). A "hardship" discharge to a debtor who makes some but not all payments required by the plan, section 1328(b).

		Chapter 7	Chapter 13
4.	**Debts Excepted from Discharge**	Section 523(a) excepts 19 classes of claims from operation of the discharge	A section 1328(a) discharge is subject to most of the important section 523(a) discharge exceptions. A section 1328(b) discharge is subject to all of section 523(a)'s exceptions to discharge
5.	**Effect on Future Chapter 7 Relief**	A debtor who receives a discharge in a Chapter 7 case may not obtain a discharge in another Chapter 7 case for eight years	A Chapter 13 discharge does not affect the availability of discharge in a future Chapter 7 case if the Chapter 13 plan was the debtor's "best effort" and paid 70% of all general claims, section 727(a)(9)
6.	**Whether Debtor's Postpetition Earnings are Property of the Estate**	No, section 541(a)(6) ("earnings from services performed by an individual")	Yes, section 1306

		Chapter 7	Chapter 13
7.	**Debtor's Ability to Terminate the Case**	"Only for cause," section 707	"On request of the debtor at any time," section 1307(b)
8.	**Amount Required to be Distributed to Holders of Claims**	Focus on property of the estate, section 541	Plan controls, confirmation requires that holders of claims receive at least as much as they would in Chapter 7 and that plan commits all focus on disposable income, section 1325(a)(4); 1325(b)

L. COMPARISON OF CHAPTERS 11 AND 13

Any debtor who files a Chapter 13 petition could instead have filed a Chapter 11 petition. We will learn about Chapter 11 and Chapter 11's special provisions for individual debtors in the next chapter.[11] Even if you read this next chapter casually and not carefully, you should see that a debtor who has a choice between Chapters 11 and 13 will almost always choose Chapter 13.[12]

[11] And Chapter XVI of this book will explain the special provisions for individual debtors who choose Subchapter V.

[12] Remember that Chapter 13 is not available to all debtors. Corporations and partnerships are not eligible for Chapter 13, and individuals have to meet the debt limits of section 109(e).

Bankruptcy and Debtor/Creditor

Seventh Edition

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Debtor Eligibility and the Different Forms of Bankruptcy Relief

§5.1 OVERVIEW

The distinction between liquidation under Ch. 7 and rehabilitation under Chs. 11 or 13[1] was introduced in section 3.5.2(f) and is taken up again here and examined from the perspective of a debtor who is about to file a bankruptcy petition. This chapter is concerned with the eligibility of different debtors for the alternative forms of bankruptcy relief provided in Chs. 7, 11, and 13, the factors that may influence a debtor in selecting between those alternatives, and the possibility of postpetition conversion from one form of relief to another.

Section 5.2 is a general overview of the distinction between liquidation and rehabilitation bankruptcy. Section 5.3 identifies different types of debtor—corporations, individuals, consumers, and businesses. In some circumstances different Code sections apply to different types of debtors, but in many situations the distinctions between them are fact-based and arise from the different nature of their financial and economic dealings and circumstances.

Section 5.4 deals with general eligibility for bankruptcy relief under §109(a). It also discusses a temporary barrier to the eligibility of a debtor who has made successive bankruptcy filings (§109(g)) and the requirement

1. Chs. 9 (municipal bankruptcy) and 12 (family farmer bankruptcy) are also concerned with rehabilitation, but are not discussed in this book.

of credit counseling that must be satisfied for the eligibility of an individual debtor (§109(h)). Section 5.5 details the specific eligibility requirements for Chs. 7, 11, and 13, provided, respectively, in §§109(b), §109(d), and §109(e). Section 5.6 discusses the conversion of a case from one chapter to another under §§706, 1112, and 1307. Section 5.7 identifies factors that are relevant to a debtor's choice of relief, and section 5.8 outlines the principal differences between Chs. 7, 11, and 13 that may be relevant to a debtor's choice of relief.

§5.2 THE DISTINCTION BETWEEN LIQUIDATION AND REHABILITATION

§5.2.1 Liquidation

Liquidation under Ch. 7 aims at the surrender and dissolution of the debtor's executable estate for the purpose of generating a fund to be applied to the payment of creditors. After the filing of the Ch. 7 bankruptcy petition, a trustee is appointed who has responsibility for collecting the debtor's nonexempt unencumbered assets, turning them into liquid form by converting them to cash, and making a distribution to creditors who have proved claims in the estate. The fund is paid out to creditors in the Code's order of priority. Because it is common for Ch. 7 debtors to be insolvent, most creditors, particularly those who hold nonpriority unsecured claims, receive only a pro rata payment of their claims. Often, the pro rata distribution is no more than a small fraction of the claim, and in quite a high percentage of cases, the estate has so few assets that after the costs of administration are paid, there are no funds left to pay unsecured creditors any distribution at all. The unpaid balance is usually discharged when the debtor is an individual. A corporate debtor does not receive a discharge under Ch. 7. As a result, it becomes a shell with no assets, no business, and an accumulated unpaid debt. The defunct corporation is usually deregistered under state corporation law. If not, the existence of the undischarged debt creates a strong disincentive to anyone who might wish to revitalize the shell.

§5.2.2 Rehabilitation Bankruptcy

Chs. 11 and 13 each have their own rules and principles, which are discussed more fully in Chapters 18, 19, and 20. However, they share a common purpose that distinguishes them from Ch. 7. Their general goal is not to

liquidate the debtor's assets[2] but to provide the debtor the opportunity of preserving all or part of the prepetition estate in return for a commitment (formulated in a plan of rehabilitation) to make specified payments or other distributions of value to creditors over a period of time. The level of payment required by the Code is too complex for discussion at this point and is left for Chapters 18 to 21. As a general yardstick, one can say that the premise of the Code is that the value received by creditors under the plan must at least be equal to the present value of what creditors would have received if the debtor had been liquidated under Ch. 7. Of course, this is regarded as the minimum. The goal is that creditors will, in fact, do better than they would have in a liquidation. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) added provisions to the Code that emphasize this goal. Prior to BAPCPA, the Code largely used incentives to encourage individual debtors to choose rehabilitation over liquidation. BAPCPA amended Ch. 7 to make it much more difficult for an individual consumer debtor to choose liquidation over rehabilitation where the debtor has the means, calculated under a complex formula, to make payments under a plan of rehabilitation. This is discussed generally in section 5.5 and in Example 2, and in more depth in section 6.8. In addition BAPCPA amended Ch. 13 (and Ch. 11 in relation to individual debtors) to impose a more stringent standard on the debtor in determining how much the debtor can afford to pay in the Ch. 13 or Ch. 11 case. (*See* sections 18.8.3 and 19.3.2.)

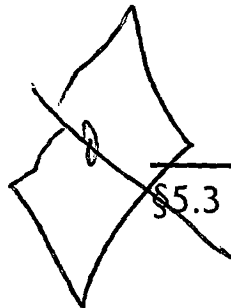
Rehabilitation under Chs. 11 or 13 is only a viable alternative to liquidation if the debtor has some reasonable prospect of honoring the commitments made in the plan. As a requirement of having the plan confirmed by the court, the debtor must be able to show that it is feasible and that there is likely to be a stream of income or other sources of funding or property to support the plan. Once the plan has been confirmed by the court, it becomes the blueprint for the debtor's rehabilitation. During the period that the debtor is in bankruptcy, that is, from the filing of the petition until the ultimate consummation of the plan, creditors are not permitted to pursue any collection activity outside the bankruptcy process, and the debtor has the opportunity to restructure business operations or to reorder financial affairs with the goal of achieving financial health. If the debtor fails to consummate the plan, the debtor might end up in liquidation. Alternatively, the case might be dismissed so that the creditors' collection rights under state law are restored.

2. Some or all of the debtor's assets might be liquidated as part of a rehabilitation plan, and Ch. 11 recognizes the possibility of a liquidation plan that fully liquidates a corporate debtor. Nevertheless, the principal goal of rehabilitation bankruptcy is to preserve the assets of the estate.

The discharge of prepetition debts is an important element of bank ruptcy. Both individuals and corporations can receive a discharge in reha bilitation bankruptcy. The discharge rules vary. *See* Chapter 21.

§5.2.3 A Practical Perspective on the Distinction Between Liquidation and Rehabilitation

Although it is possible to draw a fairly clear line between liquidation and rehabilitation based on the premises and the provisions of the Code, it is important to remember that matters become much muddier as the Code is applied in actual cases. Some of this lack of precision will become apparent later, as we take a closer look at the various specific aspects of the different types of bankruptcy, but a general observation may be helpful at the start. Although some cases do proceed exactly along the lines of a pure liquidation (that is, all the estate's assets are realized and the proceeds distributed) or a full rehabilitation (that is, the plan is completely and successfully consummated, leaving the debtor rehabilitated and creditors better off than they would have been had liquidation occurred), things are often not that tidy. For example, an individual Ch. 7 debtor has various means of avoiding the liquidation of all her property, primarily because of exemptions, but also because when the property is subject to a security interest, it may be possible for the debtor to make an arrangement with the secured creditor to keep the property in exchange for a commitment to keep paying installments due on the contract. Likewise, a rehabilitation plan under Ch. 11 or Ch. 13 may provide for the partial liquidation of assets as a means of deriving the resources needed to fund the plan. Furthermore, rehabilitation is usually a long-term process, dependent on predictions of future economic conditions, the debtor's abilities, and the cooperation of creditors or other persons (such as an employer, a lender, or investor) whose help is needed in the debtor's revival. Even if the plan is not unrealistically optimistic to begin with, economic conditions may be less than desired, the debtor may just not have the ability to do what is needed, or the anticipated cooperation may not be forthcoming. This may lead to the failure of the rehabilitation attempt and ultimate liquidation. In the end, creditors may be worse off than they would have been had liquidation taken place immediately.



§5.3 DIFFERENT TYPES OF DEBTOR

Before discussing eligibility for relief, it is useful to identify the different types of natural or legal persons that may become debtors under the Code

and to draw some distinctions between them. A debtor is a "person or municipality concerning which a case under this title has been commenced." §101(13). "Person" includes an individual, partnership, and corporation, but not a governmental unit. §101(41). The Code therefore identifies four categories of debtor: individuals, partnerships, corporations, and municipalities. This book does not deal with municipal or partnership bankruptcy, so the important distinction for our purposes is between individuals and corporations.

§5.3.1 Individuals and Corporations

"Individual" is not statutorily defined. It means a real, honest to goodness, living, breathing, warm-blooded mammal of the species *homo sapiens*. Section 101(9) defines "corporation" to include a variety of juristic persons, both incorporated and unincorporated. Most commonly, it includes limited liability entities of different kinds. It also includes some partnerships in which the partners have limited liability equivalent to that of corporate shareholders. However, it does not include other forms of partnership. For example, in *In re Dewey & LeBoeuf LLP*, 518 B.R. 766 (Bankr. S.D.N.Y. 2014) the court determined that a limited liability partnership (LLP) was a corporation because state law conferred limited liability protection equivalent to that of corporate shareholders. The classification of an entity as a corporation, rather than a partnership, could have significant consequences because the Code treats partnerships differently from corporations and individuals.

The distinction between corporate and individual debtors is pervasive, because the impact of bankruptcy on a corporation is bound to differ in many respects from that on an individual. Sometimes these differences are purely factual, reflecting the different scope and nature of corporate and individual economic operations. However, they sometimes arise from Code provisions that reflect a policy of conferring rights or imposing duties on one type of debtor but not on the other. For example, exemptions are intended to save the individual debtor from penury, so they are made available to individuals but not corporations. It is therefore important to pay attention to whether a particular Code section speaks generally of "the debtor" or is restricted to the narrower category of "individual debtor."

§5.3.2 Consumer and Business Debtors

It is easy to draw the distinction between individual and corporate debtors, because corporations are distinct legal entities in nonbankruptcy law and the Code itself recognizes this. It expressly provides for different treatment of individuals and corporations in several respects. By contrast, the Code itself

does not as clearly articulate the difference between consumer and business debtors. The only definition pertinent to the distinction is §101(8), which describes a "consumer debt" as one "incurred by an individual primarily for a personal, family or household purpose." From this it is clear that one should not simply equate individual and consumer debtors: An individual is not a consumer debtor unless the bulk of his or her debt is incurred in the course of domestic consumption. Where an individual debtor owns a business as a sole proprietorship or otherwise incurs debts in the course of commercial or other activity unrelated to household or personal purposes, some of his debts are likely to be consumer debts and some business debts.

For many purposes, it is not legally significant to differentiate between consumer or business debtors because most provisions of the Code apply equally in the bankruptcy of each. When the Code intends to provide a special rule for one or the other, it does so expressly. An important example is §707(b), which provides for the dismissal of a Ch. 7 case on grounds of abuse where the debtor is an individual whose debts are primarily consumer debts. (*See* section 6.8.)

Notwithstanding, the distinction between consumer and business debtors is functionally significant and pervasive because the property, obligations, and affairs of a consumer are likely to be quite different from those of a business. This creates factual differences between these two types of bankruptcy so that provisions of the Code relevant to the one often just do not come into issue in the other. The importance of this factual difference is accentuated by the distinct policy concerns that dominate each type. Business bankruptcies tend to implicate larger concerns of economic welfare, such as productivity, market stability, and employee protection. Consumer bankruptcies often highlight social policies such as the prevention of homelessness and the protection of the common person and her dependents, the social ills of the abuse of credit, and shortcomings in the social safety net. It should be stressed, however, that this distinction is likely to be more obvious where the business is a legal entity distinct from its owners (such as a corporation), and has operations of some size. At the margins, the difference between business and consumer bankruptcies is less functionally significant. For example, the stereotypical consumer debtor is a person who earns his income from employment and spends most of it on living expenses or on buying goods and services for personal use. However, if the same debtor is self-employed or engages in business activity, his purchases, loans, and credit card debt may commingle household and business transactions.

Because of these very different factual contexts and policy concerns, it is common for consumer and business bankruptcy to be seen as quite distinct legal regimes. This dichotomy is reflected not only in specialization by practitioners, but also in the way that some books, articles, and law school courses are organized. Although it is important to keep this in mind, it is also

necessary to recognize that many provisions of the Code do not differentiate between consumers and businesses, and are potentially applicable to both.

Within the field of business bankruptcy, there is a practical distinction between small and large businesses. As noted already, different practical considerations and some different legal rules apply to those businesses that are incorporated and those that are conducted by the individual owner in unincorporated form. Even among incorporated businesses, there are significant distinctions between the scope of operations and needs of small and large enterprises. In particular, many complex procedures in Ch. 11 were drafted with large corporations in mind, and they have proved to be cumbersome and unduly burdensome and complicated in the rehabilitation of smaller businesses. There has been growing recognition of this since the Code was enacted in 1978. Congress began to make changes to the Code to simplify the rules relating to small businesses when it enacted a special chapter (Ch. 12) in 1986 to provide a simplified version of Ch. 11 for family farming businesses. However, Congress has never extended this to other small businesses.[3] It has, however, enacted some provisions in Ch. 11 that allow for an expedited procedure for debtors that fall within the statutory definition of "small business debtor." These expedited procedures are discussed in section 20.3.1.

While this book often points to the difference between consumers, small businesses, and large corporations, it is not so organized as to treat each category as a self-contained subject. Rather, because they do have so many rules and principles in common, the preferred approach here is to focus on substantive topics, and to point out, where appropriate, that certain rules and procedures are applicable to or are likely to be more relevant to some types of debtors than to others.

§5.4 DEBTOR ELIGIBILITY

§5.4.1 General Qualifications Under §109(a)

Section 109 states who may be a debtor under the Code. Section 109(a) sets out the general qualification for bankruptcy relief. It is broad, and covers most persons (including individuals and corporations) that are resident or domiciled in or conduct business, or own property in the United States. This general qualification is narrowed by the more specific eligibility requirements for each chapter. A debtor must meet both the general requirement

3. Some years ago, a bill was proposed to create a new Ch. 10 for small businesses other than family farms, but it was never enacted.

under §109(a) and the requirements for the specific chapter under which relief is sought. Section 109 is sometimes described as providing threshold qualifications: Qualification under §109 is necessary for the debtor to be entitled to relief. However, even if the debtor is eligible, other provisions in the Code may preclude relief. For example, a debtor may be eligible for Ch. 13 but may not be able to satisfy the further requirements for plan confirmation, or the debtor may be eligible for some forms of relief under a voluntary petition but may not be compelled into that chapter by an involuntary petition.

§5.4.2 Limitation on Successive Filings Under §109(g)

Section 109(g) imposes a temporary (180 day) limitation on general eligibility to prevent abusive successive filings by individuals.[4] Section 109(g)(1) precludes an individual from becoming a debtor if, within the preceding 180 days, he was a debtor in a case that was dismissed because of willful uncooperative or disobedient behavior. Willfulness requires more than inadvertence. The party moving to dismiss the case must show deliberate conduct.

Section 109(g)(2) precludes eligibility if, within the preceding 180 days, the debtor requested and obtained the voluntary dismissal of a prior case following a creditor's application for relief from stay. Section 109(g)(2) is intended to make it difficult for a debtor to file consecutive petitions for the purpose of obstructing creditors' collection efforts at state law by interrupting them with the automatic stay. Courts differ on the exact scope of this subsection, and three different approaches have emerged.

Some courts take the §109(g)(2) at its face meaning, interpret the word "following" to mean "after," and apply it mechanically, so that the debtor is barred from filing for bankruptcy simply if voluntary dismissal occurred subsequent to the filing of a motion for relief from stay. For example, in *In re Richardson*, 217 B.R. 479 (Bankr. M.D. La. 1998), the court concluded that the clear language of §109(g) indicates that Congress intended to impose a simple standard for barring serial filings, and that the test is simply one of sequence—the section comes into effect whenever a motion for voluntary dismissal is made after a motion for relief from stay. The court

4. Apart from §109(g), which makes a debtor ineligible for relief for the 180-day period, §§727(a)(8) and (9) (discussed in section 21.5.2) place a restriction on the debtor's ability to get a discharge in a Ch. 7 case for a number of years after obtaining a discharge in an earlier case. Although both §109(g) and §727 aim at the problem of successive bankruptcies, they are distinct and should not be confused.

declined to adopt a more flexible reading of the section because it felt that this would weaken its effectiveness in curbing abusive serial filings.

Some courts have adopted a causal approach, interpreting the word "following" to mean "as a result of" so that there must be some causal link between the request for relief from stay and the voluntary dismissal. These courts consider that such an interpretation is more in accord with the purpose of §109(g)(2), which is aimed at curbing abuse and therefore should only apply where the voluntary dismissal was in response to the request for relief from stay. See, for example, *In re Payton*, 481 B.R. 460 (Bankr. N.D. Ill. 2012).

Some courts have adopted a discretionary approach, recognizing that, notwithstanding the literal language of §109(g)(2), courts have the discretion to permit the debtor to file for relief where a strict application of the section would lead to an absurd or unjust result. The discretionary approach takes into account factors such as the good faith of the creditor seeking dismissal and whether creditors would be unfairly prejudiced by failure to dismiss. See, for example, in *In re Beal*, 347 B.R. 87 (E.D. Wis. 2006). In *In re Covelli*, 550 B.R. 256 (Bankr. S.D.N.Y. 2016) the court adopted the approach that the debtor is not automatically ineligible under §109(g)(2), so that the clerk of the court must accept the petition and the court must thereafter rule on whether the debtor's case should be dismissed on the grounds of the debtor's voluntary dismissal of the prior case within the preceding 180 days.

In many cases, there may not be a significant difference between the causal approach and discretionary approach because they are likely to lead to the same result. For example, in *In re Riviera*, 494 B.R. 101 (BAP 1st Cir. 2013) the debtor filed a Ch. 13 petition on the eve of foreclosure of a mortgage on his property. He failed to make postpetition mortgage payments and the mortgagee obtained relief from stay. The debtor dismissed the case and immediately filed a second Ch. 13 petition to stay the mortgage foreclosure. The court said that it did not have to decide which approach to use because the case should be dismissed under any approach—there clearly was a causal connection between the relief from stay and the voluntary dismissal, this prejudiced the creditor by delaying the scheduled foreclosure sale, and this was exactly the kind of practice that the section was intended to defeat.

In addition to the question of the proper meaning of §109(g) in relation to the debtor's successive filings, there is an apparent absurdity that arises out of the literal language of the section. By providing that no individual "may be a debtor" under the Code, §109(g) suggests that the debtor is impervious to an involuntary petition during that 180-day period as well. This cannot be the intended result, considering that the rule is aimed at debtor abuse and should not deprive creditors of their involuntary bankruptcy remedy.

§5.4.3 Limitation Requiring Credit Counseling Under §109(h)

a. The Purpose of §109(h)

When Congress enacted BAPCPA, it had been persuaded that many individual bankruptcies result from financial incompetence, ignorance, and mismanagement, as well as the abuse of credit. In an attempt to address this problem, and to ensure that individual debtors understand the impact of a bankruptcy filing, BAPCPA added subsection (h) to §109. Section 109(h) requires individual debtors to receive credit counseling as a prerequisite to eligibility for bankruptcy relief. The principal purpose of prepetition counseling is to give the debtor the opportunity, before filing the petition, to have assistance in evaluating her financial position and to become informed about the consequences of bankruptcy, the different choices of bankruptcy relief, and alternatives to filing for bankruptcy. Although §109(h) seeks to further the laudable goal of educating debtors in financial management, it was controversial when enacted and it has proved to be troublesome. It is criticized as not being particularly effective in achieving its goal, while creating a procedural and administrative barrier to prompt debtor relief. In *In re Elmendorf*, 345 B.R. 486 (Bankr. S.D.N.Y. 2006), the court summed up the section's shortcomings by noting that this "facially well-intentioned" provision "has evolved into an expensive, draconian gatekeeping requirement" that has not achieved its purpose, while making it more difficult for deserving debtors to obtain timely relief. In *In re Enloe*, 373 B.R. 123 (Bankr. D. Colo. 2007), the court noted that there is a "developing consensus . . . that the credit counseling requirement is largely a procedural hurdle without value or consequence." Not surprisingly, courts have struggled to develop a rational and coherent application of §109(h), given its dubious value, its negative impact on debtors, and its poor drafting.

b. The Requirement of Counseling Under §109(h)(1)

Subsection 109(h)(1) provides that an individual may not be a debtor under any chapter of the Code unless he has received a briefing from an approved nonprofit budget and credit counseling agency during the 180 days preceding the date of filing the petition. The briefing may be given to the debtor individually or in a group, and it may be in person, by phone, or via the Internet. The provision gives rise to administrative and practical questions, such as the determination of reliable standards for approving an agency and the development of Internet- or phone-based programs that provide meaningful education. It has also raised a number of interpretational issues. One of these is whether the debtor may receive the counseling on the same day

that she files the petition. Section 109(h)(1) requires the debtor to have received the counseling "during the 180-day period preceding the date of filing of the petition." Some courts have interpreted this language literally to mean that the counseling must have been completed by not later than the day before the petition is filed, while others have held that because the filing of the petition is generally the legally significant point for many purposes in bankruptcy, counseling may occur on the same day as the petition, as long as it precedes the petition. *In re Francisco*, 390 B.R. 700 (B.A.P. 10th Cir. 2008), discussed this debate and sided with the courts that have taken the latter approach. Another interpretational issue is whether §109(h) applies to involuntary petitions. Taken literally, the language "an individual may not be a debtor" suggests that §109(h) applies whether the petition is voluntary or involuntary. However, the court pointed out the absurdity of such an interpretation in *In re Oberle*, 2006 WL 3949174 (Bankr. N.D. Cal. 2006), and refused to allow a debtor to dismiss an involuntary petition on the grounds that he had not received the mandatory credit counseling under §109(h). The court pointed out that such a literal reading of §109(h) would obliterate creditors' ability to seek involuntary relief.

The most profound interpretational difficulty relates to the impact on the court's discretion of the language in §109(g) that "an individual may not be a debtor" under the Code if he has not received the required counseling. Some courts have concluded that the section is jurisdictional in nature so that if the debtor has not complied with or demonstrated statutory grounds for dispensing with credit counseling, the petition must be stricken and the court may not entertain it. Other courts, such as *In re Baruch*, 564 B.R. 424 (M.D. Fla. 2016) and *In re Zamel*, 619 F.3d 156 (2d Cir. 2010), have held that the section is not jurisdictional, but rather sets forth elements that must be established to sustain the voluntary bankruptcy proceeding. On this interpretation, the petition brings a bankruptcy case into existence, even if the failure to comply with §109(h) may ultimately lead to dismissal of the case for cause under §707(a).[5] The practical significance of this conclusion is that some of the incidents of filing the petition, such as the automatic stay, will come into effect immediately. The question of whether §109(h) is jurisdictional and mandatory also affects the court's discretion to waive or loosen the counseling requirement where the debtor has not complied with it at all or has not fully complied with it. If §109(h) is mandatory, a court has no equitable power to waive its requirements, which are prerequisites to filing. See *In re Giles*, 361 B.R. 212 (Bankr. D. Ut. 2007)

5. Section §707(a) gives the judge discretion to decide whether to dismiss a case for cause. It is discussed in section 6.7.

and *In re Gee*, 332 B.R. 602 (Bankr. W.D. Mo. 2005).[6] However, if §109(h) is not jurisdictional and mandatory, a court does have the discretion to provide relief from its provisions where requiring strict compliance would cause manifest injustice to the debtor. For example, in *In re Hess*, 347 B.R. 489 (Bankr. D. Vt. 2006), debtors in two separate cases had failed to obtain counseling before filing the petition. Although neither debtor qualified under any of the exceptions in §109(h) (discussed in section 5.4.3c), the court allowed them to obtain the counseling after filing. The court reasoned that although §109(h) did not itself give the court discretion to forgive noncompliance and allow postpetition counseling, that discretion can be found in §707(a), under which the court has the power to dismiss a case for cause. In deciding to exercise its discretion, the court examined all the equities of the case, including the debtors' good faith and reasonable efforts to comply with §109(h) and the lack of prejudice to other parties.

Although the question of whether §109(h) is jurisdictional and mandatory usually arises where the debtor is seeking to avoid dismissal of the case, it has sometimes arisen where the debtor has sought to dismiss the case voluntarily. This has happened, for example, where the debtor filed a voluntary petition without undergoing the required counseling. Thereafter, the debtor had second thoughts about being in bankruptcy and sought to dismiss the case on the grounds that he never received the required counseling. (Under §707(a) even a voluntary dismissal by the debtor requires court approval for cause.) Courts have generally not allowed a debtor to rely on his own failure to follow the requirements of §109(h) as a basis for voluntary dismissal. See, for example, *In re Mendez*, 367 B.R. 109 (B.A.P. 9th Cir. 2007) and *In re Timmerman*, 379 B.R. 838 (Bankr. N.D. Iowa 2007). Both courts rejected the argument that §109(h) was jurisdictional. *Timmerman* noted that although lack of eligibility is cause for dismissal under §707(a), the court has the discretion under that section to refuse to dismiss a case on motion of the debtor where the debtor had not acted in good faith.

c. Circumstances under Which Prepetition Counseling May Be Excused: §109(h)(2), (3), and (4)

To provide some flexibility to debtors who cannot comply with the credit counseling requirement before filing the petition, Congress made provision in §109(h)(2), (3), and (4) for a softening of the requirement in limited, narrow circumstances. In some situations, the court may dispense with the counseling. In others, the court may merely allow it to be deferred for a

6. *Giles* based its conclusion not only on the clear language of §109(h) that requires absolute compliance, but also on the principle that courts should not develop new exceptions because Congress has already provided specific, narrow exceptions in subsections 109(h)(2), (3), and (4), discussed later in this section.

short period after the petition. These subsections are clearly intended to be limited in scope, and courts have generally interpreted them in that spirit.

Section 109(h)(2): Lack of Available Counseling Services Section 109(h)(2) dispenses with the counseling if the U.S. Trustee for the debtor's district of residence determines that the approved nonprofit counseling agencies in the debtor's place of residence are not able to cope with the demand for services created by §109(h)(1) and cannot reasonably provide the additional services. The U.S. Trustee must reassess this situation at least annually.

Section 109(h)(3): Exigent Circumstances Section 109(h)(3) permits the court to grant the debtor a temporary "exemption" from counseling under "exigent circumstances" so that the debtor may file the petition before receiving the counseling and obtain the counseling shortly afterward. (Therefore, although §109(h)(3) uses the words "exemption" and "waiver," it does not forgive compliance completely, but just allows for an extension of time.) This subsection is designed to deal with situations in which the debtor has an urgent need to file and cannot obtain the counseling expeditiously enough. The requirements of §109(h)(3) are strict, and the grounds for getting an extension are limited. To obtain the extension, the debtor must submit a satisfactory certification to the court describing exigent circumstances that justify the filing of the petition despite the absence of prepetition counseling, and establishing that the debtor sought but could not obtain requested counseling during the seven-day period[7] beginning on the date the debtor made the request.

"Exigent circumstances" are not defined in the Code. Courts have held that circumstances are exigent where the immediate need for action renders counseling infeasible. The question of what constitute "exigent circumstances" can be difficult. In *In re Romero*, 349 B.R. 616 (Bankr. N.D. Cal. 2006), the court described exigent circumstances as a threat of serious and immediate creditor action that would render it infeasible to obtain counseling before filing the petition. In *Romero* the creditor action in question was the impending garnishment of the debtor's wages. In *In re Cleaver*, 333 B.R. 430 (Bankr. S.D. Ohio 2005), the court found that the impending loss of the debtor's home through a sheriff's sale was an exigent circumstance. In *In re Henderson*, 364 B.R. 906 (Bankr. N.D. Tex. 2007), the court found that the debtor had demonstrated exigent circumstances because he urgently needed to file the petition to stay foreclosure on his home. Many courts have addressed the question of whether a debtor can claim exigent circumstances where the urgency has come about because he failed to take timely

7. The section originally provided for a five-day period, which was increased to seven days in 2009.

action to avert the crisis. Both *Romero* and *Cleaver* did not find that the debtor's delay in dealing with the foreseeable creditor action precluded relief. By contrast, in *In re Dixon*, 338 B.R. 383 (B.A.P. 8th Cir. 2006), the court refused to find impending foreclosure to be an exigent circumstance where the urgency was self-inflicted by the debtor through failure to act promptly on receiving the notice of foreclosure. (*See also* Example 4.)

In addition to showing exigent circumstances, the debtor must satisfy the court that he requested but was unable to obtain credit counseling services from an approved agency during the seven-day period beginning on the date that he made the request. It is not clear if the statute means that the debtor cannot file at all until the expiry of the seven-day period or if the debtor can file immediately, provided that he can show that the counseling services will not be available for seven days after they were requested. In *In re Otero*, 2010 WL 580033 (2010) (not reported in B.R.), the court held that the request must be made at least five days[8] before the bankruptcy filing. The debtor had filed his bankruptcy petition on the day that the foreclosure sale of his home was to take place. He contacted the credit counseling agency on the same day but was not able to get the counseling before the time scheduled for the sale, so he filed the petition with a request for temporary waiver under §109(h)(3). The court found that the debtor had demonstrated exigent circumstances but did not qualify for the waiver because the agency would have been able to provide the counseling within five days of the request, even if it could not have done so before the foreclosure sale. In *Romero* and *Henderson*, the courts read the section more sympathetically and held that the debtor could file before the expiry of the five-day period, provided that he could show that the agency's services would not be available within that period. (In *Henderson* the debtor had consulted with his attorney on a Saturday and the attorney determined that the petition must be filed by the following Tuesday to forestall the foreclosure sale. On the advice of his attorney, the debtor tried many times on the weekend and Monday to obtain Internet counseling, but he could not get a connection to the site until the day after the petition was filed.) (*See also* Example 4.)

If the court is satisfied with the debtor's certification of exigent circumstances, it may authorize the deferral of the counseling for a period of up to 30 days after the petition. The court can extend this period to a maximum of 45 days for cause. Many courts have indicated that all the requirements of §109(h)(3) — the debtor's certification of exigent circumstances, the showing of an unsatisfied request for counseling, and the court's finding that the certification is satisfactory — must be strictly complied with before the court can permit the debtor to file a petition in advance of obtaining the counseling. For example, in *In re Hubbard*, 332 B.R. 285 (Bankr. S.D. Tex.

8. As indicated in footnote 7, the period has now been increased from five to seven days.

2005), the court refused a Ch. 13 debtor's motion to extend the time for credit counseling for 45 days because the debtor's unverified motion contained no affidavit or other declaration as to its accuracy and therefore did not qualify as a certification. In addition, the debtor had not demonstrated exigent circumstances and did not show that she had requested but could not obtain counseling within five days of the request. The court also noted that if the debtor wanted an extension beyond the 30-day period to 45 days, she must separately show cause and explain why she needs the extra time. In *In re Cleaver* the court found exigent circumstances, but nevertheless refused to find that §109(h)(3) was satisfied. The court dismissed the case because the debtor's motion did not contain a written affirmation of the truth of its contents, so it did not constitute a certification, and the debtor made no attempt to obtain counseling. In *In re Mingueta*, 338 B.R. 833 (Bankr. C.D. Cal. 2006), the court, while noting that the requirements of §109(h) were among the most absurd provisions of BAPCPA, held that the mandate of §109(h)(3) is unambiguous and must be strictly enforced. It therefore refused to accept an unsubstantiated request to extend the time for filing the certification and dismissed the case.

Most courts require that the certification be an attestation, sworn to by the debtor under penalty of perjury. See *In re Cobb*, 343 B.R. 204 (Bankr. C.D. Ark. 2006). However, some courts have been less exacting, and have allowed the debtor to make an unsworn written and signed certification that the facts asserted are true.

Section 109(h)(4): Incapacity Section 109(h)(4) authorizes the court, after notice and a hearing, to dispense with counseling if the debtor establishes an inability to comply because of incapacity, disability, or active military duty in a combat zone. This is sometimes called the "permanent exemption" from credit counseling because it completely excuses compliance, rather than just allowing an extension of time to comply. Section 109(h)(4) makes it clear that these excuses are confined to narrow and severe circumstances. The military duty must be in a combat zone; the subsection defines incapacity narrowly to mean mental impairment of such severity that the debtor is incapable of making rational decisions about his financial responsibilities; and disability is defined to mean that the debtor is so physically impaired as to be unable, after reasonable effort, to participate in the briefing. In *In re Ramey*, 558 B.R. 160 (BAP 6th Cir. 2016) the court rejected the debtor's claim of disability under §109(h)(4) because, even though she had suffered from health problems, she was not so physically impaired as to be unable to participate in counseling. The court said that because Congress has specifically defined incapacity and disability, the court cannot use any other definition. In *In re Anderson*, 397 B.R. 363 (B.A.P. 6th Cir. 2008), the debtor, incarcerated in state prison, filed a motion to be excused from counseling on grounds of disability.

The court dismissed the case, holding that incarceration was not a disability as contemplated by §109(h)(4), and that the debtor could have received phone counseling.

§5.5 ELIGIBILITY FOR RELIEF UNDER EACH OF THE SEPARATE CHAPTERS

In addition to the general qualifications, each chapter has its own eligibility requirements. Eligibility for Ch. 7 is set out in §109(b), for Ch. 11 in §109(d), and for Ch. 13 in §109(e).[9] These qualifications are summarized here, and some of them are considered in Examples 1 and 2.

§5.5.1 Ch. 7 (§109(b))

Ch. 7 relief is widely available. Anyone who may be a debtor under the Code may be a debtor under Ch. 7 except for railroads, insurance companies, and various kinds of banking and investment institutions. (The financial failure of these types of businesses is dealt with by other statutes.) A debtor may be placed in Ch. 7 bankruptcy voluntarily or involuntarily.

Although §109(b) provides for wide Ch. 7 eligibility, it is subject to an important qualification under §707(b). Where the debtor is an individual whose debts are primarily consumer debts, §707(b), as amended by BAPCPA, requires the court to dismiss the Ch. 7 case if it finds that the granting of relief would be an abuse of Ch. 7. Abuse is presumed under §707(b) if an individual consumer debtor has disposable income deemed sufficient to make payments under a Ch. 13 plan. (This is known as the "means test" and is fully discussed in section 6.8.) Section 707(b) does not, strictly speaking, impose an eligibility requirement. Grounds for dismissing a case must be distinguished from threshold eligibility requirements of the kind set out in §109. However, the effect of §707(b) is to create a significant barrier to Ch. 7 relief for individual consumer debtors whose disposable income is not low enough or whose circumstances are not desperate enough to allow them to pursue Ch. 7 relief.

9. This book does not cover eligibility for relief under Ch. 9 (municipal bankruptcy), set out in §109(c), and Ch. 12 relief (family farmers), set out in §109(f).

§5.5.2 Ch. 11 (§109(d))

In essence, §109(d) makes Ch. 11 relief available to any person who is eligible to be a debtor under Ch. 7. (Section 109(d) sets out some specified exceptions to this general rule for various kinds of brokers and financial institutions, which need not concern us.) A debtor may be placed in Ch. 11 voluntarily or involuntarily.

Because the means test in §707(b) applies only in a Ch. 7 case, it presents no barrier to an individual consumer debtor's filing under Ch. 11. However, a debtor may not avoid the means test by filing under (or converting the case to) Ch. 11 and then proposing a plan that is equivalent to liquidation under Ch. 7. Although Ch. 11 does contemplate the possibility of a liquidating plan for other debtors, an individual consumer debtor is required to propose a rehabilitation plan in Ch. 11, under which the debtor commits future earnings or income to the payment of creditors. BAPCPA added subsection (8) to the mandatory plan requirements in §1123(a), which makes it clear that the plan proposed by an individual consumer debtor must provide for payments to creditors from the debtor's future earnings or income.

§5.5.3 Ch. 13 (§109(e))

Only an individual with regular income whose debt falls within the limits of §109(e) may be a debtor under Ch. 13. A debtor may not be placed in Ch. 13 involuntarily. Section 109(e) sets out three distinct requirements for eligibility. First, the debtor must be an individual; second, he must have regular income; and third, his total debt at the time of filing must not exceed the prescribed limit.

An "individual with regular income" is defined in §101(30) to mean an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13. . . ." Section 109(e) does not state the date on which the regular income requirement must be measured. The date of filing is pertinent, but the court may consider this issue prospectively, so that even if the debtor does not have regular income at the time of filing, he will be eligible if he has a good prospect of regular income when the time for payments under the plan arrives. If the debtor has a job and earns a periodic wage or salary, there is little difficulty in establishing that he has a stable and regular income. This is true even if he is an at-will employee who could be fired at any time. However, where the debtor's earnings come from a less conventional or predictable source, there could be a dispute over his eligibility for Ch. 13. For example, in *In re Baird*, 228 B.R. 324 (Bankr. M.D. Fla. 1999), the debtor lost his job and suffered a stroke after filing the Ch. 13 petition but before the plan was confirmed.

The court found that regular voluntary payments under the plan[10] by the debtor's son qualified as regular income. The court noted that it did not matter that the payments were voluntary and that the debtor's son could cease making them at any time, because the same might be said of a debtor's salary under an at-will employment contract.

Section 109(e) imposes debt limits that confine Ch. 13 to debtors with relatively small estates, as measured by the extent of indebtedness. Under the dollar amounts currently in effect, a debtor is not eligible for Ch. 13 relief unless her noncontingent, liquidated[11] unsecured debts are less than $394,725, and her noncontingent, liquidated secured debts are less than $1,184,200. (As with other dollar amounts, these debt limits will be next adjusted under §104 with effect from April 1, 2019.) If the debtor's secured or unsecured debts exceed the limit, she may not obtain Ch. 13 relief; she must file for rehabilitation under Ch. 11. (Liquidation under Ch. 7 may also be an alternative for some debtors but will not be available to a consumer debtor whose income exceeds the means test discussed in section 6.8.)

A debtor and spouse may file a joint Ch. 13 petition, but their combined debts must be within the limits set for an individual. An individual who is otherwise qualified for Ch. 13 but is a stockbroker or commodity broker cannot file under Ch. 13.

§5.6 CONVERSION FROM ONE CHAPTER TO ANOTHER

§5.6.1 General Principles

The selection of relief under a particular chapter is not irreversible. The debtor and other parties in interest are able, subject to certain restrictions, to apply to court to convert a case under one chapter into a case under another. Each chapter of the Code has its own rules and limitations relating to conversion. Sections 706, 1112, and 1307 govern conversion from Chs. 7, 11, and 13, respectively. A case cannot be converted to a particular chapter unless the debtor is eligible for relief under that chapter. Therefore,

10. The challenge to the debtor's eligibility was made some time after the petition had been filed but before plan confirmation. Under §1326 a debtor is required to begin making payments under the proposed plan 30 days after filing the petition. Therefore, payments under the proposed plan must begin before confirmation.

11. A debt is contingent if the debt has been created (for example, by contract or tort) but the debtor's obligation to pay it will only arise upon the occurrence of an uncertain future event. A debt is therefore noncontingent if the debtor's payment obligation is not subject to any such future contingency. A liquidated debt is one that is capable of being calculated by arithmetical means from established information. The meaning of contingent and liquidated debts is discussed more fully in section 17.2.2.

the eligibility requirements (discussed in section 5.5) apply to conversions as they do to the original petition. With some limitations, a case can be converted from one chapter to another at any time during the course of the bankruptcy proceeding. Conversion is not confined to the initial stages of the case.

There are various reasons why a party may seek to convert a case. For example, a debtor may have filed a petition for relief under Ch. 13. During the course of the case, it may become apparent to the debtor that this was not the best choice, or circumstances may have changed to alter the prospects of successful debt adjustment. The debtor is able to convert the case into a case under another chapter, such as a liquidation under Ch. 7. Creditors and other parties in interest may also seek conversion of a case. For example, if creditors can show that the debtor's Ch. 13 case is abusive or has little chance of successful consummation, they can apply for conversion of the case to Ch. 7 as an alternative to applying for dismissal of the case. Both voluntary and involuntary cases can be converted. For example, after creditors have filed a petition for involuntary relief under Ch. 7, the debtor may convert the case to Ch. 11 or 13, thereby avoiding liquidation in favor of debt adjustment.

§5.6.2 Conversion by the Debtor

The debtor is treated more liberally than other parties in converting from one chapter to another. Section 706(a) allows the debtor to convert the case from Ch. 7 to a case under Ch. 11, or 13, §1112(a) allows the debtor to convert a Ch. 11 case to Ch. 7, and §1307 allows the debtor to convert the case to Ch. 7. These sections contain few restrictions on the debtor's discretion to convert the case. Notice and a hearing are not needed and the debtor is not generally required to show cause for the conversion. Although the right to convert under these sections is broad, it is not absolute. In *In re Marrama*, 549 U.S. 365 (U.S. 2007), the U.S. Supreme Court held that although §706(a) is written in permissive terms, the bankruptcy court has the discretion to forbid the conversion if it is motivated by bad faith or is an abuse or manipulation of the Code. In *Marrama* the debtor filed misleading schedules and made a transfer of valuable property for the purpose of insulating it from creditors' claims. When the trustee sought to recover and liquidate the property, the debtor moved to convert the case to Ch. 13. The majority of the Supreme Court affirmed all the lower courts in holding that the debtor had forfeited the right to convert. The court found the basis for the bankruptcy court's discretion to refuse conversion in §706(d), which allows conversion only if a debtor "may be a debtor under such chapter," read with §1307(c), which allows a case to be dismissed for cause. The court reasoned that because there was cause to dismiss

the Ch. 13 case for bad faith, it cannot be said that the debtor may be a debtor under that chapter. The court also found that the bankruptcy court had discretion to refuse conversion under the general power conferred in §105(a) to issue orders to accomplish the aims of the Code. *Marrama* was concerned with a motion to convert a Ch. 7 case to Ch. 13. It is not clear what impact the decision has on conversions to other Chapters. In *In re Euro-American Lodging*, 365 B.R. 421 (Bankr. S.D. N.Y. 2007), the court held that the decision did apply to a conversion to Ch. 11. However, in *In re DeFrantz*, 454 B.R. 108 (B.A.P. 9th Cir. 2011), the court held that differences in procedural rules justified not applying *Marrama* to a conversion from Ch. 13 to Ch. 7, which the debtor could accomplish as a matter of right.

§5.6.3 The Impact of §707(b) on the Debtor's Ability to Convert from Ch. 13 to Ch. 7

As noted in section 5.5.1, the grounds for dismissal of a Ch. 7 case for abuse in §707(b) must be distinguished from threshold eligibility for Ch. 7. Nevertheless, some courts have interpreted §707(b) as creating a barrier to an individual debtor converting a Ch. 13 case to Ch. 7. Section 707(b) requires the dismissal of a Ch. 7 case filed by an individual debtor whose debts are primarily consumer debts if the granting of relief would be an abuse of Ch. 7. Abuse is presumed if the debtor's income exceeds the means test set out in the section.[12] By its terms, §707(b) applies to a case "filed" by a debtor under Ch. 7. It is not clear if the subsection is applicable where a debtor first files under Ch. 13 and then converts the case to Ch. 7. Courts have differed in answering this question. Some courts adopt a plain meaning approach and hold that the use of the word "filed" and the omission of any reference to conversion in §707(b) makes the means test inapplicable where the original case is filed under Ch. 13 and later converted to Ch.7. See, for example, *In re Layton*, 480 B.R. 392 (Bankr. M.D. Fla. 2012) and *In re Fox*, 370 B.R. 639 (Bankr. N.J. 2007). Other courts have rejected the plain meaning approach on the grounds that the purpose of §707(b) is to preclude Ch. 7 relief to a debtor who does not qualify for it under the means test. To allow a debtor to evade the means test by first filing under Ch. 13 and then converting to Ch. 7 undermines the intent of the section. See, for example, *In re Kellett*, 379 B.R. 332 (Bankr. D. Or. 2007). The court in *Layton* responded to this concern by observing that if a debtor deliberately uses this strategy to evade §707(b), the court has the means, either under §707(a) (dismissal for

12. *See* section 6.8 for a full discussion of §707(b).

cause) or §105 (the court's general power to issue appropriate orders), to dismiss the case.

§5.6.4 Conversion by Parties Other Than the Debtor

Chs. 7, 11, and 13 all provide for the conversion of a case at the instance of a party other than the debtor, but the wording of the provisions differ: Section 706(b) allows the court to convert a Ch. 7 case to Ch. 11 "at any time" on request of a party in interest, and after notice and a hearing. Section 1112(b) allows the court to convert a Ch. 11 case to Ch. 7 on request of a party in interest, after notice and a hearing, for cause, and upon determining that conversion is in the best interests of creditors and the estate. Section 1307(c) similarly allows the court to convert a Ch. 13 case to Ch. 7 on request of a party in interest, after notice and a hearing, for cause, if this serves the best interests of creditors. Note that none of these provisions allow for the conversion to Ch. 13 at the instance of a party other than the debtor. The restrictions applicable to an involuntary petition, discussed in Chapter 6, apply to conversion as well. Creditors cannot place the debtor into Ch. 13 by an involuntary petition, so the case cannot be converted to that chapter without the debtor's consent.

Section 706(b) does not contain language, as found in §§1112(b) and 1307(c), requiring a showing of cause and the best interests of parties. Nevertheless, the decision to grant a motion to convert from Ch. 7 to Ch. 11 is within the court's discretion, and courts do evaluate cause and the best interests of all parties in exercising this discretion. For example, in *In re Parvin*, 549 B.R. 268 (W.D. Wash. 2016) the district court upheld the bankruptcy court's conversion of a Ch. 7 case to Ch. 11 at the behest of the U. S. Trustee where creditors would receive no more than 20 percent of their claims in Ch. 7 and the debtor, an orthopedic surgeon, would earn a high enough salary to pay creditors in full over three years under a Ch. 11 plan.

§5.6.5 The Impact of Conversion on the Commencement Date of the Case

As explained in sections 6.4 and 6.6, the dates of the filing of the petition and the order for relief are significant for many purposes. When a case is converted, the date of conversion is treated like the filing of a new case for some purposes but not for others. Section 348 sets out the rules concerning the impact of conversion and indicates which incidents of bankruptcy are treated as arising on the conversion date and which of them continue to be measured from the original petition or order for relief.

As noted in section 5.8, in a Ch. 7 case, the individual debtor's postpetition income is not included in estate, but in a Ch. 13 case §1306 includes the debtor's postpetition earnings in the estate, and portion of those earning are applied under §1322 to the payment of creditors under the plan. If the debtor converts a case from Ch. 13 to Ch. 7, §348(f) provides that unless the debtor has made the conversion in bad faith, property of the Ch. 7 estate consists of property of the estate as at the date of the original petition which remains in the possession or control of the debtor at the date of conversion. (If the conversion is in bad faith, the date for determining property of the estate is the date of conversion.)

As regards the debtor's postpetition earnings, the effect of §348(f) is that the debtor's future income no longer enters the estate, but belongs to the debtor. During the course of the Ch. 13 case, prior to its conversion to Ch. 7, the debtor would have been paying to the trustee that portion of the debtor's postpetition income allocated to the payment of creditors under the plan. All such payments received by the trustee and distributed to creditors are not refundable to the debtor. However, in some cases, at the time of conversion the Ch. 13 trustee may be holding accumulated funds from the debtor's postpetition earnings that have not yet been paid out to creditors. Courts had disagreed about whether those funds should be distributed to creditors or returned to the debtor. The Supreme Court resolved this issue in *Harris v. Viegelahn*, 135 S.Ct. 1829 (U.S. 2015). It held that it would be inconsistent with the purpose of §348(f) to pay out any accumulated and undistributed funds to creditors after the debtor has converted the case. Upon conversion, the case is governed by Ch. 7, under which the debtor's postpetition earnings are part of his fresh start estate. The funds must therefore be returned to the debtor.

§5.7 THE DEBTOR'S CHOICE OF RELIEF

When a debtor is eligible for relief under more than one chapter of the Code, the debtor must decide which form of relief is most appropriate. In most cases, the choice is between liquidation or some form of rehabilitation. However, some debtors may qualify for more than one of the rehabilitation chapters and must decide not only between liquidation or rehabilitation but also between the advantages and drawbacks of the different applicable types of rehabilitation. A full understanding of the factors that influence choice of relief can only come after a thorough study of bankruptcy law, so a detailed discussion of this issue is premature at this stage. However, section 5.8 provides some guidance on these factors by summarizing the significant differences between the different forms of bankruptcy relief. Some of the issues that influence the choice of relief are introduced in Examples 1, 2, and 3.

§5.7.1 Corporate Debtors

For a corporate debtor in financial difficulty, the choice between liquidation (whether under Ch. 7 or Ch. 11) and rehabilitation under Ch. 11[13] is stark. Liquidation means the end of the debtor. Its business closes down, its assets are sold off, its employees lose their jobs, and the ownership interests of its stockholders are wiped out. It is only by seeking reorganization that the corporation has any prospect of overcoming its financial problems and surviving as a viable business.

§5.7.2 Individual Debtors

The individual debtor's choice between liquidation under Ch.7 or rehabilitation under Ch. 13 or Ch. 11 is not as dramatic. In either event, the individual will be able to handle her financial difficulties, and may hope to emerge from bankruptcy with a discharge and a fresh start. Therefore, the debtor's choice of relief will be heavily influenced by the determination of which form of bankruptcy best serves her interests. However, the debtor is not given untrammeled discretion in making this decision.

Ever since the enactment of the Code in 1978, Congress has assumed that the amount of disposable income that a debtor could commit to payments under a Ch. 13 plan, and hence the extent of creditor recovery under that chapter, would likely be higher than the liquidation value of the debtor's nonexempt assets. For this reason, the Code, as originally enacted, tried to encourage debtors to choose Ch. 13 over Ch. 7 by providing incentives, such as a broader Ch. 13 discharge. By the time that it enacted BAPCPA in 2005, Congress had been persuaded that the incentives were not effective and that many debtors who could afford to pay more under a Ch. 13 plan were choosing Ch. 7 liquidation as an easy way out: a debtor with relatively low-value nonexempt assets and a comfortable future income could shield that income by giving up the assets. This conclusion was controversial. The opposing view was that the perceived abuse of Ch. 7 was greatly exaggerated and that many Ch. 7 consumer debtors were in genuine financial distress and in need of Ch. 7 relief. Nevertheless, Congress decided that there was a problem with consumer abuse of liquidation bankruptcy, and enacted the means test, discussed in section 6.8, which creates a presumption of abuse where an individual Ch. 7 debtor has the apparent means to support a payment plan under Ch. 13.

13. As explained in section 5.5.3, a corporation is not eligible for Ch. 13 relief, so it can reorganize only under Ch. 11.

§5.8 A SUMMARY OF THE SIGNIFICANT DIFFERENCES AMONG CHS. 7, 11, AND 13 THAT MAY INFLUENCE THE CHOICE OF RELIEF

As noted in section 5.2, the principal choice to be made in selecting bankruptcy relief is that between liquidation and rehabilitation. However, even if rehabilitation is selected, there are differences among the rehabilitation chapters that will make one of them more appropriate than the others. This is a brief overview of the significant differences among the forms of bankruptcy relief under Chs. 7, 11, and 13 that may have a bearing decision of which form of bankruptcy should be selected. Of course, as explained in section 5.5, the debtor's choice between chapters is confined to those chapters for which the debtor is eligible. This summary of the important differences in the various forms of bankruptcy is intended to give you a broad perspective. It is necessarily simplified and lacks the detail and qualifications that will become apparent in the treatment of these topics in the following chapters of the book. (Examples 1, 2, and 3 illustrate how some of these differences among the Code chapters may be relevant to a debtor's choice of relief.)

(1) Involuntary petition. An involuntary petition can be filed only in a Ch. 7 or 11 case.

(2) The automatic stay. The stay applies under all chapters, but it protects certain co-debtors only in Ch. 13 (§1301). However, in Chs. 7 and 11, the court has the discretion within its general equitable powers under §105 to enjoin action against a co-debtor where appropriate.

(3) Property of the estate. In a Ch. 7 case and a Ch. 11 case involving a corporation, property of the estate consists of the debtor's property at the time of the petition. Postpetition property is generally not part of the estate. In a Ch. 13 case, or a Ch. 11 case involving an individual debtor, the estate consists of both property of the debtor at the time of the petition and postpetition property (§§541, 1115, and 1306).

(4) The disposition of estate property. In a Ch. 7 case, estate property is liquidated and the proceeds distributed to creditors. An individual debtor is entitled to claim exemptions in some property under §522. It may be possible for the debtor to reacquire estate property by redemption under §722 or reaffirmation under §524. In cases under Chs. 11 and 13, estate property is revested in the debtor upon confirmation of the plan, except to the extent that the plan allocates it to the payment of claims (§1141 and 1327). An

individual debtor is entitled to exemptions under these chapters too, but because estate property revests in the debtor, exemptions play a different role here — they factor into the analysis of the debtor's minimum required payments under the plan.

(5) The debtor's postpetition income. A Ch. 7 case does not affect the debtor's postpetition income, which is part of his fresh start estate. In cases under Ch. 13, the debtor's disposable postpetition income must be applied to payments under the plan (§§1322(a) and 1325(b)). There is no set rule on postpetition income in a corporate Ch. 11 case. Its allocation to the plan depends on the terms of the plan. However, an individual Ch. 11 debtor must commit disposable postpetition income to the plan (§§1123 and 1129).

(6) Sources of funding payments to creditors. In a Ch. 7 case, the funding of payments comes primarily from the proceeds of nonexempt estate property (§§704 and 726). In a Ch. 11 case, the debtor has flexibility in devising sources of funding, such as the sale of assets, future income, investments, or loans. Payment may be in money, property, or securities (§1123). In a Ch. 13 case, plan payments are funded by disposable future income, but property of the estate may be sold to generate funds, or may be surrendered to satisfy creditor claims (§1322).

(7) The administrator of the estate and operator of the debtor's business. In a Ch. 7 case, the trustee administers the estate and, if the debtor has a business, conducts short-term business operations. The business is liquidated as soon as possible (§§701 to 703 and 721). In a Ch. 11 case, the debtor in possession assumes the functions of the trustee and operates the business, unless there is cause to appoint a trustee (§§1104 and 1108). In a Ch. 13 case, a trustee is appointed and performs investigative and supervisory functions. If the debtor has a business, he continues to operate it under the trustee's supervision but does not have the status of a debtor in possession (§§1302 and 1304).

(8) Conversion of the case to another chapter. In cases under Chs. 7 and 13, the debtor has a broad but not absolute right to convert the case to another chapter for which the debtor is eligible (§§707 and 1307). A creditor can convert a Ch. 7 case to Ch. 11 for cause (§706). A creditor can convert a Ch.13 case to Ch. 7 for cause (§1307). In a Ch. 11 case, the debtor has a right to convert with some limitations (§1112). A creditor can convert the case to Ch. 7 for cause (§1112).

(9) Dismissal of the case. A Ch. 7 case may be dismissed by the debtor or other party in interest only for cause. In the case of an individual consumer

debtor, abuse of the Code is cause for dismissal by a creditor or other party in interest (§707). A Ch. 11 case may be dismissed by the debtor or another party in interest for cause (§1112). In a Ch. 13 case, the debtor has a broad but not absolute right to dismiss. Other parties in interest can dismiss for cause (§1307).

(10) The duration of the case. In a Ch. 7 case, property is realized and the proceeds distributed as expeditiously as possible (§704). There is no statutory limit to the duration of a Ch. 11 plan, but an individual Ch. 11 debtor must commit disposable income to the plan for five years (§1129(a)(15)). In a Ch. 13 case, the maximum payment period for a debtor who earns below the median family income is three years or, with court approval, five years. The maximum (and possibly also the minimum) payment period for an above-median debtor is five years (§1322).

(11) Standards fixing the minimum level of payment to creditors. There is no minimum level of payment prescribed in a Ch. 7 case because creditors cannot get more than the proceeds of the liquidation of the estate. These proceeds are distributed in the order of priority prescribed by the Code. Secured claims are paid to the full value of their collateral. Unsecured claims are ranked in priority order. Where the estate is badly insolvent, claims with lower priority (in particular, general unsecured claims) may get no payment at all (§§506, 507, and 726). The standards for minimum payment in a Ch. 11 case are complex. Their applicability is dependent on whether the debtor has been able to negotiate creditor assent to the plan, or must force it on unwilling classes of creditor in a cramdown. The complexity of these rules defies encapsulation here. They are governed by §1129 and are explained in section 20.4. In cases under Ch. 13, secured claims are entitled to payment in full to the value of the collateral. The debtor may surrender the property to the creditor. However, if the debtor chooses to keep the collateral, the creditor retains its lien, and the payments made on the secured claim under the plan must equal the present value of the claim — that is, its face value plus interest. Priority claims must be paid in full, and payments to general unsecured claims must at least equal the present value of what they would have received in a liquidation. In addition, the debtor is required to commit all disposable income to the plan for a prescribed period (§§1322 and 1325).

(12) Claim classification. Apart from the statutory classifications of claims into secured, priority, and general claims, alluded to in item (11), there is no claim classification in a Ch. 7 case. However, in Chs. 11 and 13, the debtor does have some ability to designate classes of creditor in the plan and to treat those classes differently, provided that there is a rational basis for

the classification and the discrimination is fair (§§1122, 1123, 1129, and 1322).

(13) The cure of default and restructuring or modification of secured obligations. In a Ch. 7 case, the debtor cannot usually keep encumbered property by restructuring the obligation, unless the debtor enters into a reaffirmation agreement with the creditor under §524. One of the benefits of rehabilitation under Ch. 11 or Ch. 13 is that the debtor is able (with some limitations) to cure default and restructure secured obligations (§§1123 and 1322).

(14) Creditor participation in formulating and voting on a plan. There is no plan in a Ch. 7 case, so this is inapplicable. Creditor consent does not feature in a Ch. 7 distribution. In a Ch. 11 case, creditors are involved in plan formulation and under some circumstances may even propose a plan in competition with the debtor's plan. Creditors vote on the plan, and the debtor needs a prescribed level of creditor approval to get the plan confirmed (§§1103, 1121, 1125, 1126, and 1129). In a Ch. 13 case, only the debtor may propose a plan, and creditors do not vote on it. The plan is confirmed if it complies with the Code requirements (§§1321, 1325, and 1327).

(15) Discharge. A corporation cannot receive a discharge under Ch. 7 (§727) but can receive a discharge under Ch. 11 (§1141). An individual may receive a discharge under all chapters of the code. There are differences in the debts encompassed by the discharge under the different Code chapters, and there is also some variation among chapters on the time that the discharge is granted and the basis for denying the discharge or excluding debts from it (§§523, 727, 1141, and 1328).

Examples

1. Virtuous Victual Company, L.L.C. makes organic microwaveable meals that it sells at wholesale to supermarkets. Virtuous Victual Company had done well until it suffered a series of calamities last year. Expensive equipment broke down and had to be replaced; its workers went on strike, shutting down its operations for three months; and bacteria in its packaged food made consumers seriously ill, resulting in lawsuits claiming millions of dollars in damages.

   These crises have drained Virtuous Victual Company's resources and have left it exposed to extensive potential liability to its poisoned customers. In addition, adverse publicity has badly damaged sales of its products. Virtuous Victual Company has not been able to keep

current on repayment of its debts, and many of its loans are in default.

Virtuous Victual Company has decided to seek bankruptcy relief. Under which chapters is it eligible for relief? What factors should it take into account in choosing between the chapters for which it is eligible?

2. What impact would it have on your answers to Example 1 if the debtor was not Virtuous Victual Company, L.L.C., but rather Ms. Virtue Victual, doing business as a sole proprietor under the trade name "Virtue's Victual Company"? Virtue owes $15,000 on credit cards for consumer purchases, and her unsecured business debts for rent, supplies, and operating expenses are $250,000. In addition, she has a mortgage of $300,000 on her home, and a mortgage of $500,000 on her business premises.

3. Viva Voce is a singer of modest talent. She ekes out a living by performing at weddings, minor clubs, and similar venues. In a typical year, she manages to find between ten and twenty jobs, and her income varies from one year to the next, depending on the nature and quality of the engagements. This year, her earnings were $55,000. Last year she earned $40,000, and the year before, $52,000.

   Viva's earnings are not enough to cover her living expenses, so she has relied on several credit cards to buy the goods and services that she needs. As a result, she has accumulated $100,000 in debt. She has used all her cards to the full extent of her credit limit, so she cannot use them anymore. She can barely afford to make the minimum required monthly payments on the cards. Viva has no nonexempt assets, and she understands that she would probably be able to discharge all her debt with no payment by filing a petition under Ch. 7. However, she feels that this would be morally wrong, and she would like to make an effort to pay off at least some of her debt under a payment plan. Is she eligible to file a petition under either Ch. 11 or Ch. 13?

4. Bud Getary has been in financial difficulty for some time. On February 1, he consulted with a nonprofit credit counseling agency approved by the U.S. Trustee and received advice on how to manage his debt and negotiate with creditors for payment extensions. He followed the advice and managed to make agreements with his creditors for the time extensions. However, he could not cope with the payment schedule and soon fell behind. Several creditors initiated collection proceedings. On August 5 the finance company that held a security interest in his car repossessed it. On August 6, he received notice that his bank account had been garnished by another creditor. On August 7, he consulted an attorney, who recommended immediate bankruptcy filing to stay the foreclosure on the

car and the garnishment. The Ch. 13 petition was filed on August 7. On August 8, Bud's attorney realized that Bud's consultation with the credit counseling agency had occurred more than 180 days prior to the petition. He therefore advised Bud to call the same nonprofit agency again to receive further counseling by phone. Bud did this on August 9. Bud satisfies the eligibility requirements for Ch. 13 as set out in §109(e).

Is there any other barrier to his eligibility for relief? If so, is there anything that he can do to overcome that barrier?

Explanations

1. Virtuous Victual Company, L.L.C., a limited liability company, falls within the broad definition of "corporation" in §101(9). It is clearly eligible for relief under Chs. 7 and 11 because none of the exclusions in §109(b) or (d) are applicable. As noted before, these two chapters of the Code are the most universally available. As a corporation, Virtuous Victual Company may not be a debtor under Ch. 13, which is confined to individuals. §109(e). In deciding whether to liquidate its business or attempt to rehabilitate it, a corporate debtor must determine, in essence, whether its financial difficulties are such that it is feasible to restructure the business operation and deal with its liabilities. If there is no prospect of reorganization, liquidation is the appropriate choice, which can be accomplished either under Ch. 7 or Ch. 11.[14] It will result in cessation of the corporation's business, the realization of its assets, and the distribution of the proceeds to creditors. The corporation will not be rehabilitated and it will become defunct, and the shareholders will lose their equity in the corporation.

   On the other hand, if there is a prospect that the corporation's business can become viable again after reorganization, Ch. 11 is an attractive alternative. It gives the debtor a great deal of flexibility in reordering its affairs. The filing of the Ch. 11 petition gives the debtor the ability to negotiate with creditors under the protection of the Code in an attempt to formulate a plan of reorganization that will allow it to continue in business while compromising its debts and restructuring its operations. Among other things, it may sell off unprofitable or unwanted assets or operations; reject or restructure its contractual relationships; resolve unliquidated, contingent, and disputed claims; and alter the terms of its secured obligations. The debtor usually remains in control of its business as a debtor in

14. As mentioned in footnote 2, it is possible to liquidate a corporation under Ch. 11. The ultimate impact of liquidation will be the same as in Ch. 7, but the debtor retains greater control of the liquidation process.

possession and is entrusted with administration of the estate. If the debtor is able to have a plan confirmed and can consummate it, it will ultimately emerge from bankruptcy in a more efficient and viable form. Although existing shareholders are not assured of retaining any equity in the reorganized corporation, they do at least have a shot at doing so.

The facts of this question are not detailed enough for a full analysis of Virtuous Victual Company's prospects of effective reorganization. However, there are some hints that Ch. 11 may be feasible. The corporation's financial problems have been caused by a series of setbacks, rather than by marketing or management difficulties (although the calamities may, of course, be attributable to lapses in management). Some ugly product liability claims have to be disposed of, but if the corporation is able to deal with this issue and restore consumer trust, its business could revive and become profitable again.

2. On this variation of the facts, the business is not a corporation, legally distinct from its owners (shareholders), but simply the individual debtor herself, Virtue Victual, doing business in her individual capacity under a trade name. The fact that the trade name includes the word "Company" does not change this. Therefore, if the debtor elects to rehabilitate instead of liquidate, she may not be confined to a choice between Chs. 7 and 11, but may be able to choose Ch. 13 instead of Ch. 11. The fact that Virtue's debts are mostly business debts, not consumer debts, does not disqualify her from Ch. 13 bankruptcy. Although Ch. 13 is commonly associated with consumer bankruptcies, it is not confined to consumer cases and is available to any individual debtor who satisfies its other eligibility requirements. In fact, many small businesses are conducted as sole proprietorships, and it is quite common to find Ch. 13 debtors who aim not only to deal with household and personal debt, but also handle business debt and attempt to save a business.

   To qualify for Ch. 13 relief under §109(e), the individual debtor must have regular income and must fit within the debt limits of noncontingent, liquidated, unsecured debts of less than $394,725 and noncontingent, liquidated, secured debts of less than $1,184,200. The question does not give us enough information to determine if Virtue has regular income. (This issue is covered in Example 3.) The question does tell us that she is within the debt limits for her noncontingent, liquidated unsecured and secured debts ($265,000 unsecured and $800,000 secured). In addition, she apparently has great potential tort liability to her poisoned customers. This would put her over the unsecured debt limit, but if her tort liability is not yet liquidated at the time that she files her petition, it is not included in the debt calculation under §109(e) for eligibility purposes. These debts are unliquidated because their amount cannot be computed arithmetically from settled facts, such as a contract term or other known figures, but can only be determined following a trial and judgment or a settlement

agreement.[15] If Virtue elects to file under Ch. 13, she has an incentive to file as soon as possible, before the tort claims become liquidated and push her over the debt limits.

If Virtue does not qualify for Ch. 13 relief, either because she cannot show stable and regular income or because her debt is too high, she would be confined to Ch. 11 for rehabilitation relief. If she is eligible for Ch. 13 relief, she would have to decide whether Ch. 13 or 11 is more suitable to her circumstances. Section 5.8 gives you some broad idea of the differences between Chs. 11 and 13 that may influence a debtor in choosing between those chapters. As a general matter, Ch. 13 is much simpler and more streamlined, so it is often the best choice for a small business debtor who is eligible for it. However, Ch. 11 gives the debtor more control over the estate and allows greater flexibility.

As regards the choice between rehabilitation (under either Ch. 11 or Ch. 13) and Ch. 7 liquidation, many of the same considerations apply as those outlined in Explanation 1. An individual debtor also has to be concerned about the potential that she will not be allowed to obtain Ch. 7 relief under §707(b), but this section will not apply to an individual in business whose debts are not primarily consumer debts. Unlike a corporation, Virtue will survive Ch. 7. (As regards an individual debtor, "liquidation" is not really used in the same sense as, say, Joseph Stalin may have used it.) Nevertheless, Ch. 7 will result in the liquidation of Virtue's nonexempt assets (both business and personal) and the termination of her business, so if she believes that there is a chance of rehabilitating the business, Ch. 13 is the better alternative.

3. Ch. 11 is widely available to both individual and corporate debtors, so Viva would be eligible to file a petition under Ch. 11. However, she has an estate of modest proportions and her financial affairs are not complex, so Ch. 13 would be more appropriate for her than Ch. 11. Ch. 13 is simpler and has fewer procedures and safeguards that have to be complied with. A trustee is appointed, so the debtor plays a less active role in administering the estate. Creditors, too, have lesser rights of involvement. The only reason a debtor like Viva would choose Ch. 11 over Ch. 13 would be ineligibility for Ch. 13.

15. Do not confuse the issue of excluding a debt for eligibility purposes from the issue of allowing the debt as a claim against the estate. If Virtue decided to pursue Ch. 13 relief, the tort claimants will prove claims in the estate which will be admitted or rejected and resolved by negotiation or litigation. Also, do not confuse unliquidated and contingent debts. Although Virtue's liability to the poisoned customers is dependent on a jury finding that Virtue is liable for their injuries, that does not make the debt contingent. A contingent debt is one that is conditional upon a future uncertain event occurring. The tortious conduct creating the debt has already occurred. The jury determination is a process of fact finding, not a legal contingency in the sense that the term is used in law. (Some courts have taken a different view and have treated disputed debts as unliquidated or contingent.)

As an individual debtor, Viva is eligible for relief under Ch. 13 if she satisfies the prerequisites of §109(e). That section has three prerequisites: She must be an individual, she must have regular income, and her noncontingent liquidated unsecured and secured debts must not exceed the maximum amount allowed. Two of these requirements are clearly satisfied: she is an individual and her debts are not even close to the maximum allowed. The only doubt is whether she has regular income.

Section 101(30) defines an "individual with regular income" as one whose income is sufficiently stable and regular to enable payments to be made under the Ch. 13 plan. Over the last three years, Viva's income ranged from a low of $40,000 to a high of $55,000. She does not have a steady job, but enters into short-term contracts for various performances each year. Although the Code does not require a person to be a regular wage earner to qualify for Ch. 13, it does require some predictability in income so that performance under the plan is reasonably assured. When a debtor is in Viva's position, the court must assess the likelihood of a reliable source of income, based on all of her circumstances: for example, her ability to budget irregular earnings, the likelihood of her being able to secure future performance engagements, and the amount she needs to maintain herself. In short, while the stability of Viva's income is an issue, she is not necessarily disqualified because of its irregularity as long as the facts show sufficient reliability to support a plan.

Viva may therefore satisfy the threshold requirement of eligibility for Ch. 13 relief. This means only that she can file for relief under that chapter, but does not ensure that she will be successful in formulating and ultimately consummating a Ch. 13 plan. Discussion of Ch. 13 requirements for the contents of the plan and the debtor's duties and obligations in the Ch. 13 case is deferred to Chapter 18.

4. Bud was not eligible for relief at the time that he filed the petition because he did not satisfy the requirements of §109(h)(1). Although he did receive credit counseling from an approved credit counseling agency before the petition, the counseling occurred about 188 days before he filed his petition, which is more than the allowed statutory period of 180 days. Some (but not all) courts are willing to exercise discretion in allowing something short of strict compliance with the requirements of §109(h). However, it is likely a rare case in which the court would consider the requirements of §109(h) to have been satisfied by counseling received prior to the statutory 180-day period. This did happen in *In re Enloe* (cited in Section 5.4.3(a)). The court found that it had discretion to depart from the strict language of §109(h)(3). It held, under all the circumstances of the case, that counseling received by the debtor 189 days before the petition was sufficient to satisfy §109(h)(3). The court felt that this was justified because the debtors delayed filing while they attempted to sell

their home to avoid foreclosure and bankruptcy; the debtors' failure to receive counseling again before they filed was due to their attorney's oversight; the debtors' financial circumstances had not changed since the counseling; and the debtors did undergo further counseling after filing the petition. Bud's counseling was about the same distance away from the petition as *Enloe's*, but there is no indication of the special circumstances that motivated the court's flexibility in that case. In any event, many courts would disagree with the *Enloe* court's exercise of discretion in light of the plain language of §109(h)(3).

Bud could try to invoke one of the three exemptions from prepetition counseling set out in §109(h)(2), (3), and (4). He clearly does not qualify for the exemptions in subsections (2) and (4), so his only chance to avoid dismissal of his case is to ask the court to validate his postpetition counseling under subsection (3). The requirements for the court's approval of postpetition counseling under §109(h)(3) are stringent.

§109(h)(3)(B). The counseling must occur within the short time limit specified — 30 days from the petition, or for cause, not more than 45 days. Bud's counseling did occur within this period — he received it the day after filing the petition.

§109(h)(3)(A). The debtor must file a motion with the court to approve the postpetition counseling. The motion must include a certification, satisfactory to the court, asserting specific facts that describe and explain the exigent circumstances that merit deferral. The certification must state that the debtor requested the services of an approved agency, but was unable to obtain them during the seven-day period after he requested them. Many (but not all) courts require the certification to be attested to under oath. Bud cannot satisfy the certification requirement because of his complete failure to seek counseling immediately before filing the petition. He cannot certify that he requested and was unable to obtain the services during the seven-day period after requesting them, even on a sympathetic reading of §109(h)(3), such as that adopted by *In re Henderson* and *In re Romero*, cited in section 5.4.3(c).§109(h)(3)(A)(i). The circumstances must be exigent. "Exigent circumstances" are not defined in the Code, but, as noted in section 5.4.3, impending creditor action, such as foreclosure on or seizure of important property, could qualify as exigent circumstances. However, some courts are less sympathetic to a claim of urgency where the debtor has failed to take earlier steps that may have prevented matters reaching a crisis point. Bud is confronted with a crisis that could qualify as exigent circumstances, and some courts may so find. However, a court that adopts a more rigorous standard for exigent circumstances may regard him as the author of his own misfortune because he stopped paying creditors and then waited for the inevitable creditor response before consulting an attorney.

10 Exemptions, Redemption, and Reaffirmation

§10.1 OVERVIEW

This chapter is concerned with ways in which a debtor may recover property that has entered the estate. The provisions discussed here are largely applicable to individual debtors and are most directly relevant in Ch. 7 cases. Sections 10.2 through 10.8 cover the exemptions claimable by an individual debtor under §522. While exemptions are claimable by individual debtors in all forms of bankruptcy, they have the most direct application in a Ch. 7 case because the debtor may claim the release of fully exempt property from the estate, or cash payment of the amount of the exemption in partially exempt property. In Chs. 11 and 13, where the debtor may obtain release of estate property under the plan, exemptions are relevant to the determination of the minimum payment required of the debtor under the plan.

Section 10.2 explains the concept and purpose of exemptions. Section 10.3 discusses the manner in which exemptions are determined under §522 (b) and (d). Section 10.4 describes the nature of exempt property under §522(d). Section 10.5 describes the procedure for claiming exemptions and objections to the claim of exemptions under §522 (l). Section 10.6 discusses the extent to which a debtor may legitimately enter into transactions before filing the bankruptcy petition for the purpose of maximizing exemptions. Section 10.7 explains the provisions of §522(o), (p), and (q), designed to curb prepetition manipulations by a debtor to enhance her homestead exemption claim. Section 10.8 covers the debtor's power under §522(f) to avoid certain liens that impair exemptions.

Section 10.9 discusses the individual debtor's limited right to redeem tangible personal property in a Ch. 7 case. Section 722 provides for the right of redemption, and §521 sets out the procedure the debtor must follow to effect it.

Section 10.10 explains the process under which a debtor may enter into a contract with a creditor to reaffirm a dischargeable debt under §524. Section 524 is part of Ch. 5, which is applicable in all forms of bankruptcy. However, it is most commonly used in a Ch. 7 liquidation where a debtor seeks to use reaffirmation to save the collateral from liquidation. Reaffirmation is not confined to this use, and a debtor may be persuaded to reaffirm a dischargeable unsecured debt. Reaffirmation, especially of an unsecured debt, is often not in the interests of a debtor and undermines the debtor's fresh start, so §524 has a number of provisions designed to caution and protect the debtor from ill-advised, misinformed, or coerced reaffirmation agreements.

Section 10.11 explains the "ride through" that is permitted by some courts. Where allowed, this is an alternative means that a debtor may use to retain property subject to a security interest by maintaining contractual payments to the lienholder. The "ride-through" is not expressly authorized by the Code, but is dealt with in part by §521(a).

§10.2 THE CONCEPT OF EXEMPTIONS

Exemptions are discussed here in connection with bankruptcy. Recall, however, that they are also available in collection proceedings under state law. As explained in section 2.2.1, state exemption statutes designate specific property or types of property that cannot be levied upon by creditors in state debt collection proceedings.

Exemptions are only available to individual debtors and, as explained in sections 10.3 and 10.5, they cannot be claimed in property to the extent that it is subject to a valid and unavoidable consensual or statutory lien on property. Whether under state law or in bankruptcy, the goal of exemptions is to insulate certain of the debtor's property from the claims of creditors so that the debtor does not lose all his property by seizure or liquidation. In bankruptcy, property released to the debtor as exempt forms part of the debtor's new estate, thereby helping the debtor to gain a fresh start. As the following sections explain, the amount and value of property that a debtor can exempt varies greatly depending on which exemption regime applies. In some cases, the value of exemptions available to a debtor could be significant, and in other cases it could be modest.

Exemptions are provided for in §522. They are claimable by individual debtors in all cases, whether under Chs. 7, 11, or 13. Exemptions are used most directly in Ch. 7 cases, where fully exempt property is released and the cash value of partial exemptions is paid out from the estate to the debtor. In cases under Chs. 11 and 13, estate property vests in the debtor upon confirmation of the plan, except as otherwise provided for in the plan. (*See* section 9.2.) Therefore, the debtor does not directly use exemptions to reacquire estate property; instead, exemptions help the debtor because they are deducted from the liquidation value of the estate. This liquidation value is one of the factors taken into account in determining the minimum level of payment required for plan confirmation. (Standards for plan confirmation are explained in Chapters 18 and 20.) Exemptions are also relevant in all cases for the purpose of lien avoidance under §522(f), which is discussed in section 10.8.

§10.3 EXEMPTIONS APPLICABLE IN BANKRUPTCY CASES

§10.3.1 The State's Power to Substitute Its Own Exemptions for Federal Exemptions

The Bankruptcy Act of 1898 provided for exemptions to individual debtors in bankruptcy, but it did not designate which property of the debtor would be exempt. Instead, it deferred to state exemption laws so that the exemptions available to the debtor in the bankruptcy case would be whatever exemptions were allowed to the debtor under the law of the debtor's state. When the Code was enacted in 1978, there was disagreement over whether the Code should continue the old approach of using state exemptions in bankruptcy or should instead provide a uniform set of federal exemptions applicable to all individual debtors, irrespective of their state of domicile. Section 522 was a compromise between these opposing views. Section 522(d) provides a set of uniform bankruptcy exemptions, but §522(b) allows a state to elect to substitute its own exemptions for those listed in §522(d).[1] This has come to be known as the "opt-out."

1. Soon after the enactment of the Bankruptcy Act, the constitutionality of its deference to state exemption laws was challenged on the grounds that this violated the requirement of Art. VI, cl. 2 that Congress establish a uniform law of bankruptcy throughout the United States. The Supreme Court upheld the Act's incorporation of state exemption law in *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902). The Court set out the fundamental principle (introduced in section 3.3) that absolute and literal uniformity is not required. Although the provisions of federal bankruptcy law must themselves be uniform throughout the United

There are two important limitations on the states' power to opt-ou §522(d). First, a state cannot provide for different sets of exemptions ap cable in bankruptcy and in collection cases under state law. If the state o out, the same exemptions available under state law become the bankrup exemptions for debtors domiciled in that state.[2] Second, the opt-out rela only to §522(d), which lists the property that the debtor may exem It does not apply to other provisions of §522, which cannot be varied the states.

The state opts out of §522(d) by enacting a statute that specifically dc not authorize debtors domiciled within its jurisdiction to use the exem tions listed in §522(d). Those debtors are confined to exemptions provide by state law, together with any applicable federal nonbankruptcy exem tions (such as exemptions provided for Social Security benefits or othe protected benefits conferred by federal statutes other than the Code). If state has not opted out, a debtor domiciled in that state may choose to clain either the exemptions provided in §522(d) or the applicable nonbankruptcy exemptions, and will claim whichever set of exemptions gives him the greatest benefit. (The debtor must choose either the state exemptions or the §522(d) exemptions. He cannot pick some exemptions from the state set and others from the federal set.)

The majority of states have opted out, so debtors are commonly not entitled to claim the exemptions set out in §522(d); they are confined to the same exemptions in bankruptcy as are available in collection proceedings in nonbankruptcy law. Many states have exemption laws that are roughly similar to the exemptions in §522(d), so it sometimes does not make a dramatic difference if state exemptions apply rather than the exemptions listed in §522(d). However, some state exemption laws are very different from the set of exemptions provided for in §522(d). Therefore, if the state has opted out, a debtor domiciled in that state may have exemptions that are dramatically better or worse than those listed in §522(d) or claimable by a debtor domiciled in another state.

The issue of uniform exemptions was revisited by the 1994 National Bankruptcy Review Commission. In its 1997 report, the majority of the Commission criticized the widely divergent treatment of debtors that resulted from deference to state law, and recommended that Congress

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States, they can take into account variations in state law. The test is not whether bankruptcy law will lead to the same outcome in every state, but whether the superstructure of bankruptcy law is evenly imposed. A few years after the Code was enacted, its continued deference to state law exemptions was again challenged on the grounds that Congress had failed to comply with the constitutional requirement of uniformity in bankruptcy law. *In re Sullivan*, 680 F.2d 1131 (7th Cir. 1982), *cert. denied*, 459 U.S. 992 (1983) rejected this argument on the precedent of *Hanover National Bank*, and it now seems settled that there is no constitutional bar to adopting state exemptions in bankruptcy.

2. See *In re Wallace*, 347 B.R. 626 (Bankr. W.D. Mich. 2006).

eliminate the states' right to opt out of the standard exemptions in §522(d). Congress declined to follow this recommendation in enacting the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), so the Code continues to allow states to opt out.

§10.3.2 Determining Which State's Law Governs Exemptions — the Debtor's Domicile

The law of the state of the debtor's domicile determines which set of exemptions applies in the bankruptcy case. Domicile requires both actual residence and a present intent to remain. (Temporary removal to another jurisdiction does not defeat domicile if the debtor intends to return.)

Because the debtor's domicile at the time of the petition can have a significant impact on what property the debtor can claim as exempt, a debtor may make the strategic decision to move to and establish domicile in a state with favorable exemptions in anticipation of the filing. Section 522(b)(3)[3] provides that the law that governs the debtor's exemption rights is the law of the state in which the debtor was domiciled for the 730 days (two years) immediately preceding the petition. If the debtor has not been domiciled in any single state for that 730-day period, the applicable exemption law is that of the state in which the debtor was domiciled in the 180 days immediately preceding the 730-day period, or for a longer portion of that 180 days than any other place. That is, if the debtor has been domiciled in a state for the two years immediately before the petition, that state's exemption law applies. If the debtor has not been domiciled in the same state for the two years immediately before the petition, we must then look back to the six-month period immediately before those two years to determine domicile. Section 522(b)(3)(C) contains a safety net for a debtor who cannot establish the requisite domicile in any state under the section — in that case federal exemptions in §522(d) apply.

Section 522(b)(3) makes it very difficult for a debtor to move to a hospitable state for the purpose of enhancing her exemptions. In close cases, the determination of the proper domicile can be tricky. For example, in *In re Dufva*, 388 B.R. 911 (Bankr. W.D. Mo. 2008), the debtors were domiciled in Missouri. However, before moving to Missouri, they had been domiciled in Nevada, which had more generous exemptions. The debtors claimed Nevada

3. Section 522(b)(3) was amended by BAPCPA in 2005 to make it harder for a debtor to engage in strategic planning to establish a favorable domicile. Before the amendment, the rule in §522(b) for determining domicile for exemption purposes was quite lenient. The section applied the exemption law of the state in which the debtor was domiciled for the 180 days (about six months) prior to the petition. If the debtor had not been domiciled in a single state during the period, the law of the place of longest domicile in the 180-day period was used.

exemptions on the grounds that they had established domicile in Missouri only 729 days before filing, and had been domiciled in Nevada during the 180-day period before that. To resolve the issue, the court had to go through a tortuously finicky counting and interpretational exercise, which led it to conclude that the debtors were in fact domiciled in Missouri for the 730 days before filing.

§10.4 THE NATURE OF EXEMPT PROPERTY

Exemptions are granted at the expense of creditors, whose recourse is limited to nonexempt assets. Because exemptions detract from creditor interests, they are limited and controlled to confine them to a level regarded as appropriate by the legislature to accomplish the goal of preventing the debtor's impoverishment. As explained in section 10.2, the list of exemptions claimable by an individual debtor in bankruptcy is set out in §522(d). However, because most states have opted out of that section and substituted their own exemptions, the actual exemptions allowed by §522(d) are commonly inapplicable. This variation of exemptions, based on the state of the debtor's domicile, could be quite dramatic. However, many state statutes provide for exemptions that are not significantly different from those provided for in §522(d).

Section 522(d) and many state exemption statutes list specific types of property that may be exempted, with a dollar limit on most categories. The problem with this method of granting exemptions is that a debtor's ability to take advantage of exemptions is dependent on the extent to which her property coincides with the exemptions provided for in §522(d) or the applicable state statute. (For example, §522(d) grants exemptions for a car and tools of trade. A debtor who owns a car or tools of trade can claim exemptions for those items, but a debtor who does not own property of that kind cannot substitute other property and so loses those exemptions.) In addition to recommending that Congress establish a uniform set of bankruptcy exemptions by eliminating the states' right to opt out of §522(d), the majority of the 1994 National Bankruptcy Review Commission recommended that the list of exempt property in §522(d) be replaced with a lump sum dollar limit, so that a debtor could pick whatever property she wanted to exempt up to that limit. This change would have eliminated the problem of disparate treatment of debtors with different types of property and would have allowed all debtors the same total exemption amount, irrespective of the type of property they own. Congress did not follow this recommendation.

Although §522(d) is not applicable in most bankruptcy cases because of the opt-out, it serves as a model of what a common set of exemptions looks

like. It specifies the types or classes of property that may be claimed as exempt and imposes a value limit on most categories of exempt property. Almost every category of exemption listed in §522(d) has a value limitation. Some have a specified dollar limitation[4] that is quite modest, and some require the court to make a determination of the amount reasonably necessary for the support of the debtor and dependents. To be exempt, an asset must fit within one of the specified categories. To the extent that the asset is worth more than the exemption limit (or to the extent that the debtor has more assets in that category than may be claimed as exempt) the exemption is only partial, and the value over the exempt amount falls into the estate. The only category of exemption in §522(d) that allows the debtor the ability to select an asset to exempt (that is, provides for a general exemption in an asset of the debtor's choice) is the so-called "wildcard exemption" explained later in this section.

For debtors who own a home, the homestead exemption provided in §522(d)(1) is usually the most important and valuable. It covers $23,675 of the value of real or personal property that the debtor or a dependent uses as a residence. Other exemptions include a motor vehicle (§522(d)(2)), household furnishings and goods (§522(d)(3)), a modest amount of personal jewelry (§522(d)(4)), tools of trade on which the debtor depends for a livelihood, (§522(d)(6)), certain interests in life insurance policies, (§522(d)(7) and (8)), professionally prescribed health aids (§522(d)(9)), and various pension, disability, or alimony payments (§522(d)(10), (11) and (12)). One exemption category, the "wildcard exemption" under §522(d)(5), differs from the others in that it does not apply to any specific category or type of property, but can be used to exempt any property that the debtor chooses. It has a relatively small dollar limit that can be increased to if the debtor does not claim the homestead exemption. (Example 4 provides an exercise in determining how the exemption categories would be applied to a debtor's assets.)

§10.5 THE PROCEDURE FOR CLAIMING EXEMPTIONS

Under §522(l) the debtor must claim exemptions by filing a list of exempt property (Official Form 106C). If the debtor fails to file the list, a dependent

4. The dollar limits in §522(d) stayed constant for almost 20 years from the enactment of the Code in 1978 to 1994. The Bankruptcy Reform Act of 1994 updated the amounts and provided in §104 for their administrative adjustment every three years based on increases in the Consumer Price Index. (*See* section 3.4.3.) The last adjustment took effect on April 1, 2016, and the next will be on April 1, 2019. The figures used in this chapter are those promulgated in 2016.

of the debtor may do so, thereby safeguarding the exemptions. Rules 1007 and 4003(a) require the list of exemptions to be included with the schedule of assets, which must be filed with the petition or within 14 days after the order for relief. Under Rule 1009, the debtor is able to amend the claim of exemptions at any time up to the closing of the case.

A party in interest has the right to challenge the debtor's claim of exemptions. Rule 4003(b) requires objection to be filed within 30 days of the creditors' meeting. Rule 4003(c) places the burden on the objector to prove that the exemption is improperly claimed. Section 522(l) states that unless such an objection is made, the property is exempted as claimed. Therefore, if the trustee, U.S. Trustee, and creditors are not vigilant, the debtor could get away with an excessive exemption claim. In *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), the Supreme Court held that if the trustee or a party in interest fails to file the objection within the 30-day period (or within such extended period as the court allows), the right to object is barred and the exemption stands, even if the debtor had no colorable basis for claiming it. In *Schwab v. Reilly*, 560 U.S. 770 (2010) the court clarified that its decision in *Taylor* applied only where, on the face of the claim of exemptions, the property does not qualify as exempt, either because there is no exemption for that type of property, the cited Code section does not support the exemption, or the debtor's statement of the value of the property exceeds the statutory limit. However, provided that on the face of the schedule, the property claimed as exempt and the asserted value of that property fall within a statutory exemption category, failure to object to the value assigned by the debtor to that property within the time set out in Rule 4003 does not bar a later challenge to its claimed value. The Court noted that an exemption covers only the debtor's interest in the property, not the property itself, so the trustee is not bound by the debtor's valuation if it turns out that the property is worth more than the debtor asserted.

It is unclear if a second 30-day objection period is created if the debtor converts the case from one chapter to another. Some courts have held that a second 30-day objection period arises after the creditors' meeting following conversion, while others hold that conversion does not create a second objection period.[5]

5. See, e.g., *In re Brown*, 375 B.R. 362 (Bankr. W.D. Mich. 2007), which discusses the conflicting case law and chooses the former approach.

§10.6 EXEMPTION PLANNING

§10.6.1 Prepetition Arrangements to Maximize Exemptions

The legislative history of §522 indicates that a debtor should be able to plan for bankruptcy and take advantage of available exemptions by selling non-exempt property and using the proceeds to buy exempt property before filing the petition. In light of this, courts have recognized that the prepetition conversion of nonexempt assets into exempt property is not per se wrongful. However, it can become wrongful if the debtor engages in fraudulent or dishonest conduct in the process of organizing his estate before filing to maximize exemptions. The line between permissible bankruptcy planning and dishonest behavior is not always easy to draw. This creates a hazard for the debtor's attorney, who must be careful about how she advises the debtor before the petition is filed. The attorney must inform the debtor of the permissible scope of prepetition planning while not encouraging or collaborating in dishonest dealings.

Courts take several factors into account to decide if prepetition planning has been legitimate. Some of the indicia of dishonesty and manipulation include the use of credit to acquire or enhance an interest in exempt property, the concealment of the activity, and other conduct designed to mislead creditors. In *In re McCabe*, 280 B.R. 841 (Bankr. N.D. Iowa 2002), the court found that in the absence of any of these indications of dishonesty, the debtor's prepetition acquisition of exempt property was permissible. (The debtor bought a valuable gun prior to filing his petition because he knew that Iowa exemption law provided for an unlimited firearm exemption, and he wished to take advantage of it.)

§10.6.2 The Sanctions for Fraudulent Prepetition Manipulation

Where a debtor has behaved dishonestly or fraudulently in the prebankruptcy period in manipulating his estate to maximize exemptions, the court has the power to sanction this conduct by dismissing or converting the case or denying the debtor a discharge. In addition, fraudulent conduct could result in the criminal prosecution of the debtor.

Courts had also assumed that they had the inherent power under §105(a) to deny the exemption on grounds of the debtor's bad faith conduct. However, in *Law v. Siegel*, 134 S.Ct. 1188 (2014) the Supreme Court indicated that courts do not have this power. The case did not involve

exemption planning, but concerned a debtor who had created a sham mortgage on his house. The debtor's house, worth about $360,000 was subject to a genuine mortgage of about $150,000 and an exemption (under state law) of $75,000. The debtor had created this fictitious mortgage of about $150,000 to make it appear that the mortgages and his exemption covered the entire value of the house, so that there was no remaining equity in the house for the estate. When the trustee discovered that the mortgage was false, he sued the debtor to recover the unencumbered equity in the house and eventually obtained that judgment. In the process, the trustee had incurred legal costs of over $500,000 and the bankruptcy court granted the trustee's motion to surcharge the debtor's exemption to defray these costs. The Supreme Court held that the bankruptcy court had exceeded its powers in surcharging the exemption because the fees were administrative expenses which could not be charged against the exemption under §522(k). The Court stated that a bankruptcy court may only deny an exemption if there is a statutory basis for doing so, and that it has no general equitable power to refuse to honor an exemption on a ground not specified in the Code. Although *Law* involved the question of surcharging an exemption as a sanction for fraud in claiming the exemption, its pronouncement that a court may not deny an exemption on grounds other than those stated in the Code is much broader, and has been understood by lower courts to deprive them of the basis to sanction bad faith conduct (including improper conduct in the prepetition planning context) by disallowing an exemption.[6]

§10.7 THE IMPACT OF IMPROPER EXEMPTION PLANNING AND OTHER PREPETITION MISCONDUCT ON THE HOMESTEAD EXEMPTION

One of the most glaring abuses of prepetition exemption planning and manipulation of the nonuniform exemption system has related to the homestead exemption. Although BAPCPA did not go as far as the Commission recommended in tackling this problem by standardizing exemptions, it did enact new provisions in §522 designed to restrain the abuse. Section 522(d) and most state exemption statutes give the debtor a limited and often modest exemption in the value of her residence. For example, the homestead exemption in §522(d)(1) is in the amount of $23,675.[7] Many state

6. See, e.g., *In re Elliot*, 544 B.R. 421 (BAP 9th Cir. 2016) and *In re Baker*, 791 F.3d 677 (6th Cir. 2015).

7. This amount is subject to periodic adjustment under §104. This is the amount promulgated with effect from April 1, 2016. The amount will be adjusted again with effect from April 1, 2019. *See* section 3.4.3.

homestead exemptions are similarly of small amount in relation to the value of the home. This means that a debtor cannot claim the home as exempt in full; he is limited to a relatively small portion of his equity in the home. A few states have considerably larger homestead exemptions, and a handful provide for an unlimited homestead exemption — that is, the complete exemption of the debtor's equity in the home. This means that debtors in some states are treated far more generously than in others. It has also given some debtors the means to manipulate the system by shifting wealth into a homestead before they file bankruptcy. There have been cases in which a debtor who was domiciled in a state with a generous homestead exemption greatly enlarged his homestead exemption prior to filing by realizing all his nonexempt property and using the proceeds to buy a homestead or to pay down the mortgage on his existing homestead. This manipulation has not been confined to debtors who already live in a state with a generous or unlimited homestead exemption. There have been cases in which a debtor who lived in a state with a small or limited homestead exemption realized nonexempt assets, moved to a state with a generous or unlimited homestead exemption, and invested those proceeds in a home. Where the debtor was wealthy and the state had an unlimited homestead exemption, the homestead exemption created by this process could shelter millions of dollars from creditors.

Section 522(o), (p), and (q) create controls to curb these abuses of the homestead exemption. (In *Law*, the Supreme Court cited these provisions as examples of statutory limitations on exemptions arising from debtor misconduct.) These subsections are written in the mind-boggling form common to so many of the provisions in BAPCPA. In essence, they do not cap overly generous state homestead exemptions in most cases. However, they do provide for controls on high homestead exemptions in certain circumstances in which the debtor has behaved dishonestly or manipulatively. Remember, as discussed in section 10.3.2, that in addition to the controls in §522(o), (p), and (q), the domicile provisions of §522(b)(3) prevent the debtor from moving to a state on the eve of bankruptcy to take advantage of desirable exemptions (including a generous homestead exemption). The controls that are imposed on the homestead exemption under §522(o), (p), and (q) boil down to this:

Section 522(o) reduces the debtor's homestead exemption under state law to the extent that the value of the debtor's interest in the homestead is attributable to the disposition of nonexempt property in the ten years before the petition, with intent to hinder, delay, or defraud creditors. The basic idea is that if the debtor had sold nonexempt property in the ten years before bankruptcy and had invested the proceeds in exempt homestead property, the exemption will be reduced by the amount of that investment if intent to hinder, delay, or defraud creditors can be shown. It is not itself fraud for the debtor to realize nonexempt property and to use the proceeds to enlarge his

exemptable equity in the homestead. For §522(o) to apply, the party challenging the debtor's exemption claim must show that this activity was for the purpose of hindering, delaying, or defrauding creditors. That is, that the debtor engaged in this activity with the intent to evade the payment of debt or to deceive and defraud creditors. Deception may be present, for example, where the debtor seeks to conceal transactions, makes misrepresentations to creditors, or realizes the nonexempt property well below its value. Because the language in §522(o) is the same as that used in §548 in relation to fraudulent transfers and in §727 in relation to denial of the discharge, the tests of fraudulent intent developed by the courts under those sections, including the use of badges of fraud, are applicable here.[8]

Section 522(p) limits the debtor's interest in a homestead exempted under state law to an amount of $160,375[9] if the debtor acquired the homestead within 1,215 days (about three years and four months) of the petition. The purpose of the section is to place a restriction on the kind of exemption planning in which a debtor buys an expensive home in a state with a high or unlimited homestead exemption. The application of the section is relatively clear where the debtor buys new property. However, it is less clear where the debtor newly establishes a homestead on property that he already owns. Section 522(p) applies to an "interest" that the debtor "acquired" during the 1,215-day period. In *In re Greene*, 583 F.3d 614 (9th Cir. 2009), the debtor had owned a parcel of undeveloped land for about ten years. About a year before he filed a Ch. 7 petition, he brought a trailer onto the property, began to live in it, and recorded a declaration of homestead with the county. In his Ch. 7 case, he claimed the full value of the land ($240,000) as exempt under the state homestead exemption. A creditor challenged the exemption and argued that even if the property was a homestead, the debtor had acquired the homestead within the 1,215-day period and should be confined to the limit in §522(p). The court conceded that §522(p) is ambiguous on the question of when the debtor acquires an exemptible interest, but it concluded that the acquisition of interest means when the debtor acquired ownership of the property, not when he began to use it as a homestead. The court distinguished a homestead claim, which is a personal right granted by statute, from an interest in property on which the exemption is dependent.

There are some exceptions to the limitation imposed by §522(p), the most notable of which is that it does not apply to the extent that proceeds of a prior home acquired before the 1,215-day period are transferred into the

8. See *In re Roberts*, 527 B.R. 461 (Bankr. N.D. Fla. 2015); *In re Anderson*, 386 B.R. 315 (Bankr. D. Kan. 2008), *aff'd* 406 B.R. 79 (D. Kan. 2009); and *In re Maronde*, 332 B.R. 593 (Bankr. D. Minn. 2005).

9. This is the amount in effect with effect from April 1, 2016. The amount will be adjusted again under §104 in 2019.

new home. *In re Summers*, 344 B.R. 108 (Bankr. N.D. Ariz. 2006), illustrates how §522(p) operates: The debtors were domiciled in Arizona, which has opted out of §522(d). The Arizona homestead exemption was $150,000. The debtors had bought a home worth $465,000 in the 1,215-day period. After deducting the amount owing on the home mortgage, the debtors had an equity of $210,000 in the home. Although Arizona law would have allowed an exemption of $150,000, the debtors would normally have been confined to an exemption of $125,000[10] under the limit imposed by §522(p). However, $54,000 of the purchase price of the house was proceeds from the sale of the debtor's previous homestead, so this amount could be added to the $125,000 limit under §522(p). This did not mean, however, that the debtors would have been entitled to an exemption of $179,000, because the state exemption of $150,000 was the upper limit of the amount of the exemption.

Section 522(q) caps the homestead exemption at $160,375[11] where the debtor has been guilty of certain kinds of misconduct. Section 522(q)(1)(A) confines the debtor's homestead exemption to $160,375 if the debtor has been convicted of a felony that, under the circumstances, demonstrates that the filing of the bankruptcy case was an abuse of the Code. Section 522(q)(1)(B) imposes that cap if the debtor owes a debt that arises from specified kinds of wrongful act, including fraud or deceit in a fiduciary capacity or any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death. In *In re Larson*, 513 F.3d 325 (1st Cir. 2008), the court held that negligent vehicular homicide qualified as a criminal act that caps the homestead exemption under §522(q)(1)(B). The section does not require mens rea, nor does it have the prerequisite (as does §522(q)(1)(A) that the debtor has been convicted of the crime.

Subsections (p) and (q) begin with unfortunately chosen language. They are stated to apply where the debtor "as a result of electing under subsection (b)(3)(A)" exempts property under state or local law. The word "electing" suggests that the subsections only apply where the state has not opted out, because if the state has opted out, the debtor is bound by state exemptions and has no right to make any election. At least one court has given the language this literal interpretation.[12] The problem with this literal interpretation is that it renders §522(p) and (q) virtually useless because so few states allow for the election. Other courts have rejected this approach. They have found the language of the subsections to be ambiguous and have consulted legislative history, which indicates congressional intent to cap the

10. $125,000 was the dollar amount of the cap under §522(p) at the time of the case. (As indicated in the text, it is now higher.)
11. Again, as adjusted with effect from April 1, 2016.
12. See *In re McNabb*, 326 B.R. 785 (Bankr. D. Ariz. 2005).

exemption in all states in which state law has an exemption in excess of $160,375.[13]

§10.8 THE DEBTOR'S POWER TO AVOID CERTAIN INTERESTS THAT IMPAIR EXEMPTIONS

§10.8.1 General Scope and Purpose of the Debtor's Avoidance Power

As a general rule, a debtor's exemption in property does not avail against the holder of a valid consensual security interest in that property. By granting the interest, a debtor has effectively waived the right to assert the exemption against the consensual lienholder. Statutory liens, conferred by the legislature to protect persons who have enhanced or preserved the value of the property, are also usually immune from exemption claims. By contrast, an exemption normally does take precedence over a judicial lien that attaches to the property. Judicial liens are acquired by the very process of seizure or judgment against which exemptions are meant to protect the property.

The purpose of §522(f)(1)(A) is to give effect to the primacy of the debtor's exemptions over judicial liens, by empowering the debtor to avoid them to the extent that they impair her exemptions. Section 522(f)(1)(B) creates a limited exception to the general rule that exemptions cannot be used to avoid consensual security interests. It extends the debtor's avoidance power to nonpossessory, nonpurchase-money security interests in specific classes of exempt property. This exception reflects Congress's determination that these types of security interest are predatory and should not be permitted to undermine the debtor's exemptions.

§10.8.2 Judicial Liens

Section 522(f)(1)(A) allows the debtor to avoid a judicial lien in exempt property to the extent that the lien impairs an exemption to which the debtor would have been entitled in the absence of the lien. With an exception relating to domestic support obligations, §522(f)(1)(A) applies to all judicial liens, whether created by prejudgment proceedings, by recording of the judgment, or by postjudgment proceedings such as execution. Also, unlike §522(f)(1)(B), it applies to all types of exempt property.

13. See, e.g., *In re Kaplan*, 331 B.R. 483 (Bankr. S.D. Fla. 2005) and *In re Summers*, 344 B.R. 108 (Bankr. N.D. Ariz. 2006).

The exclusion of domestic support obligations (as defined in §101(14A)) from the debtor's avoidance power reflects a strong policy, manifested in a number of provisions enacted by the Bankruptcy Reform Act of 1994 and reinforced by BAPCPA, that a debtor should not be able to use bankruptcy to evade domestic support obligations. The protection of domestic support recipients is provided for in several provisions of the Code. For example, the enforcement of domestic support obligations is not subject to the automatic stay (see section 7.4.3), and these obligations are also given top priority over other unsecured claims and are nondischargeable (see sections 17.5.4 and 21.5.4). In the present context, §522(f)(1)(A) does not permit the debtor to avoid a judicial lien that enforces a domestic support obligation, even if that lien impairs an exemption to which the debtor would otherwise be entitled.

§10.8.3 Avoidable Nonpossessory, Nonpurchase-Money Security Interests

Section 522(f)(1)(B) creates a narrow exception to the general rule that consensual liens take priority over an exemption in the collateral: The debtor may avoid a nonpossessory, nonpurchase-money security interest in specified household or consumer goods, tools of trade, or professionally prescribed health aids to the extent that the security interest impairs an exemption in such property.[14] The scope of §522(f)(1)(B) is very limited. The security interest can be avoided only if all three requirements of the section are satisfied: The secured party must not have perfected the interest by taking possession of the collateral, the loan or credit must not have been provided to enable the debtor to acquire the collateral, and the impaired exemption must relate to one of the three types of property specified. Section 522(f)(1)(B) is aimed at a particular type of transaction under which a creditor secures the debt by filing a security interest in household goods or other necessities already owned by the debtor. In many cases, the property is likely to be worth more to the debtor than its realization value, so that the threat of foreclosure gives the creditor great power over the debtor. Congress was concerned about abuses in transactions of this type, which it

14. Section 522(f)(4) defines "household goods" for the purpose of §522(f)(1)(B). It contains a long list of what does and does not qualify as household goods. The definition is expressly for the purpose of §522(f)(1)(B), so its restrictions should not be applicable to the term as it is used in §522(d)(3). That is, although a particular item may be omitted from the list of household goods in §522(f)(1)(B), this does not necessarily mean that it does not qualify as a household good for the purpose of claiming an exemption for it under §522(d)(3).

regarded as manipulative and unethical. It therefore subordinated them to the debtor's exemption.

The Bankruptcy Reform Act of 1994 added §522(f)(3), a limited qualification to the debtor's power to avoid a nonpossessory, nonpurchase-money lien in tools of trade where state law exemptions apply and the state either has no monetary limit on the exemption or prohibits the avoidance of consensual liens on exempt property. The subsection is obscurely drafted and its purpose unclear. It imposes a dollar limit on the extent to which the debtor may avoid the lien, so its apparent effect is to limit the amount of the debtor's avoidance under these circumstances.

§10.8.4 Avoidance "to the Extent" of Impairment

Section 522(f) does not necessarily result in the total avoidance of the judicial liens and security interests covered by the subsection. It permits avoidance only to the extent necessary to preserve the exemption. Therefore, if the debtor's equity in the property exceeds the exemption, the lien or security interest remains a valid charge on the nonexempt portion of the equity. For example, assume that the debtor owns a piece of equipment used as a tool of trade. The value of the equipment is $3,000. The debtor's exemption under §522(d)(6) is $2,375.[15] If a judicial lien attached to the property securing a judgment of $1,000, it would impair the debtor's exemption to the extent of $375. (That is, if the judicial lien was allowed in full, the debtor's equity in the property would be reduced from $3,000 to $2,000, but the debtor's exemptible interest in the property is $2,375.) The lien can therefore be avoided to the extent of $375, so it becomes a secured claim for $625 and an unsecured claim of $375. Had the value of the collateral been $2,375 or less, the lien would have been avoided entirely, and had the collateral been worth $3,375 or more, it would not have been avoidable at all. *See* Example 1.

§10.8.5 A State Cannot Override the Avoidance Power in Its Opt-Out Statute

As explained in section 10.3, states have the power under §522(b) to enact legislation substituting nonbankruptcy exemptions for those provided in §522(d). In conferring this power on the states, §522(b) refers only to the substitution for exemptions listed in §522(d). It does not authorize states to override any other provisions of §522. In *Owen v. Owen*, 500 U.S.

15. This is the amount with effect from April 1, 2016. The amount will be adjusted again under §104 in 2019.

305 (1991) the Supreme Court held that the states' power to opt-out pertains only to the selection of exemptions under §522(d), and not to the federal remedy of lien avoidance provided in §522(f). Therefore, a state statute that gives a lien precedence over exemptions is ineffective to override the debtor's avoidance power under §522(f). The Court focused on the language of §522(f), which allows avoidance of the lien to the extent that it "impairs an exemption to which the debtor would have been entitled" under §522(b). The Court reasoned that the inquiry called for by this language is not whether the lien impairs an exemption to which the debtor is actually entitled under the state statute, but whether it impairs one to which the debtor would have been entitled if no lien existed. In *In re Cleaver*, 407 B.R. 354 (B.A.P. 8th Cir. 2009), the court, applying *Owen*, held that a lien on a tool of trade (a truck) could be avoided under §522(f) even though the state had opted out of the federal exemptions and had no tool of trade exemption. The court reasoned that avoidance of a lien on a tool of trade was permitted by the federal remedy of lien avoidance under §522(f), even if tools of trade were not included in the state's list of exemptions.

§10.8.6 How Impairment Is Measured

Although *Owen* set the basic meaning of "impairment," it did not resolve the question of how that impairment is measured. Congress attempted to provide some guidance on this issue in the Bankruptcy Reform Act of 1994 by adding §522(f)(2). Section 522(f)(2)(A) defines "impairment" by setting out an arithmetical formula. To find the amount of impairment:

1. Determine what the value of the debtor's interest in the property would be — that is, the full interest or equity that the debtor would have in the property — in the absence of liens. (When the debtor is the sole and absolute owner of the property, this is equivalent to the full value of the property.)
2. Add together:
   a. the lien to be avoided plus
   b. other liens on the property plus
   c. the amount of the debtor's exemption.
3. Compare 1 and 2. The exemption is impaired to the extent that 2 is greater than 1.

   Where there is more than one lien on the property, §522(f)(2)(B) makes it clear that once any lien is avoided, the avoided lien is not taken into account in calculating the total of "other liens" for the purpose of avoiding any remaining lien.

   The formula seems quite easy to work with in an uncomplicated case. However, it does raise some questions and present interpretational

difficulties, under some circumstances. The following three examples show the basic operation of the formula in two easy cases and then in one more difficult one.

Example 1: One judicial lien

Say that a homestead worth $200,000 is subject to an exemption of $50,000. There is only one judicial lien of $180,000 on the property. The lien can be avoided to the extent that:

> *The total of*
> the amount of the lien itself ($180,000) plus
> other liens ($0) plus
> the exemption ($50,000)
> = $230,000
> *exceeds*
> the value that the debtor's interest would have in the property in the absence of liens ($200,000).

Therefore, the lien is avoided by $230,000 − $200,000 = $30,000. As a result, it remains a lien on the property to the extent of $150,000.

Example 2: Two judicial liens

Say that the same property is subject to two judgment liens, the senior is for $100,000 and the junior is for $80,000. Although §522(f)(2)(A) does not say so, the avoidance must be directed at the junior avoidable lien first. (If this were not so, the avoidance of the senior lien first would elevate the junior lien in priority, because under §522(f)(2)(B), the avoided senior lien would not be taken into account in that second avoidance action.) The calculation is therefore:

> *First, apply the calculation to the junior lien.*
> The total of
> the junior lien ($80,000) plus
> "all other liens"—the senior lien ($100,000)—plus
> the exemption ($50,000)
> = $230,000
> *exceeds*
> the debtor's equity interest ($200,000).

Therefore, the junior lien is avoided, by $230,000 − $200,000 = $30,000. As a result, it survives only to the extent of $50,000.

> *Next, apply the calculation to the senior lien.*
> The total of
> the senior lien ($100,000) plus

"all other liens"—the remaining unavoided portion of the junior lien ($50,000)—plus
the exemption ($50,000)
= $200,000.

This is exactly equal to the debtor's unencumbered equity, and it, therefore, does not impair the exemption at all and is unavoidable.

Example 3: A first mortgage, a judicial lien, and a second mortgage

Say that the homestead, worth $200,000 and subject to an exemption of $50,000, has three liens on it. The first is a consensual first mortgage of $70,000, perfected a year before bankruptcy. The second is a judgment lien of $80,000, recorded eight months before bankruptcy. The third is consensual second mortgage of $60,000, perfected six months before bankruptcy. If this was nonexempt property, the priority of the three interests would simply be based on the first-in-time rule. This would mean that the first mortgage would be entitled to full payment of $70,000, then the judgment lien would be entitled to full payment of $80,000. Finally, the second mortgage would be third in line. It would only be paid what is left of the value of the property, $50,000, and would have an unsecured deficiency of $10,000.

As the property is exempt, the debtor is able to use §522(f)(1)(A) to avoid the judicial lien, but not the consensual liens. (The consensual liens cannot be avoided under §522(f)(1)(B) because the homestead is not one of the exemptions protected by that subsection.) Therefore, the assumption that we made in the prior illustration, that the junior lien must be avoided first, cannot apply to the second mortgage. The avoidance is directed at the judgment lien only. The calculation is as follows:

The total of
the amount of the judgment lien ($80,000) plus
all other liens ($130,000) plus
the exemption ($50,000)
= $260,000
exceeds
the value that the debtor's interest would have in the property in the absence of liens ($200,000).

Therefore, the judicial lien is avoided to the extent of $60,000. It becomes a secured claim of $20,000 and an unsecured claim of $60,000. The twist here is that this does not mean merely that the debtor's exemption is preserved. It also has the effect of elevating the second mortgage above the judicial lien. That is, avoidance under §522(f)(1)(A) benefits not only the

debtor, but also the unavoidable consensual lien that would otherwise be junior to the judicial lien. This can be seen if we set out the distribution of the proceeds of the property: first mortgage, $70,000; second mortgage, $60,000; exemption $50,000; unavoided portion of judgment lien, $20,000. On similar facts, the court in *In re Kolich*, 328 F.3d 406 (8th Cir. 2003), found this apparent anomaly to be a little unsettling, but nevertheless consistent with the intent of Congress in enacting the formula in §522(f)(2). The bankruptcy court had excluded the junior mortgage from the calculation, thereby holding that the judgment lien did not impair the exemption. The bankruptcy appellate panel (BAP) reversed, and the court of appeals affirmed the BAP. The court of appeals reasoned that Congress deliberately included "all other liens" in the impairment formula, so there was no justification, on the plain wording of the subsection, to disregard the junior mortgage. The holder of the judgment lien argued that the literal application of the formula gave a windfall to the junior mortgagee, but the court was not persuaded. It said that Congress could have drafted the formula to exclude junior consensual lines from the calculation, but did not. This demonstrates congressional intent to treat consensual liens more favorably, even if it means that avoidance of the judicial lien would have the effect of elevating their priority. Similarly, in *In re Brinley*, 403 F.3d 415 (6th Cir. 2005) *cert. denied*, 126 S. Ct. 1164 (2006), the court likewise avoided the second-priority judgment lien to the extent of its impairment of the exemption, even though this benefited a third-priority second mortgage.

§10.9 THE INDIVIDUAL DEBTOR'S REDEMPTION RIGHT IN CH. 7 CASES

Under §722, when property is subject to a lien that secures a dischargeable consumer debt, an individual debtor in a Ch. 7 liquidation may redeem the property from the lienholder. The property must be tangible personal property intended primarily for personal, family, or household use and it must have been either exempted or abandoned. As the above restrictions show, redemption is available only in narrow circumstances. Under §521(a)(2) the debtor must file a statement of intention within 30 days of the petition indicating whether or not the property will be redeemed. (This is one of the supporting documents filed with the petition, as described in section 6.3.) Section 521(a)(3) requires the redemption to be affected within 30 days of the first date set for the meeting of creditors unless the court grants additional time for cause.

By redeeming the collateral, the debtor in effect buys it from the secured creditor for the amount of the allowed secured claim. If the value of the collateral is equal to or exceeds the debt, the debt will be fully allowed as a secured claim provided that is valid and unavoidable. To redeem, the debtor must pay the claim in full. However, if the collateral is worth less than the debt (so that the creditor is undersecured), the allowed secured claim, and hence the redemption price, is limited to the value of the collateral.

Section 722 requires the property to be abandoned or exempt. Unless the lien is avoidable under §522(f), the existence of an exemption does not reduce the redemption price to be paid to the lienholder. As noted in section 10.8, exemptions do not avail against liens except to the extent provided in §522(f). The requirement of abandonment or exemption relates to the existence or extent of the estate's interest in the unencumbered equity in the property. If the collateral value is exactly equal to or less than the secured debt, the estate has no interest in the property, so it is likely to be abandoned, thereby allowing the debtor to redeem it by settling the secured claim. Similarly, if the property is worth more than the debt but the equity is fully exempt, the estate has no interest in it and redemption can be affected by paying the secured claim. However, if the equity exceeds the debtor's exemption, the estate does have an interest in the property, and redemption is not possible unless the debtor first pays out the estate's interest so that the trustee will abandon the property. Following abandonment, the debtor may redeem by paying the redemption price to the secured claimant. (Example 5 illustrates this point.)

Section 722 states that the debtor must pay the lienholder the amount of the allowed secured claim "in full at the time of redemption." This language was added to the section by BAPCPA to make it clear that the debtor must redeem in cash, and may not redeem by installments (as some courts had permitted prior to the amendment). This means that redemption is not practical for a debtor who has no means to raise the necessary cash after having filed bankruptcy. A debtor in that position cannot salvage encumbered property in a Ch. 7 case unless a reaffirmation agreement can be negotiated with the secured creditor.

The debtor's right to redeem is provided for only in Ch. 7 cases because redemption is not needed in Chs. 11 and 13. Under those chapters, the debtor is able to retain desired property upon confirmation of a plan providing for protection of the security interest and periodic payments on the debt. The rehabilitation process under Chs. 11 and 13 in fact permits the debtor to "redeem" collateral by installments under the plan. Therefore, a debtor who wishes to keep property, but cannot afford to redeem it for cash, has an incentive to choose rehabilitation rather than liquidation under Ch. 7. However, even in a Ch. 7 case, the debtor may have alternatives to redemption, as discussed in the next two sections.

§10.10 REAFFIRMATION

§10.10.1 The General Principles of Reaffirmation

A reaffirmation agreement is a contract between the debtor and a creditor under which the debtor agrees to pay a debt that would otherwise be discharged. Reaffirmation therefore diminishes the debtor's discharge, which is one of the important benefits of bankruptcy. For this reason, the Code adopts a cautious approach to the validation of reaffirmation agreements to ensure that the debtor understands the impact of the agreement, that it is in the debtor's interests, and has not been coerced or unfairly imposed by the creditor.

Reaffirmation agreements are included in §524, which deals generally with the effect of the debtor's discharge, and are governed by subsections (c), (d), (k), (l), and (m). These long and detailed subsections are intended to ensure that the debtor is fully informed about the effect of a reaffirmation agreement and to protect the debtor from an inappropriate reaffirmation. They include a lengthy standard disclosure that must be provided to the debtor by the creditor at or before the time of signing the agreement.[16]

§10.10.2 Why Would a Debtor Give Up the Right to Discharge the Debt by Reaffirming It?

Section 524 makes no express distinction between secured and unsecured debts, and both are capable of being reaffirmed if the requirements of the section are satisfied. However, as explained below, there is a very important practical difference between the reaffirmation of these two classes of debt which makes courts much more wary of approving the reaffirmation of unsecured debt.

(a) The Reaffirmation of Secured Debt as an Alternative to Redemption

Reaffirmation of secured debt is commonly used by a debtor to save the collateral from liquidation. As stated in section 10.9, redemption under §722 is available only in very narrow circumstances. If the property does not qualify for redemption or the debtor cannot find the cash to redeem, reaffirmation could be an alternative means of keeping collateral that would otherwise be liquidated in a Ch. 7 case. Because reaffirmation is consensual,

16. The length of these provisions was greatly increased by amendments enacted by BAPCPA, which expanded the disclosure and added other debtor protections.

the debtor cannot force the secured creditor to reaffirm. The debtor must negotiate with the secured creditor and must usually provide an incentive—some benefit beyond that expected from liquidation of the property—to persuade the creditor to assent. (*See* Example 7.) If the debtor intends to reaffirm a secured debt, the statement of intent under §521(a)(2) must so indicate, and the debtor must perform that intent within 30 days after the first date set for the meeting of creditors, unless the court has extended that period for cause.

Unlike redemption, reaffirmation is not confined to Ch. 7 cases. However, because Chs. 11 and 13 allow the debtor to retain property by providing for payments under a plan, the debtor does not need to use reaffirmation to keep property. In fact, if the debtor's primary goal is to prevent the liquidation of encumbered property, bankruptcy under Ch. 11 or 13 may be easier and less expensive than attempting to negotiate reaffirmation agreements in a Ch. 7 case.

(b) The Reaffirmation of Unsecured Debt

Where reaffirmation is used by a debtor as a means of keeping property that would otherwise be liquidated, the rationale for the reaffirmation is clear. However, there is less obvious advantage to a debtor who reaffirms an unsecured debt. There are various reasons why a debtor may wish to pay an unenforceable unsecured debt: for example, creditor pressure, the desire not to damage a relationship, the hope of future credit, or guilt. Where the reaffirmation does not give the debtor a clear economic benefit, the court should look even more carefully at the transaction to ensure that the requirements of §524 have been satisfied.

Reacting to abuse by large providers of consumer credit, which were found to have routinely bullied bankrupt customers into entering reaffirmation agreements, the majority report of the 1994 National Bankruptcy Review Commission recommended that reaffirmation should be confined to secured debt, and no longer permitted to the extent that a debt is unsecured. Congress did not adopt this recommendation in BAPCPA and decided, instead, to strengthen the creditor's disclosure requirements relating to reaffirmation and to provide for more rigorous enforcement to ensure that creditors follow them.

§10.10.3 The Creditor's Risk of Violating the Automatic Stay or the Discharge Injunction

Under §524(c)(1) a reaffirmation must be made before the debtor has been granted the discharge. During the time leading up to the discharge, all

creditor action to collect the debt is stayed under §362 (discussed in Chapter 7). Therefore, a creditor that approaches the debtor before the grant of the discharge to propose a reaffirmation agreement runs a risk of violating the automatic stay. A creditor who seeks or executes a reaffirmation agreement after the debtor's discharge is not in compliance with the reaffirmation requirements of §524 and could incur sanctions for the violation of the discharge injunction (discussed in Chapter 21).

(a) The Automatic Stay

Sometimes the debtor may initiate negotiations for a reaffirmation agreement, and sometimes the creditor may be the party that first proposes reaffirmation to the debtor. A creditor who approaches the debtor to suggest reaffirmation takes the risk that the debtor will object to the overture and claim that the creditor has violated the stay. Courts generally do not consider a mere suggestion of reaffirmation to be a per se violation of the stay, and recognize that by providing for a reaffirmation process in §524, the Code must be somewhat tolerant of creditor-initiated proposals for a reaffirmation agreement. But if the creditor's conduct is overbearing, coercive, deceptive, or harassing, a court may well find that the creditor has overstepped the mark and is using §524 as a pretext for trying to evade the strictures of the stay. As discussed in section 7.7, this could render the creditor liable for costs, fees, and damages under §362(k) (formerly (h)) or for sanctions for contempt of court under §105(a). This distinction between legitimate negotiation and disregard for the stay is illustrated by *In re Estrada*, 439 B.R. 227 (Bankr. S.D. Fla. 2010); the court held that the creditor had violated the stay by intimating in a standard reaffirmation letter that the debtor could avoid the consequence of negative credit reporting by reaffirming. (The creditor escaped sanctions because the court was persuaded that the creditor had not intended to threaten the debtor and had since changed the wording of its standard reaffirmation letter.)

Where the debtor approaches the creditor to discuss reaffirmation, the creditor is not as much at risk of violating the stay. For example, in *In re Jamo*, 283 F.3d 392 (1st Cir. 2002), the debtor, not the creditor, initiated contact, offering to reaffirm a debt secured by a home mortgage. The creditor refused to enter a reaffirmation agreement for the mortgage debt unless the debtor also agreed to reaffirm some unsecured debts that the debtor owed to the creditor. The debtor claimed that this was a violation of the stay, but the court disagreed. It noted that reaffirmation is a contract, and the creditor can take advantage of its bargaining leverage and refuse to make the contract unless the debtor agrees to its terms. This is not a violation of the stay as long as the creditor does not engage in coercive or harassing conduct. Nevertheless, even where a debtor approaches the creditor to suggest a reaffirmation agreement, the creditor must be cautious not to overstep

the border between reasonable negotiation and conduct that could be interpreted as an improper effort to collect debt in contravention of the stay.

b. The Discharge Injunction

Section 524(c)(1) confines reaffirmation to the predischarge period. Therefore, a creditor cannot execute a valid reaffirmation agreement after the debtor has been granted a discharge, and the agreement violates the discharge injunction provided for in §524(a). This is illustrated by *In re Sandburg Financial Corp.*, 446 B.R. 793 (S.D. Tex. 2011). The creditor had entered into a reaffirmation agreement with the Ch. 11 debtor. However, the agreement did not comply with §524 in that it was made after the discharge, did not contain the required disclosures, and was not filed with the court. The court found the reaffirmation agreement invalid and held that the creditor's attempt to enforce it was a willful violation of the discharge injunction. The court found the creditor in contempt and imposed a compensatory contempt sanction, awarding the debtor damages. The creditor had argued that it should not have had to comply with §524 because it had given the debtor new and independent consideration for entering into the agreement. Like other courts, the court held that the furnishing of new consideration does not excuse the creditor from complying with §524 where the agreement reaffirms a dischargeable debt.

§10.10.4 The Restrictions on Reaffirmation Agreements

Because the debtor's discharge is such an important consequence of bankruptcy, the Code places a number of restrictions on reaffirmation agreements. To be enforceable, the agreement must comply with the following conditions set out in §524(c) and (d). (Note that the restrictions in §524(c) and (d) apply only to reaffirmation agreements, that is, to contracts under which debtors undertake the obligation to pay the debts. Under §524(f), they do not apply when, instead of promising payment, the debtor actually makes a voluntary payment of the debt.)

1. The agreement is valid only to the extent that it is enforceable in nonbankruptcy law. At common law, the debtor's promise to pay a discharged debt does not require consideration because the original consideration given by the creditor creates a "moral obligation" sufficient to support the new promise. However, statutory or common law policing doctrines such as unconscionability, fraud, and duress may make the agreement avoidable under nonbankruptcy law.

2. The agreement must have been made before the discharge is granted and it must be filed with the court.
3. The debtor may rescind the agreement at any time before the discharge is granted, or within 60 days of the agreement having been filed in the court, whichever is the later. The agreement must conspicuously express this rescission right.
4. The creditor must provide the debtor with a disclosure statement containing the information set out in §524(k) at or before the time of signing the agreement.
5. If the debtor was represented by an attorney when the agreement was negotiated, the attorney must file a declaration with the agreement stating that the debtor's consent was informed and voluntary, that the agreement does not impose an undue hardship on the debtor or a dependent, and that the attorney fully advised the debtor of the legal effect and consequences of an agreement of that kind, and of default under it. Where a debtor is legally represented, her attorney may be in the awkward position of having to go against her wishes. The debtor may want to reaffirm, but the attorney cannot certify that the reaffirmation will not impose an undue hardship on the debtor. The attorney cannot simply give in to the debtor's wishes; she must conduct a proper assessment of her financial situation. If the attorney signs the certificate without justification, she could be sanctioned. For example, in *In re Vargas*, 257 B.R. 157 (Bankr. D.N.J. 2001), an attorney who failed to conduct a proper hardship evaluation was required to disgorge his fees. (Some courts may allow the attorney to withdraw where she feels that she cannot give the certificate, so the duty of vetting the agreement falls to the court.)[17]

   Section 524(m) creates a presumption of undue hardship where the scheduled payments on the debt exceed the debtor's disposable monthly income, as reflected in the debtor's financial data submitted in support of the reaffirmation. The debtor can rebut the presumption by showing additional sources of income. If the presumption does not apply and the other requirements of §524 are met, the agreement becomes effective as soon as it is filed with the court. However, if the presumption applies, the court must conduct a hearing on notice to determine the question of undue hardship.
6. If the debtor was unrepresented at the time of negotiating the agreement and is an individual, the agreement needs court approval that is granted only if the agreement does not impose undue hardship on the debtor or a dependent and is in the debtor's best interests. (This requirement of court approval does not apply to a "consumer debt

17. See, e.g., *In re Brown*, 95 B.R. 35 (Bankr. E.D. Va. 1989).

secured by real property" — that is, a mortgage reaffirmation on the debtor's home.) The court evaluates undue hardship and the best interests of the debtor only where the debtor is unrepresented or the presumption of undue hardship applies. Otherwise the attorney's declaration is sufficient.[18]

7. At the time for the individual debtor's discharge, the court may hold a discharge hearing at which the debtor must be present in person. If the debtor had not been represented by an attorney at the time of negotiating the agreement, the court must use the occasion of the discharge hearing to tell the debtor that the agreement is not required by law. The court must explain its effect and must determine whether or not the agreement satisfies all the requirements described above. Section 524(d) makes it clear that this procedure is not to be followed if the debtor was legally represented in entering the agreement.

§10.11 THE CH. 7 DEBTOR'S RETENTION OF THE COLLATERAL UNDER THE ORIGINAL CONTRACT — THE "RIDE-THROUGH"

As noted earlier, §521(a)(2) requires the debtor to file a statement of intention concerning the retention or surrender of property securing a consumer debt, and to state whether redemption or reaffirmation will be sought. Section 521(a)(2) expressly provides only for surrender, redemption, or reaffirmation. However, some (but not all) courts have recognized an additional way for a debtor to keep property subject to a security interest. If the debtor has not defaulted on payments on the secured debt, some courts have allowed the debtor to retain the collateral while continuing to pay installments to the secured party as required by the contract. This is known as a "ride-through" because the secured transaction rides through the bankruptcy without being formally administered and dealt with as part of the estate. Where a court permits the ride-through the creditor must allow the debtor to keep the collateral as long as she remains current on the payments required by the contract. If the debtor later defaults, the creditor can foreclose on the collateral, but any deficiency would be discharged. (That is, although the creditor can enforce the security interest by foreclosing on the debt upon default, the debtor is not be liable to the creditor for any deficiency.)

Section 521(a)(6), enacted by BAPCPA, prohibits the ride-through under certain circumstances. The section states that in a Ch. 7 case, an individual debtor shall not retain personal property as to which a creditor

18. See In re Morton, 410 B.R. 556 (B.A.P. 9th Cir. 2009).

has a secured claim for its purchase price unless the debtor has entered into a reaffirmation agreement or has redeemed the property. Section 521(a)(6) therefore makes it clear that redemption for cash or reaffirmation are the only courses available to an individual debtor, and the ride-through is not a permissible alternative in situations covered by the section: the case must be under Ch. 7, the debtor must be an individual, the property securing the debt must be personal property, and the creditor's interest must secure the purchase price of the collateral (that is, it must be a purchase money interest). Because the section focuses only on situations in which all those elements are satisfied, some courts have held that the ride-through is still allowed in other cases. For example, in *In re Hart*, 402 B.R. 78 (Bankr. D. Del. 2009), the court allowed a ride-through in relation to real property.

Where §521(a)(6) applies and the ride-through is not permitted, the debtor can retain the collateral only by making a timely election under §521(a) to redeem or reaffirm and following through with a timely exercise of that intention. If he does not, §362(h) terminates the automatic stay with regard to the property that secures the claim and removes it from the estate so that the creditor can proceed to foreclose on it.[19] In one specific situation — where the debtor had entered into a reaffirmation agreement, but the court refused to approve it — some courts have made an exception to this result and have allowed the debtor to use the ride-through even though the elements of §521(a)(6) are satisfied.[20]

Examples

The Examples involving exemptions are based on the list of exempt property in §522(d). The federal exemptions provided in §522(d) are used for convenience and illustrative purposes even though, in most cases, state law exemptions substitute for those in §522(d), either because the state has opted out under §522(b) or the debtor elects state law exemptions. This does not matter for present purposes because the Examples based on that section raise principles applicable to exemption issues generally. The Examples use the exemption amounts in §522(d), as adjusted under §104 with effect from April 1, 2016. The amounts will be adjusted again with effect from April 1, 2019.

1. Melody is a composer by profession. She has managed to sell some of her musical compositions, but she has struggled for recognition in the world

19. Section 362(h) permits the trustee to retain the property in the estate and to forestall foreclosure by showing that the property is of consequential benefit or value to the estate. If this is established, the court must order the debtor to deliver the property to the trustee, and the creditor is entitled to adequate protection.

20. See, e.g., *In re Dumont*, 581 F.3d 1104 (9th Cir. 2009); *In re Baker*, 400 B.R. 136 (D. Del. 2009); and *In re Moustafi*, 371 B.R. 434 (Bankr. D. Ariz. 2007).

of music. She lives in a cold rented garret and owns no property of value except for a concert grand piano on which she composes. Despite her poor credit rating, Melody was able to procure a loan of $5,000 from Fleshpound Finance Co., secured by a security interest in the piano. The security interest was properly perfected under state law.

About a year later, Melody filed a Ch. 7 petition. At the time of the filing, the balance of the loan is $3,500. The piano is worth $6,000. Can Melody avoid the security interest under §522(f)?

2. An individual Ch. 7 debtor owns a small house valued at $250,000, subject to a security interest of $240,000. She earns her living by housesitting for people when they travel. She usually has about ten housesitting jobs a year, which means that she lives in other people's homes for a total of about 30 weeks in a year. When she is not housesitting, she lives in her own house. Is the debtor entitled to an exemption in the house? If so, how much can she exempt? What would her exemption be if the house was not subject to a mortgage?

3. The value of the house was given in Example 2. It is the prerogative of law professors to fabricate convenient facts. Courts are not supposed to exercise the same creativity with regard to fact-finding. How would the value of the debtor's home be decided in a bankruptcy case?

4. The property in the Ch. 7 estate of Earnest Everyman is valued at $52,000. It consists of the following assets: Earnest's equity of $30,000 in his home; furniture, appliances, household goods, and personal effects, with a total value of $16,000 (none of these items is worth over $600); a car worth $4,000; and carpentry tools worth $2,000, used by Earnest in his job.

   Aston Martin, another Ch. 7 debtor, loves old cars. Instead of buying a house, furniture, and other items of ordinary personal property, he has chosen to live modestly in a cheap furnished apartment. He has used all his savings to buy a vintage sports car worth $48,000. As a result, his Ch. 7 estate consists of household and personal effects worth $4,000 (none of these items is worth over $600) and the car.

   What is the maximum that each of these debtors can exempt under §522(d)? What does the comparison of their exemptions say about the emphasis, underlying policy, and possible inequity of the Code's exemption scheme?

5. Given the answer to Example 4, should Aston have sold his sports car before filing his bankruptcy petition and used the proceeds to buy property that qualifies as exempt?

6. One of the assets in the Ch. 7 estate of Eva Porate is a diamond ring. About a year before bankruptcy, Eva had obtained a loan from Unrequited Loan

Co. to buy the ring and had granted Unrequited Loan Co. a valid security interest in the diamond ring to secure the loan.

At the time of bankruptcy, the balance of the loan is $5,000. The ring is valued at $6,500. Eva would like to redeem the ring. Can she do so? How does the answer change if the ring is valued at $4,500 or $7,000?

7. As in Example 6, the ring is worth $6,500 and the balance of the debt, secured by Unrequited's valid and unavoidable security interest, is $5,000. Assume that Eva would be entitled to redeem the ring, but cannot raise the cash needed to do so. Eva wishes to enter into a reaffirmation agreement with Unrequited Loan Co. under which she will repay the debt in installments and keep the ring.

   Eva's salary is just sufficient to support herself and a minor child. If she scrimps very hard and forgoes a few meals a week, she can put aside $200 per month to pay Unrequited Loan Co. This is $75 less per month than she was obliged to pay under the original security agreement, so she needs an extension of time to pay off the debt. Eva is willing to pay interest at the rate fixed in the original contract, and Unrequited would retain its security interest. Is Eva able to use the reaffirmation process to keep the ring?

8. Another of Eva Porate's debts was an amount of $5,000 owed on a credit card. After the issuer of the card received notice of Eva's bankruptcy filing, it wrote a letter to her in which it noted the outstanding balance on the card and stated, "We realize that you have the right to discharge this debt in your bankruptcy case. However, before you do this, we urge you to bear in mind that bankruptcy can have a serious impact on your ability to obtain credit in the future. We therefore invite you to consider entering into the attached reaffirmation agreement. If you elect to make this agreement and you repay the outstanding balance due to us in installments as reflected therein, we will reinstate your credit card with your former credit limit. Please discuss this with your attorney, who will explain the procedure you must follow to reaffirm this debt." Has the credit card issuer done anything wrong in sending this letter?

Explanations

1. The piano should qualify as a tool of trade in which Melody may claim an exemption of $2,375 under §522(d)(6). Property qualifies as a tool of trade if it is used by the debtor to earn her livelihood. Although Melody uses the piano to compose, and not to perform, she is a composer by profession and needs the piano to do her work, from which she is trying to earn a living. Compare *In re Gregory*, 245 B.R. 171 (B.A.P. 10th Cir. 2000), in which the court refused to allow the debtor, a security guard, to claim a pistol as a tool of trade. The debtor argued that he used the

pistol for practice, but the debtor's employer supplied a pistol that the debtor used on the job, and the employer did not require him to have another pistol for practice. Although some courts have questioned whether expensive equipment should qualify as a tool or implement of trade and have interpreted the exemption to apply only to small hand implements or devices of modest value, most courts do not adopt such a restrictive approach.

Fleshpound's security interest in the piano is a nonpossessory, nonpurchase-money interest, and tools of trade are one of the three categories of property covered by the avoidance provisions of §522(f)(1)(B). Melody can avoid the security interest to the extent that it impairs her exemption. If only the tools of trade exemption in §522(d)(6) is used, the lien cannot be avoided. That exemption is limited to $2,375, and she has a $2,500 equity in the piano beyond the amount of the security interest. Thus, the interest does not impair the exemption, which can be fully paid out of the equity with a surplus over for the estate.

However, §522(f) states that the security interest can be avoided to the extent that it "impairs an exemption to which the debtor would have been entitled" in a tool of trade. It does not say that the exemption is confined to the amount allowed for a tool of trade under §522(a)(6). A debtor is able to apply the general exemption in §522(a)(5) to property that is otherwise nonexempt, or to augment an existing exemption. If Melody applies the general exemption to the piano, she will be able to exempt its full value, because the general exemption is $1,250, plus up to $11,850 of the unused homestead exemption, which is available to Melody because she does not own a home. In *In re McNutt*, 87 B.R. 84 (B.A.P. 9th Cir. 1988), the court allowed the debtor to apply the general exemption to a tool of trade to increase the extent of avoidance under §522(f). If Melody is able to avoid the security interest in its entirety, she will be able to keep the piano, and Fleshpound will be left with a general unsecured claim.

2. The debtor may claim the homestead exemption under §522(d)(1), provided that the debtor or a dependent uses the property as a residence. The value of the exemption is $23,675. (A debtor is able to increase it to $24,925 by adding the $1,250 general exemption provided for in §522(d)(5). Assume for the sake of this question that the debtor has used the general exemption for another asset, so the amount of the homestead exemption is $23,675.)

   The general rule is that the debtor's temporary absence from the homestead, with a specific intent to return, does not prevent the debtor from claiming the exemption. Although the debtor's absences do add up

to more than half a year, they are temporary and the debtor does always return to her home, which is her permanent abode.

This property, worth $250,000, is subject to a mortgage of $240,000, so the debtor's equity in the home is worth only $10,000. The debtor's exemption is subordinate to a valid consensual security interest in the property.[21] By granting the mortgage, the debtor is taken to have waived the exemption as against the mortgagee. This is recognized by §522(c)(2).

Therefore, the debtor may claim an exemption in the house to the extent of the equity of $10,000. However, the debtor does not necessarily lose the full unused balance of the homestead exemption. The unused portion of her homestead exemption is $13,675. Section 522(d)(5) allows her to add to the general exemption up to $11,850 of this amount to her general exemption, which can be applied to exempt any other property.

The trustee will abandon the house because the mortgage and the exemption consume the entire value of the house, leaving no value in it for the estate. (Had the mortgage on the house been, say, $200,000, the debtor would have had a $50,000 equity in the house. After the mortgage debt had been paid, the debtor would have been entitled to claim the full amount of the $23,675 exemption, and the balance of $26,325 would be paid to the estate.)

3. Section 522(a)(2) defines value for the purposes of §522 as the fair market value of the property at the date of the petition, or when property enters the estate after the petition, at the date that the estate acquires the property. The determination of fair market value is a factual issue to be decided on all the available evidence. This can in itself be a difficult question to resolve. (Some of the difficulties in valuing property are discussed in relation to relief from stay in section 8.4.2 and in Examples 1 and 2 of Chapter 8.)

   In addition, courts have had difficulty in interpreting what is meant by fair market value in the bankruptcy context. If the facts suggest that the property will not be sold on the open market but will be liquidated, the use of market value results in artificially high appraisal. The impact of an unrealistic appraisal could be to the advantage or disadvantage of the debtor, depending on the facts. For example, in some cases a high valuation could harm the debtor by leading to the conclusion that the equity in the property exceeds the debtor's exemption. In other cases, a low valuation could make it appear that the debtor has no equity over a security interest, so that the property is abandoned to the secured

21. Section 522(f) clearly does not apply to this mortgage, so there is no basis for the debtor to use that section to avoid it.

claimant, or an application for relief from stay is granted. For this reason, some courts have been influenced by liquidation value where this has seemed more realistic, in spite of the reference to market value in §522(a)(2).

4. Each of the estates is worth $52,000, yet Earnest's exemptions are greater than Aston's. Earnest can claim exemptions in a total amount of $43,325, made up as follows:
   a. Homestead under §522(d)(1), limited to $23,675.
   b. Household goods and personal effects under §522(d)(3) to a maximum aggregate value of $12,625. (Because no item is worth more than $600, this amount is not reduced by the cap on individual item value in §522(d)(3).)
   c. Motor vehicle under §522(d)(2), limited to $3,775.
   d. Tools of trade under §522(d)(6). He can claim the full $2,000 value because it is under the cap of $2,375.
   e. General exemption of $1,250 under §522(d)(5), to be applied to nonexempt property or to enhance an existing exemption category.

   Aston's total exemptions are $20,875. He can exempt all his personal and household goods. Their total value is $4,000, which is under the $12,625 cap, and no item is worth more than $600. He can partially exempt the sports car to the extent of $16,875 by adding together his motor vehicle exemption of $3,775 under §522(d)(2) and his wildcard exemption under §522(d)(5). Because Aston does not claim a homestead exemption, the wildcard is $13,100 ($1,250 plus $11,850 not used for the homestead exemption).

   The advantage of specifying exemption categories with dollar limits is that the legislature can control exemptions and confine them to property and amounts that the legislature deems essential to the debtor's reasonable needs. The drawback of this approach is that it can result in groundless discrimination between debtors whose needs and interests vary from the generalized preconception of the legislature. The problem of unequal treatment can be avoided by allowing debtors to choose any property to exempt, up to a maximum lump sum amount. Congress declined to follow the recommendation of the 1994 National Bankruptcy Review Commission to make this change.

5. As noted in section 10.6, courts, relying on the legislative history of §522, have been willing to countenance the prepetition conversion of nonexempt assets into exempt property provided that the conversion does not constitute bad faith. A debtor's ability to engage in prepetition exemption planning mitigates the concern about the unequal treatment of debtors raised in Explanation 4. Provided that Aston simply makes the conversion by selling the car at market value and reinvesting the proceeds

in exempt property, his conversion is likely to be permissible. However, if he goes beyond that and engages is deceptive or manipulative transactions (for example, if he uses credit to buy or increase the value of exempt property) he could be sanctioned, such as by denial of a discharge.[22]

6. The ring can be redeemed only if all the requirements of §722 are satisfied: Eva must be an individual (she is), the ring must be tangible personal property (it is), the ring must be intended primarily for personal use (it is), the debt must be a consumer debt, incurred to buy the ring (it is), the debt must be dischargeable (it is),[23] and the property must be exempt or abandoned. The satisfaction of this last requirement varies depending on the value of the ring.

   The ring is worth $6,500: Unrequited's claim of $5,000 is fully secured with a surplus of $1,500 (less any costs and additional interest) that constitutes the debtor's equity in the property. The equity is exemptable by Eva under §522(d)(4), which provides for a $1,600 exemption in jewelry held for personal, family, or household use. Provided that Eva has claimed the ring as exempt, she may redeem the ring by paying Unrequited the amount of its secured claim of $5,000. The redemption price must be paid in cash. Eva may not redeem by installments. (She also cannot reduce the secured claim below $5,000 by avoiding it under §522(f) because it is a purchase money interest.)

   The ring is worth $4,500: The ring is worth $500 less than the loan, Unrequited is undersecured. Eva has no exemption in the ring because Unrequited's unavoidable security interest takes priority over her exemption. However, even though the ring is not exempt, the trustee will abandon it because there is no value in it for the estate. As a result, the last requirement is satisfied in this situation too. Section 722 permits redemption by payment of the secured claim, the value of the collateral sets the upper limit on the redemption price. Eva can therefore redeem by paying Unrequited $4,500. She does not need to pay it the full amount of the $5,000 debt.

22. Had the exempt property been a homestead, the basis for policing the conversion for impropriety would have been governed by §522(o). It reduces the amount of the debtor's homestead exemption to the extent that, with intent to hinder, delay, or defraud creditors, the debtor acquired or increased an exempt homestead interest in the ten years before the petition by converting nonexempt property.

23. Discharge is discussed in Chapter 21. Under certain circumstances, detailed in that chapter, a debt may be excluded from the discharge. Assume that none of those circumstances are applicable on the facts of this case.

The ring is worth $7,000: The redemption price is set at the amount of the debt ($5,000) as in the first example. However, unlike in the first example, the debtor's equity of $2,000 exceeds the $1,600 exemption. The estate has a $400 interest in the property, so that it is not fully exempt and will not be abandoned by the trustee. To satisfy the requirements of §722 and effect redemption, Eva must pay the estate $400 so that the trustee will abandon the property. This means that Eva must be able to raise $5,400 in cash to redeem the property.

7. Reaffirmation is a consensual arrangement, and Unrequited will likely not have much incentive to agree to enter a reaffirmation agreement if immediate liquidation would fully settle its claim. Because the collateral is worth $6,500, Unrequited's secured claim will be settled in full upon impending liquidation of the property with a surplus of $1,500 (less costs and any additional interest). For this reason, Eva may not be able to persuade Unrequited to forgo immediate liquidation in exchange for a promise of extended payments from a debtor who will struggle to make payments.

   Had the value of the ring been less than the debt, Eva would have been in a better bargaining position because she could have offered to reaffirm the debt in full. The creditor would have an incentive to agree because in the absence of reaffirmation, the deficiency is an unsecured claim that would most likely receive partial payment, at best, from the estate, with the balance being discharged. This, combined with other factors (such as an attractive interest rate and a likelihood that the ring would not depreciate in value over the term of payment so that later foreclosure will not result in loss), could outweigh the risk of default under the reaffirmation agreement.

   Even if Unrequited could be persuaded to enter into a reaffirmation agreement, the provisions of §524(c) and (d) must be satisfied. These restrictions are intended to protect the debtor from the coerced or uninformed assumption of liability for a discharged debt. In addition to imposing requirements to ensure that the debtor acted voluntarily and was fully informed in entering into the reaffirmation, §524 requires an impartial review of the agreement. If Eva was represented by an attorney when negotiating the reaffirmation, the attorney must certify that the agreement is informed and voluntary and that it does not impose an undue hardship on her or her dependent. If Eva was not legally represented when negotiating the reaffirmation, the court cannot approve the agreement unless it is satisfied that it is in the debtor's best interests and does not impose an undue hardship on her or her dependent.

   Reaffirmation agreements under which the debtor receives some advantage, such as the right to retain property that would otherwise be liquidated, are generally regarded as more justifiable than those

that merely reaffirm unsecured debts. However, the facts indicate that Eva cannot afford the reaffirmation and that the proposed payments will impose a strain on her household budget. The ring is not a necessity, and Eva's efforts to keep it seem irresponsible. If Eva is legally represented, her attorney would be hard-pressed to certify the reaffirmation as not imposing an undue hardship on her and her child. If she is not legally represented, the court would have similar difficulty and would in addition be likely to find that the agreement does not serve her best interests.

Where a debtor cannot use redemption or reaffirmation to keep property in a Ch. 7 case, Ch. 13 may be an alternative if the debtor can afford to pay under a Ch. 13 plan. Ch. 13 enables a debtor to force creditors to allow her to retain property and to accept payment of the debt by installments.

8. As discussed in section 10.10, a creditor who approaches the debtor to propose reaffirmation takes the risk that its action may be construed as an attempt to recover a claim against the debtor in willful violation of the automatic stay. (§362(a)(6).)

   Most courts will not find a violation of the stay if the creditor's proposal for reaffirmation is not aggressive, coercive, or harassing. Also, it is wiser for the creditor to make the approach through the debtor's attorney, and to make sure that the debtor is fully informed about the nature and effect of the reaffirmation. Any deception or nondisclosure could cause problems for the creditor. Although the distinction between an incentive and a threat can be quite subtle, the letter in Eva's case may not overstep the mark and violate the stay. The warning of a bad credit rating could be construed as vaguely threatening, but it does not seem strong enough to be coercive. It does not really indicate that this creditor would take any action adverse to the debtor if the offer is refused. Further, as the creditor would have no obligation to extend credit to the debtor in the future, the hint that it may not do so unless the debtor reaffirms is not properly regarded as a threat.

Chapter 4

JURISDICTION AND PROCEDURE

Analysis

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§ 4.1 The Nature of the Problem

One of the most difficult and persistent problems Congress has faced in dealing with the bankruptcy system has been to find a workable approach to issues of jurisdiction and procedure. There are several reasons for this nagging difficulty. First is sheer volume: many more bankruptcy cases are processed in the federal court system than any other type of case. The number of bankruptcy cases has grown dramatically since the passage of the Code in 1978. Over a million new bankruptcy cases are filed every year.

Second is the unique nature of bankruptcy cases. A bankruptcy case is composed of many different types of matters and "proceedings." These proceedings range in complexity from uncontested administrative tasks to full-scale adversarial litigation. Traditional civil lawsuits of the "A versus B" variety comprise only a small portion of a typical bankruptcy "case."[1]

At one end of the spectrum of complexity of bankruptcy proceedings are routine administrative matters. These are the functions that inhere in the implementation of the bankruptcy process. Typically, these matters do not involve any litigation at all. Examples include sending notices, appointing a trustee in a liquidation case, approving

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[1] See, e.g. Douglas G. Baird & Edward R. Morrison, Adversary Proceedings in Bankruptcy: A Sideshow, 79 Am. Bankr. L.J. 951 (2005); Rafael I. Pardo & Kathryn A. Watts, The Structural Exceptionalism of Bankruptcy Administration, 60 UCLA L. Rev. 384 (2012); Elizabeth Warren, Vanishing Trials: The New Age of American Law, 79 Am. Bankr. L.J. 915 (2005); Elizabeth Warren, Vanishing Trials: The Bankruptcy Experience, 1 J. Emp. Legal Stud. 913 (2004).

Chapter 10

THE DISCHARGE

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A. INTRODUCTION

§ 10.1 Overview of Discharge

Most individual debtors file bankruptcy to take advantage of the bankruptcy discharge. The debtor does not have to pay discharged debts, and creditors may not try to collect debts that are discharged. Any property that the debtor earns or acquires after bankruptcy is free from discharged debts. The debtor thus is said to have a "*fresh start*" in life, in an economic sense. Several sections of the Code implement this fundamental policy. In a chapter 7 liquidation case, § 727(b) provides that a discharge under § 727(a) "discharges the debtor from all debts that arose before the date of the order for relief."[1] That date usually is the date the debtor files the bankruptcy case. A creditor need not share in the bankruptcy distribution to have its claim discharged; under § 727(b) the discharge operates even if the creditor does not file a proof of claim and even if a filed claim is not allowed.

The discharge is enforced automatically by § 524(a).[2] The debtor does not have to do anything to take advantage of the discharge. First, a discharge voids any judgment that determines the debtor's personal liability for a discharged debt. § 524(a)(1). Second, creditors are enjoined by the Code from attempting to collect discharged debts as a personal liability of the debtor. § 524(a)(2). Third, § 525 complements § 524 by protecting the debtor from discriminatory treatment inflicted solely because the debtor filed bankruptcy.[3] For example, an employer may not fire an employee for filing bankruptcy. Section 525 thus attempts to limit indirect pressures that might chill the debtor's willingness to resort to bankruptcy and obtain a fresh start.

While this is good news for debtors, it is not the whole story. The Bankruptcy Code is favorable to debtors, but it is not completely one-sided. The right to a discharge and the scope of the discharge are far from absolute. The first limitation is that the discharge only applies to *pre-bankruptcy debts*.[4] § 727(b). Creditors are entitled to collect any debts incurred *after* bankruptcy. It is sometimes said that the debtor is entitled to a "fresh start," but not a "head start." Furthermore, a debtor can only receive a bankruptcy discharge *every eight years*.[5] § 727(a)(8), (9). Thus, post-

[1] This coverage extends to those debts, which actually arise after the petition is filed but which are deemed by § 502 to arise prior to the filing of the petition.

[2] See § 10.31.

[3] See § 10.32.

[4] See § 10.2.

[5] See § 10.11.

bankruptcy creditors have ample opportunity to collect their debts before a debtor can find sanctuary in bankruptcy court again.

Second, not all debtors receive a discharge. Section 727(a) lists twelve exclusive grounds for *denial* of a discharge.[6] If any one of the § 727(a) grounds is found, none of the debtor's debts are discharged. Yet, the debtor still must turn over all of his nonexempt property for distribution to creditors. Denial of discharge thus is a draconian "lose-lose" situation for debtors. The premise behind most of the discharge-denial provisions is that only a financially honest debtor deserves a fresh start in life. Section 727(a) attempts to make the bankruptcy process a meaningful collection system for creditors, by requiring debtors to cooperate in the bankruptcy proceeding in order to receive a discharge. Thus, for example, a debtor who has hidden assets from his creditors will not receive a discharge.

A third limitation is that even a debtor who does receive a general discharge under § 727(b) may have some of her specific debts *excepted* from the operation of that discharge. Section 523(a) enumerates twenty-one different categories of debts that are not discharged.[7] Those discharge exceptions represent a hodge-podge of policy decisions by Congress either to punish the debtor for assorted bad acts (most intentional torts, for example) or to reward certain "worthy" creditors (such as taxing authorities, and alimony and child support claimants). A creditor whose debt is excepted from discharge under § 523(a) may attempt to collect that debt from the debtor after the debtor's bankruptcy case is over. That creditor also shares in the bankruptcy distribution. The debtor is protected from all other creditors, however, whose claims are still discharged. From the debtor's viewpoint, the sanction of excluding a single debt from discharge under § 523(a) is less severe than a denial of discharge of all debts under § 727(a).

An implicit fourth limitation on the availability of a chapter 7 discharge is the "*abuse*" test in § 707(b), which directs the bankruptcy court to dismiss a chapter 7 case if it finds that granting relief would be an abuse of the provisions of that chapter. As amended in 2005, the "abuse" test employs a detailed "means test" to determine whether the debtor has the capacity to repay a certain amount of his debts out of future income in a chapter 13 plan.[8] If so, the debtor's chapter 7 case will be dismissed, leaving the debtor with the choice of whether to forego bankruptcy relief altogether or to proceed under a chapter 13 payment plan. In chapter 13, the debtor would have to commit all of his "projected disposable income" for three to five years to the payment of creditor claims. § 1325(b). Thus, a debtor with few current assets and large debts, but with the prospect of substantial future earnings, may not be allowed to discharge those debts at little price in chapter 7 and then keep for himself the full fruits of his future labors. Creditors get to share some of that future income.

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[6] See §§ 10.4–10.14.

[7] See §§ 10.15–10.27. In addition to the discharge exclusions in § 523(a), Congress has sprinkled some nondischargeability rules through other parts of the United States Code. Examples include certain student loans, 42 U.S.C. § 292f(g) (Health Education Assistance Loan); 42 U.S.C. § 254o(d)(93) (National Health Service Corps loans); 37 U.S.C. § 301d(c)(3) (Armed Forces medical officers); bonus pay for an Armed Forces physician reservist, 37 U.S.C. § 302g(d), (e); and fines owed to the United States, 18 U.S.C. § 3613(e).

[8] See § 2.15.

Fifth, the debtor may choose to "*reaffirm*" debts that otherwise would be discharged.[9] § 524(c), (d). A valid reaffirmation agreement makes the debtor personally liable for the reaffirmed debt, notwithstanding the general discharge. The creditor is allowed to pursue collection if the debtor later defaults on the reaffirmed debt. While it might seem absurd for a debtor to reaffirm, there are plausible reasons why debtors reaffirm. Most often the debtor wants to keep property subject to a valid lien, such as a car. A debtor also may choose voluntarily to repay a discharged debt, even without reaffirming the debt. § 524(f).

A final limitation is that valid *liens and encumbrances* on the debtor's property are not discharged, but continue to be enforceable against that property. The Supreme Court established this principle over a century ago in *Long v. Bullard*.[10] The § 524(a) discharge injunction only halts the collection of debts that represent a personal liability of the debtor. *In rem* liability remains. Thus, if specific property is subject to the debt, the secured creditor may enforce its lien. However, the secured creditor is limited to its collateral; recourse against the debtor personally for any deficiency claim is barred by the discharge.

The discharge rules change a bit when the debtor proceeds under one of the reorganization or debt adjustment chapters.[11] In chapter 11, the critical discharge event is the *confirmation of the plan* of reorganization (except in cases where the chapter 11 debtor is an individual). Section 1141(d)(1) provides that confirmation discharges the debtor from all debts that arose prior to the date of confirmation. Note that this is a later cutoff point than in chapter 7, which draws the discharge line at the time of the initial order for bankruptcy relief. Except in cases involving individual debtors, performance under the confirmed chapter 11 plan is not a prerequisite to discharge; confirmation of the plan is all that is required. For cases where the debtor is an individual, the chapter 11 discharge rules were amended in 2005 to conform more closely to chapter 13. For individuals, discharge normally occurs not at plan confirmation, but instead only after completion of all payments required by the plan, although the court has the power to order otherwise in certain circumstances. § 1141(d)(5). For individual debtors, the exceptions to discharge in § 523(a) apply in chapter 11 just as in chapter 7. § 1141(d)(2). However, the chapter 7 grounds for denial of discharge in § 727(a) only apply in a chapter 11 case in the event that the debtor is liquidating rather than reorganizing. § 1141(d)(3).

Chapter 13 is different still. Confirming a plan is much simpler than in chapter 11. However, discharge is not granted on confirmation, as it is in chapter 11 (except for individuals). Instead, a chapter 13 debtor receives a discharge under § 1328(a) only when she completes all payments under the confirmed plan. The only exception is that the court has the discretion to grant a "hardship" discharge under § 1328(b) to a debtor who fails to complete performance under the plan.

Until 2005, a full-compliance discharge under § 1328(a) was considerably broader than a chapter 7 discharge; many types of debts that are excluded from a chapter 7 discharge under § 523(a) (such as for fraud or taxes) were discharged under § 1328(a).

[9] See §§ 10.34–10.36.

[10] 117 U.S. 617 (1886).

[11] See §§ 10.37–10.39.

For this reason the chapter 13 discharge was referred to as a "super" discharge. However, in 2005, Congress amended the full-compliance chapter 13 discharge by taking away most of the "super" provisions; now, almost all of the important § 523(a) exceptions are excluded from discharge in chapter 13 as well. A § 1328(b) hardship discharge is and always has been subject to all of the § 523(a) exceptions. § 1328(c)(2). Long-term debts, i.e., those that extend beyond the life of the chapter 13 plan, are not discharged by the completion of plan payments under either type of chapter 13 discharge. § 1328(a)(1), (c)(1).

Until 2005, none of the chapter 7 grounds for discharge denial in § 727(a) applied in a chapter 13 case. In 2005, Congress added three grounds for denying (or delaying) a chapter 13 discharge that mirror similar rules in chapter 7. First, a restriction on discharges in successive cases was introduced for the first time. Now, a chapter 13 discharge is barred if the debtor received a discharge in a previous case under chapter 7, 11, or 12 that was filed during the previous four years, § 1328(f)(1), or in a prior chapter 13 case filed in the past two years, § 1328(f)(2). These time periods are shorter than those in chapter 7. § 727(a)(8), (9) (eight and six years). Second, the debtor must complete a course in personal financial management, unless excused. § 1328(g); compare § 727(a)(11). Finally, the debtor's discharge may be delayed if there is reason to believe that § 522(q) might be applicable to the debtor. §§ 1328(h), 727(a)(12).

Chapter 12, which provides for the adjustment of debts of family farmers, closely tracked chapter 13's discharge provisions until 2005. § 1228. One difference from the chapter 13 discharge is that in chapter 12, all of the § 523(a) discharge exceptions have always applied with full force. With the substantial changes to the chapter 13 discharge in 2005, there now are several more differences in the discharge provisions of the two chapters. There is no limitation in chapter 12 on receiving discharges in successive cases, as there now is in chapter 13. Nor is there a requirement in chapter 12 that the debtor complete a course in personal financial management, as in chapter 13. However, chapter 12 does also now require the court to delay the discharge if there is a possible pending action under § 522(q). § 1228(f).

A discharge may not necessarily be permanent. For a limited time (180 days in chapter 11, one year in all the other chapters), the court has the power to revoke the discharge. This drastic action, which is rarely invoked, usually is based on the debtor's fraud in procuring the discharge. §§ 727(d), (e), 1144, 1228(d), 1328(e).

Most discharge litigation takes place in the bankruptcy court.[12] This makes sense, given that discharge is entirely a federal bankruptcy policy. The bankruptcy court is the exclusive forum for resolution of all issues relating to the denial of a chapter 7 discharge under § 727(a).[13] Rule 4004(a). Likewise, complaints asserting that a debt is excepted from discharge under § 523(a)(2), (4), or (6) may be brought only in the bankruptcy court.[14] § 523(c)(1); Rule 4007(c). However, collateral estoppel may

[12] Under 28 U.S.C. § 157(b)(2)(I)–(J), objections to discharge under § 727(a) and dischargeability determinations under § 523(a) are core proceedings, which the bankruptcy court may "hear and determine" by entering a final order, reviewable only on appeal. See also Stern v. Marshall, 564 U.S. 462 (2011). If the district court withdraws the reference of a case to the bankruptcy court under 28 U.S.C. § 157(d), it then serves as the trial court for core proceedings.

[13] See § 10.28.

[14] See § 10.29.

effectively foreclose litigation of discharge issues in the bankruptcy court when the debtor and creditor had previously litigated those issues in a non-bankruptcy forum.[15] Non-bankruptcy courts have concurrent jurisdiction with bankruptcy courts to hear issues under the remaining subsections of § 523(a).[16] However, discharge revocation issues must be tried solely in the bankruptcy court.

§ 10.2 The Scope of the Discharge

The discharge has a broad but not unlimited scope. In a chapter 7 liquidation case, § 727(b) governs the scope of the discharge. In the reorganization chapters, the discharge may have an even greater reach. Section 727(b) contains four basic premises:

1. Those debts listed in § 523(a) are excepted from the general discharge;
2. All other "debts" are discharged, provided that:
3. The debt arose or is deemed to arise prior to bankruptcy, and
4. Creditors do not have to share in the bankruptcy distribution for their debt to be discharged.

The exclusions from the discharge in § 523(a) are discussed at length later in this chapter.[17] In a chapter 7 case or a chapter 12 case, § 523(a) applies in its entirety. § 727(b) (chapter 7), § 1228(a)(2) (chapter 12). In chapter 11, § 523(a) applies to individual debtors only, thereby excluding corporate and partnership debtors from its coverage (except for a few types of tax debts, § 1141(d)(6)). § 1141(d)(2). Finally, until 2005, in chapter 13 many of the § 523(a) debts were discharged if the debtor completed performance under the plan. However, in 2005, Congress substantially amended the chapter 13 discharge provisions. Now, most important § 523(a) debts are excluded from discharge in chapter 13 as well, even if the debtor receives a "full compliance" discharge under § 1328(a).[18] § 1328(a)(2)–(4). A chapter 13 debtor who does not complete plan payments but receives a hardship discharge is subject to all of the § 523(a) exceptions. § 1328(c)(2). A chapter 13 discharge does not apply to long-term debts paid beyond the life of the plan. § 1328(a)(1), (c)(1).

The second limitation on the reach of the discharge is that only *"debts"* are discharged. This restriction applies in all chapters. "Debt" is a term of art in bankruptcy. Section 101(12) defines "debt" as "liability on a claim"; "claim," in turn, is defined in § 101(5). The operative principle of the § 101(5) definition is that any "right to payment" existing at the time of bankruptcy constitutes a claim cognizable in bankruptcy, and thus is potentially dischargeable.[19] A right to payment is still a claim even if it is unliquidated, contingent, unmatured, or disputed. § 101(5). Even rights to equitable remedies may be discharged if an alternative right to payment exists.[20] § 101(5)(B). The amount of any of these types of uncertain claims may have to be fixed or estimated during the bankruptcy case, § 502(c), but that does not defeat their status

[15] See § 10.30.

[16] 28 U.S.C. § 1334(b).

[17] See §§ 10.15–10.27.

[18] See § 10.38.

[19] See §§ 7.1–7.2.

[20] See § 7.3.

as a claim. The Bankruptcy Code significantly expands the concept of claims from that which prevailed under prior law. The legislative history to the Code expresses the congressional intent "that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."[21]

The Supreme Court has implemented this legislative directive by giving "debt" and "claim" the broadest possible construction. In *Ohio v. Kovacs*, the Court held that a debtor's environmental cleanup obligation constituted a dischargeable debt, noting that the only performance sought by the state was the payment of money by the debtor.[22] In 1990 the Court held in *Pennsylvania Department of Public Welfare v. Davenport* that a criminal restitution obligation was a debt dischargeable in a chapter 13 case.[23] A year later in *Johnson v. Home State Bank* the Court concluded that a mortgage constituted a claim in chapter 13 even though the debtor's personal liability had previously been discharged in a chapter 7 case, reasoning that the mortgagee still had a right to payment through foreclosure of the mortgaged property.[24]

Not every conceivable legal obligation is a debt, however. A right to *payment* must exist as part of that obligation. This limitation has been most important in excluding certain types of equitable remedies from the debt definition, and thus from the discharge, when under applicable law a right to payment may not be substituted for the equitable relief. For example, an order commanding the debtor to clean up polluted property has been held not to be a debt if the environmental agency does not have the option of accepting a monetary payment in lieu of the cleanup.[25] Similarly, an employer's right to an injunction to enforce a covenant not to compete has been held not to be a claim dischargeable in bankruptcy if under state law money damages cannot be substituted for injunctive relief.[26]

The third limitation on the scope of the discharge relates to the timing of when the debt arose. Generally, the bankruptcy filing operates as the point of cleavage: pre-bankruptcy debts are discharged, while those arising after bankruptcy are not. In chapter 7 the discharge applies to "debts that arose before the date of the order for relief under this chapter." § 727(b). In the typical voluntary case filed by the debtor, the order for relief is the date the original bankruptcy petition is filed. § 301. Note that some types of claims that actually arise postpetition are deemed for bankruptcy purposes to arise prepetition, and accordingly are also covered by the discharge. § 502(f)–(i). For example, the trustee may reject an executory contract during the bankruptcy case, giving rise to a breach of contract claim by the other party to the

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21 H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 309 (1977); S. Rep. No. 95–989, 95th Cong., 2d Sess., at 22 (1978).

22 469 U.S. 274, 285 (1985). The debtor had been dispossessed prior to bankruptcy by a receiver, and thus could not personally effect the cleanup of the polluted property.

23 495 U.S. 552, 564 (1990).

24 501 U.S. 78 (1991). The Court's decision thus opened up the possibility of a "chapter 20" case (i.e., chapter 7 + chapter 13), in which a debtor first files chapter 7 to discharge personal liability, and then files chapter 13 to restructure the secured claim.

25 See, e.g., United States v. Apex Oil Co., Inc., 579 F.3d 734 (7th Cir. 2009); In re Torwico Elecs., Inc., 8 F.3d 146 (3d Cir. 1993); In re Chateaugay Corp., 944 F.2d 997 (2d Cir. 1991). See also § 7.3.b.

26 See, e.g., In re Udell, 18 F.3d 403 (7th Cir. 1994). See also Kennedy v. Medicap Pharms., Inc., 267 F.3d 493 (6th Cir. 2001). See also § 7.3.c.

contract. §§ 365(g)(1), 502(g). That claim is treated as a prepetition claim in the bankruptcy case.

The order for relief comes at a later date in an involuntary case or in a case converted to chapter 7 from another chapter, and thus some debts that arise after the initial bankruptcy filing may be discharged. In an involuntary case, the bankruptcy filing by the petitioning creditors does not constitute an order for relief. Instead, the order for relief is entered later by the court if it finds that grounds exist for the bankruptcy case to go forward. § 303(h). The result is that debts that arise after the filing of the bankruptcy petition but before the order for relief in an involuntary case are discharged. For converted cases, the conversion order constitutes the chapter 7 order for relief. § 348(a), (b). Thus, all pre-conversion debts are discharged.

A later discharge cutoff date governs in chapter 11 reorganization cases. All debts that arise before the date the plan of reorganization is confirmed are discharged. § 1141(d)(1)(A). In other words, all debts that arise during the pendency of the chapter 11 case are subject to discharge. Chapters 12 and 13 do not have a similar blanket discharge of pre-confirmation claims. In those chapters, discharge applies to all debts "provided for by the plan." §§ 1228(a), 1328(a). Typically only pre-bankruptcy debts will be provided for by the plan, thus effectively limiting the discharge to such debts. In chapter 13, however, certain types of postpetition claims may be allowed and dealt with in the plan, and thus discharged. § 1305.

Sometimes it is quite difficult to determine when a debt "arose." A difficult timing issue is created when the underlying acts that lead to the creation of the claim all occur prior to the bankruptcy case, but nevertheless under state law a cause of action is not cognizable until after the bankruptcy is filed. This scenario often arises for tort claims. The asbestos cases present a good example. The claimants were exposed to asbestos long before the filing of the bankruptcy case, but often did not manifest injury until many decades later, after bankruptcy.[27] On a simpler level, a dentist may commit negligent malpractice prior to filing for bankruptcy, but the patient may not discover the injuries until after the dentist has filed.[28] The states vary on when the tort cause of action accrues in this type of situation, and may postpone accrual until manifestation of an injury.

Several approaches have been taken to deal with these timing problems.[29] Under the "conduct" test, a claim is deemed to arise for bankruptcy purposes if the conduct of the debtor that gives rise to the claim occurs prior to bankruptcy.[30] This approach moves the claim determination up to the earliest possible point in time. A discredited minority view, the "accrued state law theory," defers to the states by linking the

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[27] See, e.g., In re Placid Oil Co., 753 F.3d 151 (5th Cir. 2014).

[28] See In re Edge, 60 B.R. 690 (Bankr. M.D. Tenn. 1986).

[29] See § 7.2.

[30] See, e.g., Grady v. A.H. Robins Co., 839 F.2d 198 (4th Cir. 1988), cert. denied, 487 U.S. 1260 (1988). Prior to the bankruptcy filing of A.H. Robins Co., a Dalkon Shield IUD manufactured by Robins was inserted into Rebecca Grady; however, she did not manifest symptoms until after the filing. The court held that she had a claim, which was barred by the automatic stay. Note, though, that Grady *also* had been exposed to the defective product prior to bankruptcy, so she would have had a claim under the now-prevailing "prepetition relationship" test as well. See also Wright v. Corning, 679 F.3d 101 (3d Cir. 2012).

concept of a bankruptcy claim to the accrual of a state law cause of action.[31] In contrast to the conduct test, the accrued state law theory postpones recognition of a claim. In between these two polar positions is the now dominant "prepetition relationship" test, which recognizes a claim if the claimant had a sufficient relationship with the debtor at the time of filing.[32] Conduct alone by the debtor would not be enough, but conduct coupled with exposure to a defective product might be, even if injuries are not manifested until after bankruptcy. Due process also may preclude the recognition of a claim and its discharge before the creditor even becomes aware that she has a claim.[33]

Environmental claims present a similar timing problem. The debtor may pollute prior to bankruptcy, but will not have cleaned up the property in accordance with the state or federal environmental law when the bankruptcy petition is filed. Thus, at the time of filing, cleanup obligations remain. The prospective environmental liability may still be undiscovered at the time bankruptcy is filed. Adding to the confusion is the fact that pollution is not a static act, but may instead present an ongoing threat. Once pollutants have been discharged, they may continue to be released, leaking into surrounding lands or water. The courts have had trouble in determining when a claim arises in these situations.[34] A common approach is to find a claim only if the environmental agency had "fair contemplation" of the environmental threat at the time of filing.[35]

A final important principle is that the discharge of debts is not dependent on the distribution of a dividend to the creditor. The discharge is effective against a debt even if no proof of claim is filed or if a claim is filed but not allowed. This rule applies in cases under all the chapters. § 727(b) (chapter 7); § 1141(d)(1)(A) (chapter 11); § 1228(a), (c) (chapter 12); § 1328(a), (c) (chapter 13). The creditor therefore does not have the ability to opt out of the bankruptcy discharge by forgoing a dividend in bankruptcy.

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[31] In re M. Frenville Co., 744 F.2d 332 (3d Cir. 1984), cert. denied, 469 U.S. 1160 (1985). In *Frenville,* a claim for contribution was brought against a debtor after bankruptcy. The contribution claim did not accrue under state law until the party seeking contribution had itself been sued, which took place after the bankruptcy filing. However, all of the debtor's acts which gave rise to the contribution claim were performed prior to bankruptcy. The Third Circuit held there was no claim. The Third Circuit now has abandoned *Frenville*. See In re Grossman's, Inc., 607 F.3d 114, 121, 125 (3d Cir. 2010):

> Courts have declined to follow *Frenville* because of its apparent conflict with the Bankruptcy Code's expansive treatment of the term 'claim'. . . .
>
> Irrespective of the title used, there seems to be something approaching a consensus among the courts that a prerequisite for recognizing a "claim" is that the claimant's exposure to a product giving rise to the "claim" occurred pre-petition, even though the injury manifested after the reorganization. We agree and hold that a "claim" arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury, which underlies a "right to payment" under the Bankruptcy Code.

[32] See, e.g., *Grossman's*, 607 F.3d at 125; Epstein v. Official Comm. of Unsecured Creditors of Piper Aircraft Corp., 58 F.3d 1573 (11th Cir. 1995).

[33] See, e.g., Wright v. Corning, 679 F.3d 101 (3d Cir. 2012); Lemelle v. Universal Mfg. Corp., 18 F.3d 1268 (5th Cir. 1994).

[34] See Kathryn R. Heidt, Environmental Obligations in Bankruptcy: A Fundamental Framework, 44 Fla. L. Rev. 153 (1992).

[35] See, e.g., ZiLOG, Inc. v. Corning, 450 F.3d 996 (9th Cir. 2006) (adopting a "fair contemplation" test, which is similar to the pre-petition relationship test); In re Jensen, 995 F.2d 925, 930 (9th Cir. 1993).

§ 10.3 The Policy Behind the Discharge

A discharge of debts is not a necessary or inevitable part of a bankruptcy law. The essence of a bankruptcy proceeding, as with any other collective collection mechanism, is only that the nonexempt assets of the debtor be collected, liquidated, and distributed in a fair manner to the debtor's creditors. This task can be accomplished without a discharge.

Bankruptcy history illustrates that a freely available discharge is not required.[36] The first bankruptcy law in Anglo-American jurisprudence was passed in England in 1543,[37] but no discharge was offered until 1706.[38] Even then the debtor could not file a voluntary bankruptcy case to avail himself of the discharge; only creditors could commence a bankruptcy case involuntarily against a debtor. Debtors could not file a voluntary bankruptcy case in order to receive a discharge until the 1841 United States law[39]—almost 300 years after the passage of the first bankruptcy law. Even today, most other "civilized" countries do not offer the debtor as liberal a discharge from his debts as does the United States.

No single explanation can be offered for the current United States discharge policy. In fact, the policy justifications for the discharge and for exceptions to that discharge often are self-contradictory.[40] The most fundamental policy statement is that of the United States Supreme Court in the famous *Local Loan* case: that the bankruptcy discharge is designed to give "the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[41] One may ask why a debtor needs or deserves such a fresh start.

Two primary justifications usually are given. First, it is considered humane not to require the debtor to spend the rest of his life buried under the weight of hopeless insolvency. Second, being humane to the debtor by discharging his debts actually indirectly benefits the rest of society. This social utility occurs because the debtor who has been freed from his debts has an incentive to work more and be a productive member of society, because he may keep from his creditors the product of his labors. As Justice Sutherland explained in *Local Loan,* where the Court held that William Hunt was freed from his pre-bankruptcy assignment of wages by his bankruptcy discharge:

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[36] See Charles J. Tabb, The Historical Evolution of the Bankruptcy Discharge, 65 Am. Bankr. L.J. 325 (1991).

[37] 34 & 35 Hen. 8, c. 4 (1542).

[38] 4 Anne, c. 17 (1705). See John C. McCoid, II, Discharge: The Most Important Development in Bankruptcy History, 70 Am. Bankr. L.J. 163 (1996).

[39] Bankruptcy Act of 1841, ch. 9, §§ 1, 4, 5 Stat. 441, 443–44 (repealed 1843). See John C. McCoid, II, The Origins of Voluntary Bankruptcy, 5 Bankr. Dev. J. 361 (1988).

[40] The justifications for discharge are explored in more detail in Charles J. Tabb, The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate, 59 Geo. Wash. L. Rev. 56, 89–103 (1990). See also Margaret Howard, A Theory of Discharge in Consumer Bankruptcy, 48 Ohio St. L.J. 1047 (1987). For further discussions, see Barry Adler, Ben Polak, & Alan Schwartz, Regulating Consumer Bankruptcy: A Theoretical Inquiry, 29 J. Legal Stud. 585 (2000); Richard M. Hynes, Why (Consumer) Bankruptcy?, 56 Alal. L. Rev. 121 (2004).

[41] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

> When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. . . . The new opportunity in life and the clear field for future effort, which it is the purpose of the Bankruptcy Act to afford the emancipated debtor, would be of little value to the wage-earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy.[42]

The generous discharge right that the *Local Loan* Court was construing had been passed by Congress in 1898,[43] directly in response to the devastating Panic of 1893.[44] In an 1897 Report, the House of Representatives explained the justifications for this discharge provision in very human terms:

> This vast number constitutes an army of men crippled financially—most of them active, aggressive, honest men who have met with misfortune in the struggle of life, and who, if relieved from the burden of debt, would reenter the struggle with fresh hope and vigor and become active and useful members of society. . . .
>
> [T]he passage of a bankrupt law . . . will lift these terrible and hopeless burdens, and restore to the business and commercial circles of the country the active and aggressive elements that have met with misfortune and are now practically disabled for the battle of life. . . .
>
> [W]hen an honest man is hopelessly down financially, nothing is gained for the public by keeping him down, but, on the contrary, the public good will be promoted by having his assets distributed ratably as far as they will go among his creditors and letting him start anew.[45]

The statements in *Local Loan* and the House Report also point out the basic restriction of the fresh start policy: that it is only available to "honest but unfortunate" debtors. Bankruptcy is not intended to be a haven for crooks and other bad actors. Some of the grounds for denial of discharge in § 727(a) and most of the exceptions to

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[42] Id.

[43] Bankruptcy Act of 1898, ch. 541, 30 Stat. 550, §§ 14, 17 (1898) (repealed 1978).

[44] See Tabb, supra note 36, 65 Am. Bankr. L.J. at 362–63.

[45] Id. at 365 n.21, (quoting H.R. Rep. No. 65, 55th Cong., 2d Sess., at 30–32 (1897) (incorporating H.R. Rep. No. 1228, 54th Cong., 1st Sess. (1896)).

Tabb further notes at id.:

> In a similar vein, Representative Henderson of Iowa, the House manager of the bill, argued, "Is it not better for the creditors to divide among them fairly what these poor fellows have and let them once more hold up their heads among their fellow-men and join their energies to those of the rest of the community for the common welfare?" Speech of Hon. David B. Henderson, in the House of Representatives, Feb. 16, 1898, in A National Bankruptcy Law, at 16.

discharge in § 523(a) are intended to withhold the benefits of the discharge from debtors who are not honest and just unfortunate, in order to deter the debtor's bad behavior. However, it appears somewhat inconsistent with the humanity and social utility rationales to keep even dishonest debtors bound eternally to their debts.

Another justification for our discharge policy may be labeled the "debtor cooperation" theory. The discharge is seen as a carrot offered to the debtor to entice him to cooperate in the bankruptcy case, so that more assets may be recovered for distribution to creditors. Those creditors basically are willing to forego the possibility of post-bankruptcy recovery later in the hope of a larger bankruptcy dividend now. Most of the discharge denial provisions in § 727(a) are directly related to the debtor's lack of cooperation in the bankruptcy case itself. The discharge originally came into English and American law to serve this induced compliance function. The debtor compliance rationale does not, however, mesh well with discharge exceptions, which undermine the debtor's incentive to cooperate.

These are not the only rationales for the discharge offered by scholars and courts. It has been suggested that the discharge is necessary to correct systematic overborrowing by debtors who are unable to control their impulses to take on too much credit and who are unable to project in advance their inability to repay their debts.[46] These phenomena may explain why the discharge is made nonwaivable in advance. § 727(a)(10). Others have posited that the bankruptcy discharge may operate as a form of limited liability for individuals. This argument leads to the question of whether the discharge is economically efficient, the answer to which depends largely on whether one believes the creditor or the debtor to be the superior risk-bearer.[47]

Unfortunately, Congress and the courts have not always clearly elucidated the policies supporting the discharge. Until recently, most courts had viewed the discharge as a fundamental debtor benefit, and accordingly had construed statutory limitations on the free grant of the discharge narrowly. This traditional pro-debtor orientation was redirected somewhat by the Supreme Court's 1991 decision in *Grogan v. Garner*, which, in holding that a preponderance of the evidence standard was proper under § 523(a), emphasized that the restriction to "honest but unfortunate" debtors was in fact intended to be a meaningful limitation on the fresh start policy.[48] The decline of the fresh start policy became more evident with the passage of BAPCPA in 2005, with its numerous provisions designed specifically to curtail the debtor's fresh start, substituting instead a policy "intended to ensure that debtors repay creditors the maximum they can afford."[49] In some cases, it appears that the Supreme Court has taken Congress at its word, interpreting the Bankruptcy Code in a way that in cases of doubt does not further the fresh start policy as much as the "make the debtor pay"

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[46] Thomas Jackson first expressed this view in Thomas H. Jackson, The Fresh-Start Policy in Bankruptcy Law, 98 Harv. L. Rev. 1393 (1985), and repeated it in Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 232–48 (1986).

[47] Compare Theodore Eisenberg, Bankruptcy Law in Perspective, 28 UCLA L. Rev. 953 (1981) (arguing that the debtor is best able to assess the risk of default, and thus should not be offered a freely available discharge), with Margaret Howard, supra note 40, 48 Ohio St. L.J. 1047, and Steven L. Harris, A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective, 30 UCLA L. Rev. 327 (1982) (asserting that the creditor may be a better risk monitor and that discharge should be broadly available).

[48] 498 U.S. 279, 286–87 (1991).

[49] H.R. Rep. No. 109–31, 109th Cong., 1st Sess., at 2 (2005).

policy.[50] As the Sixth Circuit has concluded, "[w]e believe it is now clear that . . . we must, as the Supreme Court did, . . . apply the interpretation that has the best chance of fulfilling [the] . . . purpose of maximizing creditor recoveries."[51] And yet, in a 2013 case, *Bullock v. BankChampaign, N.A.*,[52] the Supreme Court reaffirmed its longstanding policy of narrowly construing exceptions to discharge, so as to promote the fresh start, typically denying it only in instances of knowing and clear debtor fault.

B. GROUNDS FOR DENIAL OF A CHAPTER 7 DISCHARGE: § 727

§ 10.4 Individual Debtors Only

The first limitation on the grant of the discharge is that only an individual debtor is eligible. § 727(a)(1). A corporation or a partnership may file a chapter 7 case, but will not receive a discharge. Since the business entity is being liquidated, and will not continue to exist after bankruptcy, a discharge is unnecessary. Only people need a "fresh start" in life; they do continue to exist after a bankruptcy liquidation. An individual who is a partner in a partnership thus needs to file personal bankruptcy to discharge his personal responsibility for partnership debts. Causing the partnership alone to go through chapter 7 will not relieve the individual partner of liability for partnership debts. This first limitation on the discharge right, unlike most in § 727(a), is self-executing; Rule 4004(c)(1) requires the court to refuse the discharge if the debtor is not an individual, even if no complaint objecting to discharge is filed.

§ 10.5 Actual Fraudulent Transfers

The current Bankruptcy Code follows centuries of precedent in demanding that a debtor who seeks the privilege of a discharge in bankruptcy must not intentionally attempt to frustrate the collection efforts of creditors prior to and in that bankruptcy case. Section 727(a)(2) bars the discharge of a debtor who has made an actual fraudulent transfer of property of the debtor within a year of the bankruptcy or of property of the estate in the bankruptcy case itself. Several elements must be proven by a party objecting to the debtor's discharge under that section.

First, the requisite "intent to hinder, delay, or defraud" of the debtor must be established. This evil intent must be directed at either a creditor, typically one seeking to collect a debt prior to bankruptcy, or an officer in the bankruptcy case charged with custody of estate property, typically the bankruptcy trustee. Actual fraudulent intent must be proven; constructive fraud is not enough.[53] Evidence of surrounding circumstances—"badges of fraud"—may be considered to help prove actual fraudulent intent. Common indicia of fraud include transfers for no consideration or for nominal consideration; transfers to relatives, friends, or business associates; transfers made at suspicious times, such as shortly before filing bankruptcy or after a creditor files a

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[50] See, e.g., Ransom v. FIA Card Servs., N.A., 562 U.S. 61 (2011). See also § 2.15.c.

[51] Baud v. Carroll, 634 F.3d 327, 356 (6th Cir. 2011).

[52] 133 S.Ct. 1754 (2013). The issue before the Court was the scope of the term "defalcation" in § 523(a)(4). See § 10.19.

[53] See, e.g., In re Miller, 39 F.3d 301 (11th Cir. 1994). See also In re Herman, 396 Fed. Appx. 108, 110 (5th Cir. 2010) ("A plaintiff must prove actual fraud—not constructive fraud. . . .").

lawsuit; the debtor's continued possession and use of the supposedly transferred property; secrecy in the transaction; and so forth. While circumstantial evidence is helpful, fraudulent intent nevertheless is not lightly found.

A common defense debtors raise when challenged under § 727(a)(2) is that they did not have the requisite fraudulent intent because they were relying on someone else's advice—their attorney, or their accountant, or their spouse.[54] Courts have been surprisingly receptive to such self-serving claims of innocence in many cases, at least if the alleged reliance is even remotely reasonable. An unsophisticated debtor is most likely to be granted leniency in these cases.

The second element of a § 727(a)(2) case is that the property of the debtor or of the estate must be "transferred, removed, destroyed, mutilated, or concealed." The statutory list is designed to be broad, in order to encompass a variety of acts that potentially could frustrate collection efforts. It is the possibility of harm to the creditor that is relevant, not the benefit to the debtor. For example, if something is done to the property with the requisite intent so as to make it unavailable to both the creditor and the debtor, the statute is satisfied. The last category, concealment, is of particular relevance in the bankruptcy case itself. The debtor must be totally forthcoming in his bankruptcy schedules and at the meeting of creditors regarding the description and location of his assets.

While in most cases the actor effectuating the transfer, destruction, or the like will be the debtor himself, such is not an absolute requirement. The statute is met if the debtor "permitted" any such activity. In other words, the debtor cannot hide behind the façade of an agent or intermediary, but is held fully responsible for the authorized acts of that agent.

Third, the property affected must be property which either before or in the bankruptcy case would have been available for distribution to creditors but for the fraudulent activity. Otherwise no harm to creditors (even theoretically) could occur, and no reason exists to deprive the debtor of his discharge. The property must be that of the debtor with regard to pre-bankruptcy activities, or property of the bankruptcy estate for activities occurring after the bankruptcy is filed. Thus, if the debtor engineers a fraudulent transfer of property of a company he controls, rather than of his own personal assets, discharge denial under § 727(a)(2) is not possible, even if the debtor is held personally liable on the debt of the company, unless the corporate veil is pierced.[55]

An intriguing question that has arisen is whether a debtor can effectively "undo" a fraudulent transfer before bankruptcy and thereby avoid denial of discharge under

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[54] See, e.g., Gregory E. Maggs, Consumer Bankruptcy Fraud and the "Reliance on Advice of Counsel" Argument, 69 Am. Bankr. L.J. 1 (1995).

[55] This exact scenario was presented in *Husky Int'l Elec., Inc. v. Ritz*, 136 S.Ct. 1581 (2016). Since § 727(a)(2) was unavailable to the defrauded creditor, the creditor sought to except the debtor's debt from discharge under § 523(a)(2) as "actual fraud." The Court held that it was possible for a fraudulent transfer to suffice as proof of fraud under § 523(a)(2), even absent a false representation. Id. at 1590. However, the Court did acknowledge that in such a situation, the creditor might have trouble proving that the debtor himself "obtained" anything by the fraud, but noted that such proof could be possible if the debtor as transferor *also* was the transferee of his own fraudulent conveyance. Id. at 1589. For more discussion of the case, see § 10.17.

§ 727(a)(2). This might occur if the debtor initially has gotten extremely bad advice—to make a fraudulent transfer (e.g., quitclaim Blackacre to your spouse)—from a misguided and morally suspect "friend," and then learns the truth from an attorney before filing, and thus reverses the deed. The argument that the debtor should still receive a discharge is that this will encourage debtors to "come clean" and restore property for the benefit of their creditors before bankruptcy.[56] The more literal reading of the Code language, however, points the other way; if the debtor makes a fraudulent transfer, the discharge right is lost, no matter what happens thereafter.[57]

Finally, § 727(a)(2) only has a limited reach-back in time. The fraudulent act must have occurred within *one year* of the bankruptcy petition to bar the debtor's discharge. A two-year limitation exists for the avoidance of fraudulent transfers by the bankruptcy trustee under § 548, and a trustee also may be able to avoid transfers more than two years old by resort to state fraudulent transfer law under § 544(b). Under § 727(a)(2), however, the one-year limit is set in stone, and cannot be circumvented by resort to longer state law periods. Having said that, in some situations the one-year period in § 727(a)(2) may as a practical matter be stretched a bit. For example, if the debtor delayed recording or perfecting the fraudulent transfer (e.g., the proverbial quitclaim deed of Blackacre to the debtor's spouse), the time of the transfer may be deemed to occur at the time of recordation or perfection, see § 548(d), not when the transfer actually occurred. A second illustration is that a fraudulent transfer that was originally made more than a year prior to bankruptcy may be brought within the one-year period if the debtor actively concealed the transfer in that year. On the other end of the time spectrum, the debtor has a continuing responsibility during the bankruptcy case not to deal fraudulently with estate property. However, the debtor's postpetition actions with regard to his own property cannot serve as a basis for discharge denial. This is because a debtor's postpetition property, which does not go into the estate, is not distributed to the bankruptcy creditors anyway.

A debtor who makes a preferential transfer to a creditor generally is not brought within the scope of § 727(a)(2). A preference, while perhaps avoidable in its own right under § 547, is not fraud that will deprive a debtor of his discharge. In contrast, a debtor who makes a preferential transfer to an "insider" may face some risk of classification of the transfer as a fraudulent conveyance[58] and thus within § 727(a)(2). Most likely, however, such a transfer would constitute only constructive and not actual fraud, and would thus be outside the ambit of § 727(a)(2).

An area of controversy under § 727(a)(2) concerns a debtor who converts nonexempt property to exempt property shortly before bankruptcy. The legislative history suggests that such a practice is not necessarily fraudulent:

> As under current law, the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition. The

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[56] See, e.g., In re Retz, 606 F.3d 1189 (9th Cir. 2010); In re Adeeb, 787 F.2d 1339 (9th Cir. 1986).

[57] See, e.g., In re Davis, 911 F.2d 560 (11th Cir. 1990). See also Village of San Jose v. McWilliams, 284 F.3d 785 (7th Cir. 2002).

[58] See Unif. Fraudulent Conveyance Act § 5(b).

practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.[59]

Courts differ on whether such activity is simply prudent planning by the debtor or fraud within the meaning of § 727(a)(2). While courts agree that "mere" conversion of nonexempt to exempt property is not enough to prove fraud, they differ on how much more must be shown. Perhaps the clearest illustration of the hopelessly confused state of the law is found in two decisions handed down by the Eighth Circuit on the very same day that reached opposite results. The only apparent differences were that in one case the debtor was a doctor who converted over $700,000 into exempt assets and sought to discharge $19 million,[60] whereas in the other the debtor was a farmer who converted only a few thousand dollars and had much smaller total debts.[61] The disparate results are best summed up in the homespun expression that "when a pig becomes a hog it is slaughtered."[62] If the debtor has actively misled creditors in connection with the exemption conversion scheme, however, courts have no trouble in finding fraud and denying the discharge.[63] In short, exemption planning poses a risk to the debtor's discharge.[64]

§ 10.6 Unjustified Failure to Keep Proper Books and Records

A debtor may be denied a discharge if she has unjustifiably failed to keep books and records that are adequate to permit creditors and the bankruptcy trustee to ascertain the true status of the debtor's financial condition and her past business transactions. § 727(a)(3). Complete disclosure is thus a condition of the discharge. Interested parties must be able to figure out, at least roughly, what went wrong.[65] They do not, however, have to be happy with what they discover.

Section 727(a)(3) may be triggered either by an act or omission by the debtor. The objecting party must prove either an act—that the debtor "has concealed, destroyed, mutilated, [or] falsified" financial records—or an omission—that the debtor has "failed to keep or preserve" such records. Thus, a debtor has both an affirmative duty to keep proper records in the first place and to refrain from using the paper shredder. Unlike § 727(a)(2), the objecting party does *not* have to prove any culpable mental state of the debtor in connection with the requisite act or omission.[66] Also unlike § 727(a)(2), the "bad books" exception does not on its face extend to the acts (or omissions) of an

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[59] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 361 (1977); S. Rep. No. 95–989, 95th Cong. 2d Sess., at 76 (1978).

[60] Northwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988).

[61] Hanson v. First Nat'l Bank, 848 F.2d 866 (8th Cir. 1988).

[62] In re Swift, 3 F.3d 929 (5th Cir. 1993).

[63] See, e.g., In re Reed, 700 F.2d 986 (5th Cir. 1983).

[64] See § 9.5.

[65] In re Rosebar, Bankr. No. 13-00535, 2015 WL 296076 (Bankr. D.D.C. Jan. 21, 2015).

[66] In re Mahfouz, 529 B.R. 431, 452 (Bankr. D.Mass. 2015) (it was unclear whether the debtors were "simply poor record keepers who failed to fully grasp their disclosure duties . . . or were, at worst, actively engaged in concealment of their financial condition." The court explained that "intent to conceal, however, is not a necessary element to support an objection to discharge under § 727(a)(3).").

authorized agent of the debtor, although courts have held the debtor responsible for an agent's acts or omissions under § 727(a)(3) as well.[67]

The section is noticeably and perhaps intentionally vague about exactly what kind of financial records the debtor must have. "[A]ny recorded information, including books, documents, records, and papers," may qualify, depending on whether they would have served the function of assisting in ascertaining "the debtor's financial condition or business transactions." Note that non-business consumer debtors are covered by the reference to "financial condition." Courts have fleshed out the section by requiring records of a type typical for someone in the debtor's circumstances—in effect a "reasonable financial record-keeper" standard.[68] It is common for debtors to be viewed along a sliding scale, with one end consisting of large businesses, who are expected to maintain in-depth records, and the other end consisting of unsophisticated consumer debtors, who can get by with far less documentation.[69] Application of this standard will vary depending on the debtor's line of work, education, business sophistication, and the like.[70] For those to whom much is given, much is expected.[71]

Even if the court finds that the objecting party has established that the debtor's records were inadequate, the final clause of § 727(a)(3) offers the debtor an escape hatch. The debtor still may receive a discharge if the court finds the debtor's failure was *justified* in light of the surrounding circumstances of the case.[72] For example, an "innocent" spouse may be able to establish justification by showing they relied on the other spouse to keep the records,[73] or one partner may show that he justifiably relied on another partner to maintain partnership records.[74]

Courts have differed over whether the debtor has the burden of proving justification once the creditor or trustee has proven inadequate records, or whether the objecting party still has to prove the absence of justification. The two-step burden-shifting approach now appears to be the prevailing view.[75] In any event, justification

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[67] See, e.g., In re Sherod, Bankr. No. 89-2007-C H, 1990 WL 10593998 (S.D. Iowa Nov. 2, 1990); In re Kandel, Bankr. No. 11-62597, 2015 WL 1207014 (Bankr. N.D. Ohio Mar. 13, 2015). In *Kandel*, the court found that the debtor "did not take necessary actions to assure his employees or agents maintained financial records." The court explained that "being heavily involved in one aspect of a business does not alleviate a business owner's responsibility to moitor his company's overall financial health."

[68] See, e.g., In re Banks, 420 B.R. 579 (Bankr. M.D. Fla. 2009) (excusing folk artist-debtor's failure to keep adequate records); In re Sigust, 255 B.R. 822 (Bankr. W.D. La. 2000) (requiring debtor with MBA do more than retain tax returns); In re Kinard, 518 B.R. 290, 304–05 (Bankr. E.D. Pa. 2014).

[69] See, e.g., In re Devani, 535 B.R. 26 (Bankr. E.D.N.Y. 2015); In re Roller, Bankr. No. 12-61145, 2014 WL 644590 (Bankr. N.D. Ohio Feb. 19, 2014).

[70] In re Antoniou, 527 B.R. 71, 81 (Bankr. E.D.N.Y 2015) ("Even accepting the debtor's characterization of himself as an unsophisticated businessman as true, the Court finds that to be no excuse for the complete failure of record-keeping by [the] debtor for the two years prior to bankruptcy.").

[71] See, e.g., Meridian Bank v. Alten, 958 F.2d 1226 (3d Cir. 1992). See also In re Womble, 108 Fed. Appx. 993 (5th Cir. 2004); In re Steffensen, 534 B.R. 180 (Bankr. D. Utah 2015).

[72] In re Russell, Bankr. No. 13-33190-HDH7, 2014 WL 6982574 (Bankr. N.D. Tex. 2014). In *Russell*, the debtor was "on the run" from her husband and failed to preserve her records, however, in light of the debtor's unusual circumstances, the court found that the debtor was justified in failing to keep or preserve records. Accord, In re Lorenzo, 606 Fed. Appx. 548, 552 (11th Cir. 2015) (rejecting the debtor's argument that her destruction of records being held on a computer server was justified because she was 'upset' and 'mad' when she "smashed [the] computer server with a hammer.").

[73] E.g., In re Cox, 41 F.3d 1294 (9th Cir. 1994).

[74] E.g., In re Cacioli, 463 F.3d 229 (2d Cir. 2006).

[75] See id.

can be difficult to establish. The debtor must come forward with a convincing explanation as to why she should not be held accountable for a very real failure that indisputably has interfered with the efficacious administration of the bankruptcy case.

§ 10.7 Bankruptcy Crimes

The fourth ground for denial of discharge is the commission by the debtor of a bankruptcy crime "in or in connection with the case." Section 727(a)(4) specifies four different acts that, when done "knowingly and fraudulently," will bar discharge. If the United States Attorney chooses to pursue the matter (and the bankruptcy court has a duty to inform the United States Attorney when it believes a bankruptcy crime has been committed), the debtor may face an even more unpleasant prospect than loss of discharge: conviction of a federal felony under 18 U.S.C. § 152. Such a conviction carries a possible penalty of a fine or five years in prison, or both. Of course, not every debtor whose discharge is denied under § 727(a)(4) will end up serving time. The United States Attorney may choose not to prosecute, and the standard of proof is higher in the criminal proceeding (beyond a reasonable doubt) than in the bankruptcy discharge trial (preponderance). A criminal conviction would be conclusive in a subsequent bankruptcy discharge proceeding through application of collateral estoppel.[76]

The acts contained in the statutory list of § 727(a)(4)(A)–(D) all pertain in some way to the fair and effective operation of the bankruptcy process. They give content to the requirement in early bankruptcy laws that the debtor must "conform" to the bankruptcy law in order to receive his discharge. A party objecting to discharge under § 727(a)(4) need only prove one of the four specified grounds to prevail.

The first act is probably of the greatest practical importance: making a false oath or account in the bankruptcy case. The debtor has a duty to prepare and file detailed schedules and statements of affairs. The trustee and the creditors then can pore over those schedules, which are a matter of public record, and question the debtor at the meeting of creditors about his financial affairs. Any misstatement or omission by the debtor exposes him to possible loss of discharge under § 727(a)(4), subject to proof of the requisite *mens rea*. Courts also have required the mistake to be material.[77] For example, a common scenario involves the debtor's failure to list a valuable asset on his schedules.[78] Harm to creditors need not be proven, however.[79]

The other acts under § 727(a)(4) occur—or at least are litigated—much less frequently than subsection (A). Subsection (B) proscribes presenting or using a false claim in the case. The third subsection, (C), prohibits a discharge in the event of the

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[76] E.g., In re Raiford, 695 F.2d 521 (11th Cir. 1983). See also In re Jasper, 312 F.App'x. 97 (10th Cir. 2008).

[77] See In re Tripp, 224 B.R. 95 (Bankr. N.D. Iowa 1998). In *Tripp*, the debtors failed to list illegal marijuana on their property schedules. The court rejected the debtors' argument that this omission was not material since no value could be realized for the estate by the sale of the illegal drug. The court explained that the debtor's obligation is to disclose all of their property.

[78] See, e.g., Stamat v. Neary, 635 F.4d 974 (7th Cir. 2011); In re Calder, 907 F.2d 953 (10th Cir. 1990).

[79] E.g., In re Bressler, 387 B.R. 446 (Bankr. S.D.N.Y 2008) ("Omitted or incorrect information may be 'material' for purposes of section 727(a)(4)(A) even if the failure to disclose was not prejudicial to creditors."); *Tripp*, supra note 77, 224 B.R. 95.

debtor's extortion, bribery, or attempts at the same. The final subsection, (D), bars the discharge for withholding books and records relating to the debtor's property and financial affairs from an officer of the estate. The close relationship between this ground and § 727(a)(3) is apparent.

The hard proof for a party objecting to discharge under § 727(a)(4) is proof of the requisite mental state of the debtor. The specified act must be committed "*knowingly and fraudulently*" by the debtor. An honest or even a negligent mistake will not deprive the debtor of the benefits of a discharge. A debtor may argue that the mistake was not his but that of his attorney or accountant. Courts try to determine whether the mistake should have been evident to the debtor, who is ultimately responsible for his schedules.[80] In many cases, "direct evidence of fraudulent intent is unavailable" so courts are left to infer fraudulent intent from circumstantial evidence.[81] Generally courts find a pattern of misconduct, taken as a whole, to be sufficient evidence to establish a debtor's fraudulent intent. There is a limit to the "see no evil, hear no evil" attitude behind which courts will permit debtors to hide. At some point, an extreme reckless disregard for the truth will suffice to block the discharge.

§ 10.8 Failure to Explain Loss of Assets

Debtors who end up in bankruptcy court usually have lost a considerable portion of their property, and no longer have sufficient assets to meet their liabilities. The fifth ground for denial of discharge requires the debtor to "explain satisfactorily" how this financial situation came to pass. § 727(a)(5). This explanation requirement is presented in the statements of affairs that the debtor has to file, and in the official meeting of creditors.

The critical question under § 727(a)(5) is what constitutes a "satisfactory" explanation. The Code itself is silent on the issue; much is left to the discretion of the court in the particular case.[82] The objecting party usually establishes a *prima facie* case by showing a significant loss of assets or general insolvency. The debtor then has the burden of going forward with a satisfactory explanation of what happened. To be "satisfactory" the debtor's explanation does not have to convince the court that the loss was not the debtor's fault, or that the debtor acted properly in the past in incurring the to-be-explained loss. All that § 727(a)(5) asks of the debtor is that he shed sufficient light on what transpired in the past that the trustee and the creditors know what happened, even though they may not be too happy with what they have learned. For

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[80] In re Clark, 525 B.R. 442, 460 (Bankr. D. Idaho 2015) ("Generally, a debtor who acts in reliance on the advice of his attorney lacks the intent required to deny him a discharge of his debts. However, the debtor's reliance must be in good faith. Reliance on counsel is not effective if the debtor has sufficient reason to know that the disclosures are inaccurate in addition to being incomplete." (internal citations omitted)).

[81] In re Cummings, 595 Fed. Appx. 707, 710 (9th Cir. 2015) ("The sequence of the debtor's filings substantiates the presence of fraud."); Eifler v. Wilson & Muir Bank & Trust Co., 588 Fed. Appx. 473, 478 (6th Cir. 2014) ("The bankruptcy court inferred that [the debtor] omitted relevant information with fraudulent intent because of the number of omissions and the pattern of false statements."); In re Korner, Bankr. No. 10 B 50703, 2013 WL 1700935 (Bankr. N.D. Ill. Apr. 18, 2013).

[82] See, e.g., In re Martin, 698 F.2d 883, 886 (7th Cir. 1983) ("Section 727(a)(5) is broadly drawn and clearly gives a court broad power to decline to grant a discharge in bankruptcy where the debtor does not adequately explain a shortage, loss, or disappearance of assets."); In re Mihalatos, 527 B.R. 55, 70–71 (Bankr. E.D.N.Y. 2015) (debtor's explanation was sufficient even though the court found the debtor's explanation to be "not particularly 'praiseworthy.' ").

example, a debtor who testifies credibly that he bet all of his savings on "Lucky Star" to win in the seventh race at Louisiana Downs should be granted a discharge. Courts most often find explanations to be unsatisfactory when they are very general or vague ("spent everything on drugs"), or of suspect credibility ("the dog ate my bearer bonds").[83] The lack of documentation or other independent corroboration also may be quite important. The debtor who bet on Lucky Star will fare better in court if he still has the losing race ticket.

In some ways § 727(a)(5) has a broader scope than some of the other grounds in § 727(a). Noticeable by its absence is any requirement of a particular intent or mental state on the part of the debtor. Even if the court believes the debtor is doing the very best job he can to reconstruct the details of his financial downfall, if the debtor fails in that task, his discharge will be denied. The section also does not contain any limitation on how far back in time the loss that is to be explained can have occurred, although a few courts have read in a two-year limit, perhaps as a sort of "penumbra" from other parts of § 727(a).[84] The farther back in time the debtor has to go to explain losses, the more difficult his job becomes.

§ 10.9 Refusal to Testify or Obey Lawful Court Order

The debtor's duty to cooperate in the bankruptcy case is reinforced by § 727(a)(6), which bars the discharge if the debtor refuses to testify in the bankruptcy case or to obey lawful court orders. The debtor will be required to testify at the § 341 meeting of creditors, and may have to testify thereafter at a variety of court proceedings or depositions. The court also may order the debtor to take certain actions in the case, such as to turn over property, amend schedules, produce documents, appear in court or at a deposition, and so on. If the order is lawful,[85] the debtor must comply or lose his discharge under subsection (A). If the objecting party demonstrates that the debtor failed to comply with the order in question, "such a showing then imposes upon the debtor an obligation to explain his non-compliance."[86] The debtor might try to squirm off the hook by arguing that his failure to comply was not a "refusal," but rather only an oversight, or was subject to forces beyond his control, thereby reading an element of willful disobedience into the statute. Some courts have accepted this interpretation of the statute.[87]

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[83] See, e.g., In re D'Agnese, 86 F.3d 732 (7th Cir. 1996). In *D'Agnese*, the debtor was unable to remember what had happened to over $300,000 in assets, which included various pieces of jewelry, Waterford crystal decanters, and sterling silver serving pieces; In re Simmons, 525 B.R. 543, 548–49 (B.A.P. 1st Cir. 2015); In re O'Donnell, 523 B.R. 308, 327–29 (Bankr. D. Mass. 2014); In re Potts, 501 B.R. 711, 724–26 (Bankr. D. Colo. 2013).

[84] See, e.g., In re Lindemann, 375 B.R. 450, 472 (Bankr. N.D. Ill. 2007) (noting that a focus on the two years prior to the bankruptcy filing is common); see also In re Stiff, 512 B.R. 893, 900–01 (Bankr. E.D. Ky. 2014) (discussing the two-year look back period and circumstances that may warrant extending the lookback period).

[85] An order would usually be unlawful only in the rare event that the bankruptcy court exceeded its jurisdiction.

[86] In re Miller, No. 9:13-bk-10313, 2015 WL 3750830, at *5 (Bankr. C.D. Cal. June 12, 2015).

[87] See, e.g., Standiferd v. U.S. Trustee, 641 F.3d 1209, 1212 (10th Cir. 2011) ("Ultimately, the court may not deny discharge under § 727(a)(6)(A) unless it finds that the debtor's non-compliance was willful."); In re Jordan, 521 F.3d 430, 433 (4th Cir. 2008) (noting that a majority of courts have found that the word "refused" requires the showing of a willful or intentional act); In re Casab, 523 B.R. 543, 554–55 (Bankr. E.D. Mich. 2015) (prior orders of the court and the debtor's own testimony established that debtor's

A major change was made by Congress in the 1978 Bankruptcy Reform Act with regard to the debtor's refusal to testify. Under prior law, the debtor had to choose between invoking her Fifth Amendment privilege against self-incrimination, in which case she lost her discharge, or testifying in order to receive a discharge. Under the current Bankruptcy Code the debtor no longer faces this dilemma. She may invoke her constitutional privilege against self-incrimination and still receive a discharge. § 727(a)(6)(B). If, however, the debtor is granted immunity, she then must testify or lose her discharge. The immunity given is use immunity, not transactional immunity.[88] And even though a debtor cannot be denied a discharge for exercising her Fifth Amendment rights, that does not otherwise excuse the debtor from cooperating with the trustee.[89]

The statute does not permit any basis for refusal to answer other than invocation of the Fifth Amendment privilege. It has been held, contrary to the apparent facial meaning of § 727(a)(6)(C), that a debtor may invoke any privilege contained in Rule 501 of the Federal Rules of Evidence without losing his discharge. If a debtor does refuse to answer a question, the other party must then go to the bankruptcy court and get the question approved as material, at which point the debtor is again given the opportunity to answer and preserve his discharge. A final line of defense for the debtor will be that he has not "refused" to answer, if he has given equivocal and evasive answers. When "I can't remember" becomes the equivalent of "I refuse to answer" is a matter for the court's sound discretion.

§ 10.10 Commission of Prohibited Acts in Bankruptcy of an Insider

The seventh ground for denial of discharge goes beyond prior law, making a debtor responsible for the consequences of his actions not just in his own bankruptcy case, but also in the bankruptcy case of an "insider." § 727(a)(7). An individual debtor is denied discharge in his own case if he committed any of the acts specified in subsections (2), (3), (4), (5), or (6) of § 727(a) in an insider's bankruptcy case. One court noted that the section "strengthens the court's ability to prevent abuse to the system as a whole and provides additional means to defeat a discharge of those who may damage the integrity of the bankruptcy system through impropriety in a prior case."[90]

Section 727(a)(7) applies to acts committed up to one year prior to the debtor's own case, and continues to apply throughout the debtor's case. Section 101(31)(A) defines who is an "insider" to an individual debtor. Included are close personal or business associates: the debtor's relatives, relatives of a general partner of the debtor, a partnership of which the debtor is the general partner, a general partner of the debtor, or a corporation of which the debtor is an officer, director, or control person. Thus, even if the debtor in his own individual case acts in a totally exemplary manner, he still will be denied a discharge in his personal case if he commits a proscribed act in the

noncompliance with a document production order was not a mere failure, but instead a refusal to obey a lawful court order).

[88] See generally Kastigar v. United States, 406 U.S. 441 (1972) (discussing the difference between use immunity and transactional immunity).

[89] In re Lopez, 532 B.R. 140, 158–59 (Bankr. C.D. Cal. 2015) (the Fifth Amendment privilege against self-incrimination does not excuse a debtor from cooperating with the trustee and does not protect the debtor from being denied a discharge).

[90] Am. Savs. & Loan Ass'n v. Weber (In re Weber), 99 B.R. 1001, 1015 (Bankr. D. Utah 1989).

bankruptcy case involving his business.[91] Note, however, that a debtor cannot be an "insider" of himself (this is bankruptcy, not psychiatry), so if a debtor commits a prohibited act in his own case, which is then dismissed, that earlier malfeasance will not bar his discharge in a subsequent case.

§ 10.11 Time Bar on Successive Discharges

One of the principal restrictions on the availability of the discharge is that a debtor may only avail himself of the discharge privilege every *six* or *eight* years (depending on which bankruptcy chapter he received a discharge under in the prior case). Prior to the 2005 amendments, the time bar was six years in all instances. The time bar is intended to prevent abuse of the bankruptcy system, and to avoid having a habitual debtor class. Early bankruptcy laws approached the problem of successive bankruptcies by conditioning the discharge in the second case on the payment of a significant minimum dividend to creditors in the first case.[92] Current law does not prevent the filing and processing of a second bankruptcy case within six or eight years of a prior case; it simply does not permit a discharge in that second case.

The six or eight-year time bar applies only when the *second case* is a *chapter 7*. The debtor can cut the time limit by filing a chapter 13 case the second time around, instead of a chapter 7. Section 727(a) does not apply in chapter 13. A chapter 13 debtor will be denied discharge if the debtor received a discharge in a case filed under Chapter 7, 11, or 12 in the *four years* preceding the second filing, § 1328(f)(1), or in a chapter 13 case in the past two years, § 1328(f)(2). The 2005 amendments imposed a time bar in chapter 13 for the first time.[93] A debtor may avoid the time bar entirely by reorganizing under chapter 11 in the second case. However, if the debtor liquidates in chapter 11, § 1141(d)(3) reimposes the time limitation.

There are two possible time bars (six years or eight years) when the second case is a chapter 7, depending on what chapter the debtor received a discharge under in the first case. Subsection (8) of § 727(a) addresses the situation where the *first* case was under *chapter 7 or chapter 11*. If the debtor received a discharge in the first case, he is absolutely precluded from receiving a discharge in a second case under chapter 7 commenced within *eight years*. § 727(a)(8). This time period was extended from six to eight years in 2005.[94] Rule 4004(c) apparently requires an objection to be filed alleging a violation of the eight-year bar, even though the times of the respective filings would seem to be a fact of which a court could take judicial notice.

The eight-year period is computed from the date of the *commencement* of case 1 to the commencement of case 2, *not* from discharge to discharge. Thus, if the second case is *filed* more than eight years after the first case was filed, § 727(a)(8) will not bar discharge, irrespective of whether the discharges were granted within eight years of each other. Even if the debtor did not receive a discharge in the first case (thereby

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[91] E.g., In re Krehl, 86 F.3d 737, 743 (7th Cir. 1996); In re Adams, 31 F.3d 389 (6th Cir. 1994), cert. denied, 513 U.S. 1111 (1995); In re Poffenberger, 471 B.R. 807, 815–18 (Bankr. D. Md. 2012).

[92] See Tabb, supra note 36, 65 Am. Bankr. L.J. 325.

[93] Pub. L. No. 109–8, § 312(2), 119 Stat. 87 (2005).

[94] Id. § 312(1), 119 Stat. 86–87.

rendering § 727(a)(8) inapplicable), § 523(a)(10) will prevent him from discharging in the second case the debts not discharged in the first case.

Section 727(a)(9) provides a slightly different rule for the situation where the first case was a debt adjustment case under *chapter 13* or *chapter 12*. Assuming again that the debtor did receive a discharge in the first case (even a hardship discharge, i.e., one in which plan payments were not completed), whether the discharge in the subsequent chapter 7 case is barred under § 727(a)(9) depends on what happened in the first case. Unlike subsection (8), subsection (9) does not impose an absolute bar, and the time limit is six years, not eight. Like subsection (8), the six-year time between cases is computed between filing dates, not discharge dates.

The debtor may receive his discharge in a chapter 7 case following a chapter 13 or chapter 12 case in one of two circumstances. First, if unsecured creditors were paid 100% on their claims in the original debt adjustment case, § 727(a)(9)(A) permits discharge in the ensuing liquidation case. The full payout case cannot be considered an abuse of the bankruptcy system, and the creditors were not harmed in that first case. Even if the debtor did not pay 100% on unsecured claims in the first chapter 13 or 12 case, he still may receive a discharge if 70% was paid on unsecured claims in the first case *and* that 70% plan was proposed in good faith by the debtor and represented the debtor's best efforts. § 727(a)(9)(B). The confirmation of the chapter 13 plan in the first case must contain a finding of good faith, § 1325(a)(3), and the legislative history suggests that debtors likewise should be able to obtain a "best efforts" finding in the confirmation order.[95] Those findings in the first case should clear the way for a discharge in a subsequent chapter 7.

§ 10.12 Waiver of Discharge

The bankruptcy discharge privilege is offered to most individual debtors for most debts, but not all eligible debtors choose to accept the discharge offer. Instead, for a variety of reasons, a few debtors elect to waive the discharge. This waiver is valid and enforceable against the debtor, pursuant to § 727(a)(10), subject to a few important restrictions.

By far the most important and meaningful restriction is that the discharge is not waivable *in advance*. Waiver is only valid when executed *after* the bankruptcy case is commenced. This prevents creditors from obtaining blanket discharge waivers as a matter of course at the time credit is extended. The nonwaivability of the discharge is one of the cornerstones of the United States consumer bankruptcy system.

Section 727(a)(10) also requires the waiver to be in *writing*, thus obviating any argument either of "implied waiver" from the debtor's actions or of an oral waiver. Finally, the court is required to approve the waiver, which is a change from prior law. It should be noted that the statute does not elucidate any standard pursuant to which the court may choose not to approve the executed waiver, and Rule 4004(c) likewise does not suggest any basis for the court to exercise its discretion to decline to approve a waiver. This is to be contrasted with the substantive requirements for court approval of agreements to reaffirm particular debts in certain circumstances under § 524(c). The

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[95] 124 Cong. Rec. H11,098 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,415 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

approval limitation thus may only demand that the court ascertain that the waiver in fact was knowingly and voluntarily made, although some courts will undertake a more substantive paternalistic review of the wisdom of the debtor's choice.

§ 10.13 Failure to Complete Personal Financial Management Course

The 2005 amendments added a series of provisions to the Code imposing requirements of "credit counseling" for individual debtors.[96] The new provisions require an individual debtor to get counseling *twice*: first, *before* filing bankruptcy, as a condition of eligibility to file bankruptcy at all, under any chapter,[97] § 109(h), and then again *after* filing, during the case, as a condition of receiving a discharge in a case under chapter 7 (§ 727(a)(11)) or chapter 13 (§ 1328(g)). These debtor education requirements were proudly hailed as significant "*Consumer Debtor Bankruptcy Protections*."[98] Given that the only consequence of non-compliance in both cases is to harm the debtor—first, by barring the debtor from filing bankruptcy, and second, by denying the debtor a discharge—debtors might prefer a little less "protection." Perhaps Congress also contemplated some "protection" for *creditors*, who would be exposed to fewer credit risks if dealing with a more financially savvy debtor class.

The purported idea behind the new discharge rule was stated in the House Report: "The bill also requires debtors, after they file for bankruptcy relief, to receive financial management training that will provide them with guidance about how to manage their finances, so that they can avoid future financial difficulties."[99] Congress must have been inspired by the old Confucian proverb, "give a man a fish, you feed him for a day; teach a man to fish, you feed him for a lifetime" (and, perhaps, given the function of § 727(a)(11)—"if he won't learn how to fish, you throw him overboard"!).

To avoid the discharge bar of § 727(a)(11) (in chapter 7) or § 1328(g) (in chapter 13), the debtor must complete an approved "instructional course concerning personal financial management." The debtor then must file a certificate of completion (following Official Form 23) with the court, within 60 days of the first date set for the § 341 meeting of creditors. Rule 1007(b)(7), (c). Note that the course *must* be completed *after* the bankruptcy filing, and, in order to receive the discharge, before the discharge hearing. Most courts have allowed a debtor who failed to complete the course to reopen their case, take the course, and then receive a discharge.[100] Some courts, however, employ a four-part consideration to determine whether cause for reopening a case exists: "(1) a reasonable explanation for the failure to comply with the financial course requirements; (2) a timely request for relief; (3) explanation of counsel's failure to monitor the debtor's compliance; and (4) no prejudice to creditors."[101] The statute does not appear to allow a debtor who took an approved course *prior* to filing to count that course for purposes of avoiding the discharge bar.

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[96] Pub. L. No. 109–8, 119 Stat. 37–42 (2005).

[97] See § 2.3.b.

[98] H.R. Rep. No. 109–31 (pt. 1), 109th Cong., 1st Sess., at 17–18 (2005).

[99] Id. at 18.

[100] See, e.g., In re Rising, No. 07-50123, 2015 WL 393416 (Bankr. M.D.N.C. 2015); In re Meaney, 397 B.R. 390 (Bankr. N.D. Ill. 2008).

[101] In re Johnson, 500 B.R. 594, 597 (Bankr. D. Minn. 2013).

The 2005 Act added § 111, which provides detailed requirements regulating approved credit counseling agencies and the financial management instructional services to be offered. The United States trustee supervises the approval of counseling agencies and instructional courses. The only statutory standard regarding the content of the required courses is that they must assist debtors in "understanding personal financial management." While the agencies may charge a reasonable fee, counseling services must be provided "without regard to [the debtor's] ability to pay the fee." § 111(c)(2)(B). Counseling may be done over the telephone or Internet. No guidance is given as to how long or how detailed the course must be.

The discharge denial rule is subject to limited, and exclusive, exceptions: (1) for debtors described in § 109(h)(4), e.g., debtors who are "incapacitated" (which is defined to mean a mental disability); "disabled" (defined to mean physical inability to take advantage of counseling services); or on active military duty in a military combat zone; or (2) if the United States trustee determines that adequate approved instructional courses are not available in the district in which the debtor resides. As to the latter exception, since telephonic or Internet-based instruction is allowed, one wonders how this could ever come to pass in any district.

§ 10.14 Delay of Discharge Due to Possible Proceeding Under § 522(q)

In 2005, Congress added a provision, which delays entry of the discharge order if the court finds that there is reasonable cause to believe that the debtor is subject to a pending proceeding that might give rise to a limitation of the homestead exception under § 522(q).[102] § 727(a)(12). The same rule applies in all chapters: chapter 7 (§ 727(a)(12)); chapter 11 (§ 1141(d)(5)(C)); chapter 12 (§ 1228(f)); and chapter 13 (§ 1328(h)). Under § 522(q), a debtor who elects a state law homestead exception in bankruptcy is limited to a homestead exemption of $160,375 (as indexed to 2016) if either (1) the debtor has been convicted of a felony which demonstrates that the filing of the bankruptcy case was an abuse, or (2) the debtor owes a debt arising from a securities law violation, racketeering, fiduciary fraud, or a criminal act or intentional tort that caused death or personal injury in the past 5 years.[103] Although, as one court observed, "It would strain the faculties of the layperson and the lawyer alike to try to understand why Congress linked these statutes together in the manner provided by § 727(a)(12),"[104] the bankruptcy courts must try to give effect to the new rule.

The effect of the new discharge rule apparently is to *postpone* the debtor's discharge until the proceeding that could impact § 522(q) is completed and the exemption issue resolved, although the statute does not clearly say that in so many words. It does not appear that the rule effects a *permanent* denial of discharge. The Bankruptcy Rules take this view, providing that the court is to enter a discharge upon expiration of the time for objecting "unless a motion *to delay or postpone* discharge under § 727(a)(12) is pending." Rule 4004(c)(1)(I). Once the § 522(q) matter is settled, then the debtor's exemption is capped (or not), and the court can then go ahead and enter the debtor's discharge. So, for example, if the debtor is the defendant in a

[102] Pub. L. No. 109–8, § 330(a)(3), 119 Stat. 101 (2005).

[103] See § 9.5.b.

[104] In re Jacobs, 342 B.R. 114, 115 (Bankr. D.D.C. 2006).

pending action alleging that the debtor is liable for securities fraud, and has claimed a homestead exemption under state law in excess of $160,375, and the date set for entry of the discharge is approaching, the court (within ten days before the entry of the discharge order[105]) must not enter the discharge order. Instead, the court should wait until the securities fraud action is concluded (which may require the court to lift the automatic stay), allowing the bankruptcy court to make a determination under § 522(q) whether to cap the exemption claim. Having done that, the court then is free to enter the discharge; § 727(a)(12) will no longer bar the discharge, because no § 522(q)-related proceeding will be "pending."

Note that the § 727(a)(12) rule (and the similar rules in the other chapters) can only apply if (1) the debtor has elected a homestead exemption under *state* law, and (2) that exemption claim exceeds $160,375. If either of those conditions is not satisfied, then there is no possible application of § 522(q), which is a prerequisite to the invocation of § 727(a)(12).[106]

Furthermore, the statute specifically requires that the proceeding that might affect § 522(q) must already be *pending.* § 727(a)(12)(B). If literally applied, this limitation seems to say that the court cannot delay entry of the discharge order in a situation where the debtor is *alleged* to have committed a felony within the meaning of § 522(q)(1)(A) or to be liable for a debt of the type described in § 522(q)(1)(B), but no proceeding to prosecute the debtor for the felony or to hold the debtor liable for the debt has yet been filed. That is, can the debtor preclude a § 727(a)(12) problem by winning a race to the courthouse? Probably not, notwithstanding the apparent possibility if the statutory language were to be rigidly construed. Under the Bankruptcy Rules, the court "shall forthwith grant the discharge" upon expiration of the time for filing objections to discharge or to dismiss the case, "unless . . . a motion to delay or postpone discharge under § 727(a)(12) *is pending.*" Rule 4004(c)(1)(I). The time period by which the proceeding must be "pending" is just 60 days after the first date set for the meeting of creditors, unless extended within that time. Rule 4004(a). Note also that except for criminal proceedings, no action to hold the debtor liable for a debt may be filed once a bankruptcy case is commenced, because of the automatic stay. Yet, one suspects that if faced with this situation, a court would exercise its equitable powers to defer entry of the discharge (to the extent possible under the strict language of Rule 4004), and then either grant relief from the stay to permit the proceeding against the debtor to be filed, so it then would be "pending," or would simply deem the claim filed against the debtor to be the "pending" proceeding.

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[105] Note the "Alice in Wonderland" impossibility of complying literally with the statute on this procedural point. How can a court enter an order within ten days *before* the *entry* of an order it will not be able to enter once it has entered the first order? It is likely that Congress *meant* to fix the referent date as the date *scheduled* for the bankruptcy court to enter the discharge order under Rule 4004, but for the interposition of the § 522(q) pending proceeding problem that triggers § 727(a)(12).

[106] See, e.g., *Jacobs*, 342 B.R., at 114–15.

C. EXCEPTIONS TO DISCHARGE UNDER § 523: NONDISCHARGEABLE DEBTS

§ 10.15 Overview

A debtor who receives a general discharge from his debts under § 727 still may not exit bankruptcy with a full financial fresh start in life. Specific debts may be excepted from the operation of the general discharge pursuant to § 523, leaving those creditors free to pursue collection from the debtor after bankruptcy. All other creditors will still be bound by the discharge, however. The debts excepted under § 523 are similar to those enumerated in § 17 of the 1898 Act. Section 523(a) contains the complete and exclusive list of excepted debts in the Code;[107] a bankruptcy court has no power to exercise its equitable discretion to create new discharge exceptions.

Section 523(a) applies only to the debts of *individual* debtors. This restriction is congruent with the limitations of chapter 7, in which only individual debtors may receive a discharge at all, § 727(a)(1), and chapter 13, in which only individuals may be debtors in the first place. § 109(e). Corporate and partnership debtors may receive a discharge, however, in chapter 11 and in chapter 12. Section 1141(d)(2) coordinates the chapter 11 discharge with § 523(a) by specifying that an individual debtor is not discharged from a § 523(a) debt. By negative inference, corporate and partnership debtors thus will be discharged in chapter 11 even from debts under § 523(a). One exception to this general rule was added in 2005, whereby corporate debtors are not discharged in chapter 11 from fraud debts or from tax debts as to which the debtor either filed a fraudulent return or willfully attempted to evade or defeat the tax. § 1141(d)(6).

The marriage between § 523 and chapter 12 for corporate and partnership debtors is less tidy. Section 1228, which governs the discharge in chapter 12, provides that no chapter 12 debtor is discharged from a § 523(a) debt. § 1228(a)(2), (c)(2). This would extend the scope of § 523(a) to corporate and partnership debtors, who are eligible for chapter 12 relief. § 109(f), § 101(18)(B). As just mentioned above, however, § 523 by its terms is limited to individual debtors. What Congress intended to do in chapter 12 cases is not clear.[108]

Section 523 applies in all types of cases. Subject to the limitation to individual debtors just discussed, the section operates with full force not only in a chapter 7 case, but also in chapter 11 and in chapter 12.

In chapter 13, however, all of the § 523(a) exceptions apply only in the event a "*hardship*" discharge is granted. § 1328(b), (c)(2). Before 2005, in the event the debtor was granted a full-compliance discharge under § 1328(a), the only § 523(a) debts *not* discharged were for family support debts, educational loans, DWI liabilities, and criminal fines and restitution obligations. § 1328(a)(2), (3). Congress has made steady inroads into this so-called Chapter 13 "super" discharge, however, suggesting a move in Congressional policy towards conforming chapter 13 to the other chapters and applying

[107] Some discharge exceptions are located in other titles of the United States Code.

[108] Courts have held that corporate debtors in chapter 12 are precluded from obtaining a discharge of debts excepted under § 523(a). E.g., In re JRB Consol., Inc. 188 B.R. 373 (Bankr. W.D. Tex. 1995).

all § 523(a) exceptions uniformly. In 2005, Congress added to the list of nondischargeable debts (even in a chapter 13 full-compliance discharge) the following: (1) some types of debts for taxes (§ 523(a)(1)(B) & (C), § 507(a)(8)(C), § 1328(a)(2)); (2) fraud debts (§ 523(a)(2), § 1328(a)(2)); (3) unscheduled debts (§ 523(a)(3), § 1328(a)(2)); (4) debts for fiduciary fraud or defalcation, larceny, or embezzlement (§ 523(a)(4), § 1328(a)(2)); and (5) debts for restitution or damages awarded in a civil action where the debtor was found to have acted willfully or maliciously and caused death or personal injury (§ 1328(a)(4), see also § 523(a)(6)).

The only significant debts that still remain as part of the chapter 13 "super" discharge are: (1) income taxes due more than three years before bankruptcy, if the debtor filed a timely and non-fraudulent return, and if the debtor did not try to evade the tax (§ 523(a)(1)(A));[109] (2) debts for willful and malicious injury to property (§ 523(a)(6)); and (3) debts arising from property settlements in divorce or separation proceedings. (§ 523(a)(15)). All of the discharge exceptions in § 523(a)(10)–(19) are still covered by the current version of the "super" discharge of § 1328(a).

§ 10.16 Taxes

The policy of giving an honest debtor a fresh start in life is subordinated to the goal of protecting the public fisc through a discharge exception for certain taxes by § 523(a)(1). In addition, § 523(a)(7) makes some tax penalties nondischargeable.[110] These exceptions are automatic, requiring no action to be taken by the taxing authority in the bankruptcy case to preserve its rights. Some diligence may be required of the government, however, in attempting to collect its taxes in order to bring the debt within the scope of § 523(a)(1).

The first of the three categories of nondischargeable tax debts in subsection (1) is for those tax debts which are entitled to either third or eighth priority under § 507(a)(3) or § 507(a)(8). § 523(a)(1)(A). Since priority claims by definition are paid prior to general unsecured claims, the amount of the tax for which the debtor ultimately will be responsible after bankruptcy because of the discharge exception is reduced by the priority treatment given the same claim in the bankruptcy. Third priority taxes are those taxes incurred in the ordinary course of the debtor's business or financial affairs in an involuntary case during the gap period between the commencement of the case, and the entry of the order for bankruptcy relief or the appointment of a trustee. §§ 507(a)(3), 502(f).

Eighth priority taxes are much more comprehensive in their reach and much more important in the normal case.[111] Included are income or gross receipts taxes, property taxes, withholding taxes, employment taxes, excise taxes, and customs duties. Many of these taxes enjoy priority only if not stale; others have no time limitation. An example of the latter type is a "trust fund" withholding tax, which enjoys priority and nondischargeability no matter how long before bankruptcy it was incurred. § 507(a)(8)(D).

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[109] The tax exception does not help the debtor, though, because tax debts under § 523(a)(1)(A) are those which are entitled to priority under § 507(a)(3) or (8), and to confirm a chapter 13 plan the debtor must provide for full payment of all priority debts. § 1322(a)(2).

[110] See § 10.22.

[111] See § 7.21.

The most common example of the time-sensitive taxes is income taxes. The income tax priority generally includes only those taxes for which a required return was last due within *three years* of the bankruptcy case. § 507(a)(8)(A)(i). Alternatively, a tax that is assessed within 240 days of bankruptcy will be granted priority and excepted from discharge, § 507(a)(8)(A)(ii), as will a tax that remains assessable at the time of bankruptcy. § 507(a)(8)(A)(iii).

A tax debt that is older than the statutorily-prescribed period is denied priority and is therefore dischargeable. Congress intended to place some duty of diligence on the government in collecting taxes. For example, income taxes for the 2010 tax year normally would be due on April 15 of the following year (2011). If the taxpayer-debtor filed bankruptcy anytime on or before April 15, 2014, the debt for the 2010 income taxes would be entitled to priority and would therefore not be dischargeable under § 523(a)(1)(A). If the debtor filed after April 15, 2014, however, the 2010 tax debt would be discharged and not entitled to priority.

An issue that has arisen with considerable frequency is whether the pendency of a prior bankruptcy case suspends the running of the three-year period. For example, in the above hypothetical, assume that the debtor filed bankruptcy on April 20, 2014—more than four years after the due date for filing the 2010 tax return. Without more, the 2010 tax debt would be discharged. However, what if the debtor had been in bankruptcy previously, from May 2011 until May 2013? The taxing authority would have been prevented by the automatic stay from attempting to collect the tax during the prior bankruptcy case, and thus would not have enjoyed three "stay-free" years to try to collect. Until 2002, in the face of statutory silence on the tolling question, the courts were split over whether a prior bankruptcy case tolled the three-year period.[112]

The Supreme Court settled the issue in 2002 in the case of *Young v. United States*, holding that the running of the three-year period is equitably tolled during the pendency of a bankruptcy case.[113] In 2005, Congress codified a tolling rule with regard to the 240-day assessment priority provision, suspending that time period for any time that the government was prohibited from collecting under non-bankruptcy law or pursuant to a bankruptcy case, plus an additional 90 days. § 507(a)(8)(A)(ii)(II). There is no reason to believe that by codifying tolling for the 240-day assessment priority but not doing so for the general three-year priority, Congress intended to overturn the *Young* holding.

The second category of nondischargeable tax claims is those for which a required return (or equivalent report or notice) either was not filed at all prior to bankruptcy or was filed late and within two years of bankruptcy or thereafter. § 523(a)(1)(B). The tax year to which the return applies is irrelevant. This subsection thus balances the dilatoriness of the taxpayer-debtor in filing the return (or not) against that of the taxing authority in pursuing the taxpayer. The government is never time-barred in the

[112] Compare In re Taylor, 81 F.3d 20 (3d Cir. 1996) (toll), with In re Quenzer, 19 F.3d 163 (5th Cir. 1993) (not toll).

[113] 535 U.S. 43 (2002).

case of the non-filing debtor, but once a late return is filed, the government has only two years to take action, such as obtaining a tax lien.[114]

The final category of nondischargeable tax claims covers those claims as to which the debtor either (1) filed a fraudulent return or (2) in any way willfully attempted to evade or defeat the tax. § 523(a)(1)(C). No time bar exists for these claims. Most of the litigation has concerned the second prong, that of willful evasion. Courts note that "[t]he willful attempt to evade prong of 523(a)(1)(C) includes 'both a conduct requirement (that the debtor sought 'in any manner to evade or defeat' his tax liability) and a mental state requirement (that the debtor did so 'willfully').' "[115] One of the issues courts have struggled with is where the debtor's "conduct" is simply choosing to pay other debts before he pays his back taxes; is that enough of an "evasion"? If the *only* "conduct" of the debtor is not paying the tax, that should not be enough to constitute evasion;[116] otherwise almost every tax debt would, by definition, be nondischargeable. However, if nonpayment is coupled with even the slenderest of reeds of affirmative dubious conduct, courts will find the tax debt nondischargeable,[117] assuming the requisite mental state can be established.[118] A debtor who can do so but who intentionally fails to file a return and pay a tax may be considered a tax evader within the meaning of the exception.[119] As to the mental state requirement, "the proper test is whether, in the case of a debtor who is financially able to pay his taxes but chooses not to do so, (1) the debtor had a duty under the law, (2) the debtor knew he had that duty, and (3) the debtor voluntarily and intentionally violated that duty."[120] Under that test, debtors have almost no chance of prevailing.

An important practical question is whether *interest* continues to accrue on an unpaid tax liability even after the filing of a bankruptcy petition. As against the bankruptcy estate itself, a claim for postpetition interest is only paid in the rare case in which the estate is solvent.[121] §§ 726(a)(5), 502(b)(2). However, if the underlying tax debt is nondischargeable as to the debtor, then the debtor himself remains personally

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[114] In re Putnam, 503 B.R. 656, 659 (Bankr. E.D.N.C. 2014) (the court extended the holding in *Young* with respect to equitable tolling, finding that the two-year lookback period for late-filed tax returns is similarly subject to equitable tolling).

[115] In re Griffith, 206 F.3d 1389, 1396 (11th Cir. 2000) (en banc) (quoting In re Birkenstock, 87 F.3d 947, 951 (7th Cir. 1996)).

[116] In re Haas, 48 F.3d 1153 (11th Cir. 1995), abrogated on other grounds by *Griffith*, 206 F.3d 1389. The Eleventh Circuit sitting en banc in *Griffith*, while abrogating the conclusion of the *Haas* court that evading *payment* of the tax could never be nondischargeable, still reaffirmed *Haas* on the point that nonpayment by itself was not enough to constitute evasion. 206 F.3d at 1395.

[117] See, e.g., *Griffith*, 206 F.3d at 1396; In re Bruner, 55 F.3d 195, 200 (5th Cir. 1995); In re Blalock, 537 B.R. 284, 307–09 (Bankr. S.D. Miss. 2014); See also United States v. Coney, 689 F.3d 365, 375 (5th Cir. 2012) (holding that the debtor's attempts to "structure cash transactions to avoid federal reporting requirements" and "obstruct the Government's investigation of his activities" satisfied the conduct requirement of § 523(a)(1)(C)).

[118] Hawkins v. Franchise Tax Bd. of California, 769 F.3d 662, 669 (9th Cir. 2014) (holding that "willfully attempted . . . to evade or defeat [a] tax" requires a "specific intent to evade the tax." Merely "spending in excess of income" or "living beyond one's means" will not suffice).

[119] In re Toti, 24 F.3d 806 (6th Cir. 1994). See also In re Fretz, 244 F.3d 1323, 1329–30 (11th Cir. 2001).

[120] *Bruner*, 55 F.3d at 197. See also *Coney*, 689 F.3d at 374.

[121] New York v. Saper, 336 U.S. 328 (1949) (disallowing postpetition interest on tax claim against bankruptcy trustee).

liable for postpetition interest, under the rule laid down by the Supreme Court in *Bruning v. United States*.[122]

A new dischargeability exception relating to tax debts was added to the Code in 1994. Under § 523(a)(14), a debt that is incurred to pay a tax to the United States that itself would be nondischargeable under § 523(a)(1) is likewise deemed nondischargeable. In 2005, a similar provision was added for debts incurred to pay nondischargeable taxes to a governmental unit other than the United States, i.e., state and local taxes. § 523(a)(14A). These rules prevent debtors from converting a nondischargeable debt into a dischargeable debt by using their credit cards shortly before filing bankruptcy to pay a tax debt that would be excepted from discharge and then filing bankruptcy and discharging the credit card debt. The new rule should facilitate the ability of debtors to use their credit cards to pay tax debts.[123]

§ 10.17 Fraud

By far the most important and most litigated discharge exception is § 523(a)(2), for debts based on fraud. The purposes of the fraud exception are "to punish egregious debtor misconduct and to protect the interests of innocent parties victimized by fraud."[124] Section 523(a)(2) is set up in a somewhat awkward fashion. Subsection (A) applies to all types of nondischargeable fraud debts *except* those based on false financial statements, which are covered by subsection (B). Subsections (A) and (B) therefore are mutually exclusive. However, most (but not all) of the elements necessary to establish the exception are the same under either (A) or (B). As explained below, the primary difference is whether the creditor must prove reasonable reliance or justifiable reliance. Finally, subsection (C) establishes a rebuttable presumption of fraud under subsection (A) in the specific context of eve-of-bankruptcy "load-ups" by consumers.

Some other provisions of § 523 are designed to alleviate possible creditor abuse of the fraud exception. Section 523(c)(1) requires the creditor to file the fraud complaint in the bankruptcy court. Bankruptcy Rule 4007(c) puts the creditor on a short time leash to file—within 60 days of the first meeting of creditors. Section 523(d) exposes a creditor who loses a § 523(a)(2) action to possible liability to a consumer debtor for costs and attorneys' fees incurred in that action, if the creditor's position "was not substantially justified," unless the court finds that "special circumstances would make the award unjust." The current version of § 523(d) has been watered down significantly from the original version contained in the 1978 Bankruptcy Reform Act, which provided for judgment to be granted against the losing creditor in every § 523(a)(2) case, "unless such granting of judgment would be clearly inequitable."[125]

The statute spells out in detail the elements of a cause of action under § 523(a)(2)(B). As the Supreme Court explained in *Field v. Mans*,[126] this specificity in subsection (B) is necessary because the false financial statement provision is entirely a

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[122] 376 U.S. 358, 360 (1964). See, e.g., In re Hanna, 872 F.2d 829, 830–31 (8th Cir.1989).

[123] Section-by-Section Analysis, commentary on § 221 of Bankruptcy Reform Act of 1994, 140 Cong. Rec. H10,769 (daily ed. Oct. 4, 1994).

[124] Luther Zeigler, The Fraud Exception to Discharge in Bankruptcy: A Reappraisal, 38 Stanford L. Rev. 891, 899 (1986).

[125] Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, § 523(d), 92 Stat. 2592.

[126] 516 U.S. 59, 68–69 (1995).

product of congressional creation, without an obvious analogue in the common law of torts. The elements under (B) are that the debt must be obtained by:

> use of statement in writing—(i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor to whom the debtor is liable . . . reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive.

In contrast to subsection (B), § 523(a)(2)(A) does not delineate the elements that the creditor must prove. The Supreme Court in *Mans* explained that such statutory specificity is unnecessary in subsection (A), because Congress intended to incorporate by reference the elements of common law fraud as generally understood when the Bankruptcy Code was enacted in 1978.[127]

Note, though, that this supposed incorporation of the elements of common law fraud no longer fully holds after the Supreme Court's 2016 decision in *Husky International Electronics, Inc. v. Ritz.*[128] In that case, the Court held that a creditor need not prove a false representation to establish an exception to discharge under § 523(a)(2), but in the alternative it would suffice to prove that the debtor made an actually fraudulent transfer.[129] The *Ritz* Court noted that "fraudulent conveyances are not an inducement-based fraud,"[130] with the consequence being not only that the creditor need not prove that the debtor made a false representation (the specific holding in the case), but also, as a logical extension, need not prove any reliance at all on the fraud by that particular creditor. That, of course, potentially opens up the field of defrauded creditors with a viable discharge exception action under § 523(a)(2) to *all* of the debtor's creditors—a reality that underscores how misguided the Court's holding was in *Ritz*. Essentially, the Court's holding imports the discharge *denial* ground of § 727(a)(2) into the discharge *exception* realm of § 523(a)(2), but without the constraining limitations of § 727(a)(2) (such as, for example, the one-year reachback period). Such an outcome is implausible in the extreme as a matter of statutory interpretation, and undermines the debtor's fresh start.

A creditor seeking to establish a nondischargeable fraud debt must prove that the debtor, either by "false pretenses, a false representation, or actual fraud," obtained "money, property, services, or an extension, renewal, or refinancing of credit" from the creditor. § 523(a)(2). This statutory definition of what may be obtained is quite broad; broader in fact than under prior law, especially due to the specific inclusion of "services."[131] At the same time, Congress, by using the phrase "to the extent obtained by," intended that only what was so obtained should escape discharge. The language "to the extent" limits the exception to that portion of the debt directly traceable to the fraud. This problem often arises in the case of a refinancing.

The word "obtained" is construed strictly to mean that some form of pecuniary benefit must be procured directly by reason of the fraud. It does not extend to consequential losses caused by the debtor's misrepresentations. In the *Mans* case,

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[127] Id.

[128] 136 S.Ct. 1581 (2016).

[129] Id. at 1586.

[130] Id. at 1587.

[131] The Code thus overrules *Gleason v. Thaw*, 236 U.S. 558 (1915).

Justice Ginsburg in her concurrence raised a question as to whether the debt in question was "obtained by" the claimed fraud.[132] In that case, the debtor fraudulently omitted to disclose to the creditors that he had already sold property and thereby triggered a due-on-sale clause. The debt had been created previously, without any taint of fraud. The only effect of the debtor's fraud was to lull the creditors into not pursuing collection of the accelerated debt. Such inaction might not be enough to satisfy the "obtained by" requirement. A related question, on which the courts have split, is whether the debtor personally must receive the obtained benefit, or whether the exception applies even if a third person receives the benefit, as long as the debtor was the fraudulent actor.[133]

One context in which the "obtained by" limitation has proven quite important is where the original debt arguably was obtained by fraud, but the parties then enter into a settlement agreement and release that says nothing about fraud, and that itself was not the product of fraud. The classic fact scenario is outlined by the Supreme Court in *Archer v. Warner*:[134] "(1) *A* sues *B* seeking money that (*A* says) *B* obtained through fraud; (2) the parties settle the lawsuit and release related claims; (3) the settlement agreement does not resolve the issue of fraud, but provides that *B* will pay *A* a fixed sum; (4) *B* does not pay the fixed sum; (5) *B* enters bankruptcy; and (6) *A* claims that *B*'s obligation to pay the fixed settlement sum is nondischargeable because, like the original debt, it is for 'money . . . obtained by . . . fraud.' " The Court held that, for purposes of the fraud exception to discharge, the original character of the debt as fraudulent survived the execution of a settlement agreement and release.[135] The *Archer* Court found that the case was controlled by its earlier decision in *Brown v. Felsen*,[136] in which the Supreme Court rejected a *res judicata* argument and allowed a creditor to try to prove fraud even though the original, allegedly fraudulent debt had been reduced prior to bankruptcy to a state court consent judgment that was silent as to fraud.

Another scenario in which the "obtained by" limitation could prove significant is where the debtor makes a fraudulent transfer. As noted above, in 2016, the United States Supreme Court held in *Husky International Electronics, Inc. v. Ritz*[137] that a creditor need not prove that a debtor made a false representation, but could instead prove that the debtor made an actually fraudulent transfer. However, in that situation, the creditor still might have trouble proving that the debtor "obtained" something from his fraud within the meaning of § 523(a)(2).[138] So, for example, if the debtor fraudulently transferred his Revolutionary War musket to his uncle Leo, the § 523(a)(2) action would fail. But if the debtor transferred that musket to a trust of which he himself was the primary beneficiary, and thus was also the *transferee* of the fraudulent conveyance, the "obtained by" requirement would be satisfied.

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[132] 516 U.S. 59, at 78–79 (Ginsburg, J., concurring).

[133] Compare In re Sabban, 600 F.3d 1219 (9th Cir. 2010); In re Saenz, 516 B.R. 423, 430–32 (Bankr. S.D. Tex. 2014) (noting there is no requirement that the debtor receive a benefit from his or her fraudulent activity to violate § 523(a)(2)(A)), with In re Rountree, 478 F.3d 215 (4th Cir. 2007) (holding that a debtor must obtain something through fraud for the § 523(a)(2)(A) exception to apply).

[134] 538 U.S. 314, 316 (2003).

[135] Id. at 323.

[136] 442 U.S. 127 (1979).

[137] 136 S.Ct. 1581 (2016).

[138] Id. at 1589.

The requirement that something of value be obtained from the creditor is really secondary to the essential focus of the exception, however. The vast majority of claims by definition involve the procurement of some form of property or credit from the creditor by the debtor, and most of those claims nevertheless are discharged. What makes claims under § 523(a)(2) nondischargeable is the debtor's fraudulent activity in obtaining that property or credit. Such fraud, with resulting nondischargeability, is not lightly found, but only applies "to actual or positive fraud rather than fraud implied in law."[139]

Under subsection (A), unlike subsection (B), the representation (if one is required in the particular case) does not have to be in writing, but may be oral. Silence as to or concealment of a material fact is held to be sufficient by the overwhelming majority of courts, although a small minority insist on an actual overt false representation. In *Mans* the Court implicitly approved the majority view, as the Court addressed the reliance issue on the merits without expressing any concern over the fact that the representation was not overt but was by omission.[140] The misrepresented fact cannot be as to the financial condition of the debtor or an insider, however, which is covered exclusively by subsection (B). Since § 523(a)(2)(B) also requires a writing, this means that an oral misrepresentation as to financial condition is dischargeable.

A common problem is whether a debtor's statement is one of fact, and thus potentially within the discharge exception, or just the expression of an opinion—mere "puffery"—in which case the exception fails. This problem often arises when the debtor makes a statement as to the value of property to the creditor in connection with the obtaining of property or credit, which later proves to be wildly inaccurate.

The scienter requirement has been construed with some sympathy toward the creditor's inherent difficulty in proving a case predicated on the other party's actual state of mind. Circumstantial evidence of the debtor's intent to deceive is permissible. Furthermore, most courts allow recklessness as to the truth of a statement to satisfy the intent element.

The courts have had substantial difficulty in resolving the case in which the debtor issues a check for goods or services and the check is then dishonored. Some courts have held that the issuance of a check constitutes an implied representation that there are sufficient funds in the account to cover the check, and that fraud is thus established upon further proof that the debtor knew at the time the check was issued that sufficient funds in fact were lacking. Other courts, however, have held that the mere issuance of a bad check is not in and of itself a fraudulent misrepresentation sufficient to establish a cause of action under § 523(a)(2). These cases rely on the non-bankruptcy Supreme Court case of *Williams v. United States*.[141] The Court in *Williams* stated that, "a check is not a factual assertion at all, and therefore cannot be characterized as 'true' or 'false.' "[142] Those courts that rely on *Williams* require

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[139] 124 Cong. Rec. H11,096 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini). These excerpts from the legislative history show the intent of Congress to codify thereby the holding of *Neal v. Clark*, 95 U.S. 704 (1877), that actual fraud is required.

[140] 516 U.S. 59 (1995)

[141] 458 U.S. 279 (1982).

[142] Id. at 284–85.

something more to trigger § 523(a)(2), such as an additional oral representation that the check will be honored or the intentional issuance of the bad check to forestall imminent collection efforts. Of course, it is possible that the Supreme Court's decision in *Ritz,* holding that a false representation by the debtor is not necessarily required under § 523(a)(2), as long as the debtor commited some form of "actual fraud," might encourage courts in "bad check" cases likewise to ignore the lack of a technical "representation," and simply to hang their hats on the inherent fraud of issuing the NSF check.

Perhaps the most common, difficult and contentious question courts have faced under the fraud exception is the situation where the debtor runs up a *credit card* debt and then shortly thereafter files bankruptcy.. While at first blush such a debtor's behavior seems obviously fraudulent, on closer examination the nature of a credit card case makes for an awkward fit for fraud. Given the way credit cards are used and approved, it often is problematic to find several of the elements of fraud, including (1) a *representation* of fact by the debtor to the credit card issuer as to either the debtor's ability to pay or intent to pay; (2) the debtor's *intent* to deceive the creditor; and (3) actual and justifiable *reliance* by the creditor.[143] Note that in these credit card cases, even after *Ritz,* complaining creditors will have to prove traditional common law fraud elements, since there is no handy alternative generic "actual fraud" to use instead, as there is the fraudulent transfer cases.

As to the representation issue, the credit card case is difficult to distinguish from the bad check case, and thus arguably should be controlled by *Williams*. As one prominent bankruptcy judge observed in concluding that "[t]he use of a credit card to incur debt in a typical credit card transaction involves no representation, express or implied," the force of *Williams* is inescapable:

> The similarities between the issuance of a check and the use of a credit card are sufficient to make it illogical to conclude that the use of a credit card in an ordinary credit transaction necessarily invokes a representation, when the issuance of a bad check does not, per se, involve a representation. Just as the Supreme Court has held a check is not capable of being true or false, using a credit card to incur debt in of itself is not capable of being true or false.[144]

Nevertheless, the vast majority of courts have held that the debtor, by using the credit card, *is* making an *implied* representation that he at least has the *intent* to repay the debt.[145] Thus, to give an extreme example to illustrate the point, a debtor who stops on the way to the federal courthouse to file bankruptcy and charges $5,000 on his credit card obviously never intended to repay that credit card debt, and most courts are going to exclude that debt from discharge under § 523(a)(2)(A). A debtor who wantonly "runs up" a substantial credit card debt in the days and weeks before filing bankruptcy is a prime candidate to be caught under the fraud exception. But the debtor who simply gets in over her head, and keeps getting in deeper and deeper, all the while hoping

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[143] *In re Stearns*, 241 B.R. 611 (Bankr. D. Minn. 1999), thoughtfully examines the difficulties in proving fraud from the mere use of a credit card. See also In re Mercer, 246 F.3d 391 (5th Cir. 2001); In re Anastas, 94 F.3d 1280 (9th Cir. 1996); In re Mowdy, 526 B.R. 63 (Bankr. W.D. Okla. 2015).

[144] In re Alvi, 191 B.R. 724, 732 (Bankr. N.D. Ill. 1996).

[145] See, e.g., cases cited supra note 141.

against hope that she can "turn it around" and pay off her debts, might escape.[146] Such debtor may be a fool, but she is not a crook.

Some courts have even concluded that the debtor's use of a credit card is an implied representation that the debtor has the *ability* to repay the debt, but that view should be plainly foreclosed under the Code's scheme. The representation of "ability" to pay is a representation as to *financial condition* and thus can be dealt with only under subsection (B) of § 523(a)(2), which requires a written—not an implied—representation by the debtor.[147]

Assuming that a court is willing, as a matter of law, to follow the implied misrepresentation of intent to repay approach, the challenging task remains of determining whether such an intent can be shown on the facts. The creditor must prove that at the time the card was used the debtor did not have a present intent to repay; the fact that the charges ultimately were not paid is not sufficient proof by itself. Section 523(a)(2)(C), discussed below, now may ease the creditor's proof problems in the case of pre-bankruptcy spending sprees.

Most courts have resorted to examination of a variety of objective surrounding circumstantial factors to determine the subjective *intent* of the debtor, both in determining the intent to repay and the intent to deceive. In other words, these courts assess the "totality of the circumstances,"[148] weighing various factors in an effort to divine whether the debtor has been engaged in an overall pattern of deceptive conduct.[149] In effect, courts employ "badges of fraud" tailored to the specific circumstances of credit card use. At some point the objective unlikelihood of repayment casts enough doubt on the credibility of the debtor's protestations of subjective

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[146] See, e.g., *Stearns*, 241 B.R. at 624.

[147] See In re Ortiz, 441 B.R. 73, 83 (Bankr. W.D. Tex. 2010).

[148] See, e.g., In re Morrison, 555 F.3d 473, 482 (5th Cir. 2009); In re White, 128 Fed. Appx. 994, 999 (4th Cir. 2005); In re Massa, 187 F.3d 292, 297 (2d Cir. 1999); In re Rembert, 141 F.3d 277, 282 (6th Cir. 1998); Palmacci v. Umpierrez, 121 F.3d 781, 789 (1st Cir. 1997); In re Eashai, 87 F.3d 1082, 1087 (9th Cir. 1996); In re Quinn, 492 B.R. 341 (Bankr. N.D. Ga. 2013); In re Warren, 507 B.R. 862, 876 (Bankr. D.S.C. 2013).

[149] See *Eashai*, 87 F.3d at 1087–88 (citing In re Dougherty, 84 B.R. 653 (B.A.P. 9th Cir. 1988)) (incorporating the twelve *Dougherty* factors, used to establish the element of intent to deceive, into an approach which also considers all of the elements of common law fraud). The twelve factors from *Dougherty* are:

1. The length of time between the charges made and the filing of bankruptcy;
2. Whether or not an attorney has been consulted concerning the filing of bankruptcy before the charges were made;
3. The number of charges made;
4. The amount of the charges;
5. The financial condition of the debtor at the time the charges are made;
6. Whether the charges were above the credit limit of the account;
7. Whether the debtor made multiple charges on the same day;
8. Whether or not the debtor was employed;
9. The debtor's prospects for employment;
10. Financial sophistication of the debtor;
11. Whether there was a sudden change in the debtor's buying habits; and
12. Whether the purchases were made for luxuries or necessities.

innocence that the creditor will prevail. But the possibility of an "empty head, pure heart" defense remains.

A competing minority approach is the "assumption of risk" test. Under this view, the credit card issuer is assigned more responsibility to monitor the activities of the debtor. Discharge of the debt will be denied only if the charges were made after the card was revoked, or if a known credit limit was exceeded.[150] Otherwise, the creditor is said to assume the risk that the debtor will incur charges that it cannot repay.

Assuming that the creditor can surmount the misrepresentation and intent hurdles, it still must prove that it actually and justifiably *relied* on the debtor's implied representation of intent to repay.[151] Here again, given the reality of how credit card transactions are approved and processed, finding specific reliance by the credit card issuer in any particular transaction is essentially fictional. In effect, courts must imply a reliance on an implied representation—a house of legal cards that is hard to square with the notion that actual fraud must be established. As one court noted, "In a dischargeability proceeding based on a depersonalized and open-ended credit relationship like that on today's charge card accounts, identifying just how a creditor 'relies' should be done only in focus, after a finding of active wrongdoing on the part of the account holder."[152] What many courts do is infer reliance unless the creditor has reason to know otherwise: "the credit card issuer justifiably relies on a representation of intent to repay as long as the account is not in default and any initial investigations into a credit report do not raise red flags that would make reliance unjustifiable."[153]

The litigated cases often turn on the nature and degree of the creditor's reliance on the fraudulent statement. In cases involving a false financial statement under subsection (B), the Code expressly requires the creditor to prove *reasonable* reliance. Under this objective test, the courts often will only deny discharge of the debt if the creditor made reasonable efforts to investigate the truth of the debtor's statements.

Subsection (A) is silent on the reliance issue, however. Until the Supreme Court settled the issue in 1995 in *Field v. Mans*,[154] this silence in (A), contrasted with the express requirement of reasonable reliance in (B), gave rise to considerable disagreement as to whether reasonableness was also required under (A). Prior to *Mans*, the majority of courts did demand proof that the creditor's reliance was reasonable in (A) as well as in (B).[155] A few courts held that only actual reliance need be proved under (A).[156] An intermediate view was that the creditor's reliance must be "justifiable," which is a subjective test that takes account of the particular facts and circumstances applicable to this creditor's case.[157] While the creditor under this

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[150] First Nat'l Bank v. Roddenberry, 701 F.2d 927 (11th Cir. 1983). See also AT & T Universal Card Servs. Corp. v. Pakdaman, 210 B.R. 886, 888 (D. Mass. 1997); In re Marrow, 488 B.R. 471, 478 (Bankr. N.D. Ga. 2012); In re Allen, 528 B.R. 854, 858–59 (Bankr. N.D. Ga. 2015).

[151] See *Mercer*, 246 F.3d at 403. See also *Warren*, 507 B.R. at 878–81.

[152] *Stearns*, 241 B.R. at 627.

[153] *Anastas*, 94 F.3d at 1286 (citing *Eashai*, 87 F.3d at 1091).

[154] 516 U.S. 59 (1995).

[155] E.g., In re Mullet, 817 F.2d 677 (10th Cir. 1987) (abrogated by Field v. Mans, 516 U.S. 59 (1995)).

[156] E.g., In re Mayer, 51 F.3d 670 (7th Cir. 1995); In re Ophaug, 827 F.2d 340 (8th Cir. 1987).

[157] In re Kirsh, 973 F.2d 1454, 1460 (9th Cir. 1992); In re Vincent Andrews Management Corp., 507 B.R. 78, 82–85 (D. Conn. 2014).

intermediate test did not have to live up to the standard of diligence and inquiry demanded of an objectively reasonable person, that creditor could not go out of its way to avoid discovering the truth.[158]

In *Field v. Mans* the Supreme Court adopted the *justifiable* reliance standard for fraud cases under § 523(a)(2)(A).[159] The Court reasoned that Congress, by using a well-understood term of art in (A), had intended to incorporate the common law meaning of fraud. The prevailing common law view in fraud cases in 1978 (when the Code was enacted) was to require proof only of subjectively justifiable reliance, rather than objectively reasonable reliance. As the Court observed, though, reasonableness is not entirely irrelevant, because extremely unreasonable behavior by the creditor raises serious doubts as to the existence of actual reliance in fact. The Court's holding in *Mans* creates the anomaly (which the Court frankly admitted)[160] that the creditor has a more demanding proof burden when the debtor's fraud is incorporated in a written financial statement. The Court explained this oddity by showing that in the legislative history to the Code Congress expressed concern about creditor abuses with regard to false financial statements.[161]

The creditor trying to prove reliance must establish a proper temporal relation between the false statement and the credit decision. If the statement was made after the credit decision, then reliance obviously is negated; at the same time, it has been held that a creditor cannot reasonably or justifiably rely upon an extremely old and outdated statement.[162] Furthermore, if the creditor knows that the information is false, or should see "red flags" raised by the statement, then reliance on the truthfulness of the statement is unjustified.[163] Many courts assessing reasonableness look to objective factors such as the creditor's normal business practices, the standards and customs of the industry, past relationships between the parties, the amount of the loan, and the sophistication of the lender, all viewed in light of the circumstances surrounding the specific transaction.

One set of issues unique to § 523(a)(2)(B) addresses what constitutes a writing "respecting the debtor's . . . financial condition." Although the normal § 523(a)(2)(B) case involves the familiar formal financial statement, such is not absolutely required by Congress. Any writing that concerns the debtor's financial condition will be enough.

The test of the materiality of the falsehood usually is stated as a "but-for" issue, i.e., whether the creditor would have made the loan even if the truth about the debtor's financial condition had been known. The willingness of courts to allow creditors to prevail on the lesser showing that the false statement was only one contributing factor to the decision to lend is more problematic. Whatever test is used, bankruptcy courts are skeptical of self-serving statements by credit officials regarding the supposedly great import of picayune misstatements or omissions by the debtor.

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[158] Id. at 1461.

[159] 516 U.S. at 74–75.

[160] Id. at 76–77.

[161] Id. at 447 & n.13 (quoting H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 130–31 (1977)).

[162] See, e.g., In re Baratta, 272 B.R. 501, 506 (Bankr. M.D. Fla. 2001).

[163] See, e.g., In re Gunsteen, 487 B.R. 887, 901–02 (N.D. Ill. 2013).

Section 523(a)(2)(C), added by the 1984 amendments and amended in 1994 and 2005, improves the creditor's ability to win one particular type of dischargeability case: eve-of-bankruptcy consumer spending sprees. That subsection applies by its terms to subsection (A) cases only, and not to subsection (B) cases. The important litigation benefit to the complaining creditor is that in the described situation a *presumption* of nondischargeability is raised, which the debtor then may try to rebut. The presumption applies to two types of "load-ups" by consumers: (1) debts for luxury goods and services totaling more than $675 incurred in the 90 days preceding bankruptcy, and (2) cash advances under an open end credit plan totaling more than $950 in the 70 days preceding bankruptcy. Much of the litigation under subsection (C) concerns what is and what is not a "luxury" item. The statute itself states that a luxury item does "not include goods or services reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor." § 523(a)(2)(C)(ii)(II).

§ 10.18 Unscheduled Debts

The debtor is responsible for scheduling creditors so that they may be notified of the deadlines for filing claims and § 523(c)(1) lawsuits. § 521(1); Rule 1007. A creditor's claim usually will not be allowed if a proof of claim is not filed by the set bar date; and if the claim is not allowed it will not be paid in the ultimate distribution. §§ 501, 502, 726(a). Yet, the discharge under § 727(b) operates as to all prepetition claims, whether or not a proof of claim was filed or the claim was allowed. It would be most unfair to exclude a creditor from the bankruptcy distribution (or prevent the creditor from contesting dischargeability) because the debtor failed to list the creditor properly in the schedules, but nevertheless to discharge that creditor's claim. There are three possible solutions: pay the creditor anyway; not discharge the debt; or both.

Attempting to pay a creditor who has not timely filed a claim usually will not be a viable response to the unscheduled creditor problem. Finding such a creditor may be difficult in the first place. Furthermore, waiting to discover the unknown creditor undermines the goal of distributing the bankruptcy estate to known creditors as promptly as possible. The court may not retroactively extend the time for filing claims to include the omitted creditor.[164] Even though the innocent unscheduled creditor thus may be deprived of the benefit side of a liquidation bankruptcy, the discharge (the detriment side) can easily be avoided as to such a creditor by the simple expedient of excepting the unscheduled debt from discharge. This is the solution the Code adopts in § 523(a)(3).

Section 523(a)(3) operates in a straightforward way. The debt is not discharged if it was not listed in the debtor's schedules in time to permit the creditor to file a proof of claim or a complaint alleging nondischargeability under § 523(a)(2), (4), or (6). The proper listing of the creditor in the schedules must include the correct name and address of the creditor, if known or discoverable by debtor through the exercise of reasonable diligence. §§ 523(a)(3), 521(a)(1); Rule 1007(a), (b). If the debtor accurately lists the creditor, but the creditor is not notified due to the failure of the clerk's office or the mails, the discharge will be effective.

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[164] In re Smith, 21 F.3d 660 (5th Cir. 1994).

A major exception to the operation of § 523(a)(3)'s nondischargeability rule is when the creditor "had notice or actual knowledge" of the bankruptcy case in time to file the proof of claim or dischargeability complaint. The knowledge referred to is of the bankruptcy case generally, and not of the specific bar dates. The debt of such a creditor is discharged in all events, scheduled or not. The rationale is that a creditor with actual knowledge of the bankruptcy case possesses the ability to inquire further and preserve her rights. The usual question that arises is what constitutes "notice or actual knowledge." Creditors are not required to follow up on unsubstantiated rumors. However, notice to an agent or attorney of the creditor typically will be imputed to the creditor. Although a plausible argument can be made that § 523(a)(3) is unconstitutional under the due process clause, based on the Supreme Court's 1953 decision in *City of New York v. New York, New Haven & Hartford Railroad Co.*,[165] the courts under the Code have upheld the constitutionality of that section.[166]

Another question concerns how § 523(a)(3) applies in a no-asset case.[167] In such a case, which occurs with great frequency, creditors are usually notified that it is unnecessary to file a proof of claim. Rule 2002(e). Many courts have permitted the debtor to amend his schedules or reopen a case to include an omitted creditor, as long as the original omission was not fraudulent or intentional, and thereby discharge the creditor's claim.[168] Those courts reason that the creditor was not harmed by the omission, since no dividend was payable anyway, and further state that § 523(a)(3) is not triggered by its terms, since "timely filing" of a proof of claim is inapposite in a no-asset case in which creditors have been instructed not to file claims. The rationale of these cases, where the only "right" lost by not being scheduled was the meaningless filing of a proof of claim, would not seem to apply equally to cases where the lost right is the timely filing of a dischargeability complaint as required by § 523(c)(1) and Rule 4007(c). Other courts reject the "no harm" theory, reasoning that the purpose of the notice to creditors is not just to allow them to file a proof of claim, but also to participate fully in the bankruptcy case, such as by attending the § 341 creditors' meeting and questioning the debtor, voting for the trustee, and the like. The latter view is more prevalent in chapter 11 cases, where creditor participation may actually be meaningful.

§ 10.19 Fiduciary Fraud or Defalcation, Embezzlement, Larceny

Section 523(a)(4) excepts from discharge debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The requirement that the debtor be acting in a fiduciary capacity applies only to the acts of fraud or defalcation; any debtor, fiduciary or not, found to have incurred a debt by embezzlement or larceny will not have that debt discharged. Complaints asserting nondischargeability under § 523(a)(4) must be brought within 60 days of the first meeting of creditors and only in the bankruptcy court. § 523(c)(1); Rule 4007(c).

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[165] 344 U.S. 293, 297 (1953).

[166] See In re Medaglia, 52 F.3d 451 (2d Cir. 1995); Yukon Self Storage Fund v. Green (In re Green), 876 F.2d 854, 856–57 (10th Cir. 1989); In re Sunland, Inc., 534 B.R. 793, 798–99 (Bankr. D.N.M. 2015).

[167] See Lauren A. Helbling & Christopher M. Klein, The Emerging Harmless Innocent Omission Defense to Nondischargeability Under Bankruptcy Code § 523(a)(3)(A): Making Sense of the Confusion Over Reopening Cases and Amending Schedules to Add Omitted Debts, 69 Am. Bankr. L.J. 33, 42–43 (1995).

[168] E.g., In re Stone, 10 F.3d 285 (5th Cir. 1994).

Relatively fewer cases involve allegations of embezzlement or larceny than fiduciary misconduct. Both embezzlement and larceny involve the fraudulent appropriation of the money or property of another by the debtor with the intent to convert that property to the debtor's own use. The difference is that in larceny the initial taking itself must have been wrongful, whereas in embezzlement the debtor's original possession is lawful, with the misappropriation occurring subsequent thereto. Regardless, both constitute crimes, and a prior criminal conviction will be given collateral estoppel effect on the dischargeability issue.

Many more cases address the fiduciary wrongdoings prong, although courts narrowly construe both the requirements of (1) a fiduciary relationship and (2) fraud or defalcation. The necessary fiduciary relationship, determined as a matter of federal law, must arise out of a technical or express trust, and must exist independently of the alleged wrongdoing.[169] Implied or constructive trusts are not enough. Usually a contract or statute (state or federal) creating the fiduciary relationship is required. Misfeasance in the context of ordinary commercial relationships normally will not suffice.

Common types of litigated cases involve the conversion of a secured party's collateral by a debtor; the misapplication of funds collected by an insurance agent; the diversion of payments by a building contractor; or a failure to make required contributions to an ERISA plan. In the collateral conversion case, courts almost never except the debt under § 523(a)(4),[170] although § 523(a)(6) remains a possibility.[171] In the insurance cases the creditor stands a better chance, depending on the terms of the contract and on the existence of a state statute.[172] The builder cases often turn on the specific terms of the governing state statute,[173] but often the contractor is found to be a fiduciary.[174] In some situations courts will ignore a state statute that purports to make the debtor a fiduciary to the state itself, reasoning that the statute is nothing more than the state's attempt to make its own claim nondischargeable in bankruptcy.[175] Creditors rarely prevail in the ERISA cases, either because the unpaid contributions are not considered plan assets, or because the debtor who is the plan administrator is not deemed a sufficient fiduciary for purposes of § 523(a)(4).[176]

Even if a fiduciary relationship is found, the creditor must also prove that the debtor committed "fraud" or "defalcation" while acting in that capacity. An early Supreme Court case, *Neal v. Clark*, which arose under the Bankruptcy Act of 1867, concluded that "fraud" had the same meaning in the fourth exception as under the second exception, namely that it "means positive fraud, or fraud in fact, involving

[169] Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934).

[170] Id.

[171] See, e.g., In re Tinkler, 311 B.R. 869 (Bankr. D. Colo. 2004).

[172] E.g., In re Coley, 354 B.R. 813 (Bankr. N.D. Tex. 2006).

[173] E.g., In re Johnson, 691 F.2d 249 (6th Cir. 1982).

[174] See, e.g., In re Patel, 565 F.3d 963 (6th Cir. 2009).

[175] See, e.g., In re Marchiando, 13 F.3d 1111 (7th Cir.), cert. denied, 512 U.S. 1205 (1994) (lottery agent who failed to remit proceeds of lottery sales discharged).

[176] See, e.g., In re Halpin, 566 F.3d 286 (2d Cir. 2009); In re Bucci, 493 F.3d 635 (6th Cir. 2007), cert. denied, 553 U.S. 1093 (2008); In re Luna, 406 F.3d 1192 (10th Cir. 2005); Bos v. Board of Trustees, 795 F.3d 1006 (9th Cir. 2015). But see In re Hemmeter, 242 F.3d 1186 (9th Cir. 2001).

moral turpitude or intentional wrong, . . . and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality."[177] Justice Harlan for the Court came to this conclusion in part because of the grouping of "fraud" with "embezzlement," which does require intentional wrongdoing, and in part to further "the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency."[178]

The meaning of "defalcation," by contrast, was the subject of widespread disagreement for well over a century. Courts differed sharply over what mental state had to be proven. The leading historical exposition of the development and meaning of the "defalcation" rule was by Judge Learned Hand in a 1937 case, *Central Hanover Bank & Trust Co. v. Herbst*.[179] While far from crystalline, that opinion at the very least appeared to stand for the proposition that "defalcation" required *less* of a culpable mental state than its statutory companions in the fourth exception (fraud, misappropriation, and embezzlement under the Bankruptcy Act then in effect).[180] As to how much less, though, Hand equivocated; he observed both that " 'defalcation' may demand some portion of misconduct" and yet also acknowledged the possibility that a prior version of the statute "may have included innocent defaults."[181]

Hand's equivocation was repeated endlessly in hopelessly conflicting circuit court decisions for the next three-quarters of a century, both under the Bankruptcy Act and the 1978 Bankruptcy Code now in effect, until finally settled by the Supreme Court in 2013. The Courts of Appeals embraced at least three different standards. The least demanding was that even an innocent mistake, or at the most negligence, would suffice.[182] The middle view, which commanded the largest following, required proof that the debtor acted recklessly, judged objectively.[183] The most demanding standard was extreme recklessness.[184]

In 2013 the Supreme Court opted for the most demanding standard of culpability in *Bullock v. BankChampaign, N.A.*[185] As it had in *Neal v. Clark*, the *Bullock* Court presumed that the various terms in the fourth exception—*including* "defalcation"—carried similar culpability requirements, all necessitating proof of scienter.[186] The Court in *Bullock* accordingly held that "the term 'defalcation' . . . includes a culpable state of mind requirement akin to that which accompanies application of the other

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[177] 95 U.S. 704, 709 (1878).

[178] Id.

[179] 93 F.2d 510 (2d Cir. 1937).

[180] Id. at 512.

[181] Id. at 511–12.

[182] See, e.g., In re Strack, 524 F.3d 493 (4th Cir. 2008); In re Banks, 263 F.3d 862 (9th Cir. 2001); In re Cochrane, 124 F.3d 978, 984 (8th Cir. 1997).

[183] See, e.g., Bullock v. BankChampaign, N.A. (In re Bullock), 670 F.3d 1160, 1166 (11th Cir. 2012), vacated and remanded, 133 S.Ct. 1754 (2013); In re Harwood, 637 F.3d 615, 624 (5th Cir. 2011); In re Berman, 629 F.3d 761, 765 n.3 (7th Cir. 2011); In re Patel, 565 F.3d 963, 970 (6th Cir. 2009). See also Meyer v. Rigdon, 36 F.3d 1375, 1385 (7th Cir. 1994).

[184] See, e.g., In re Hyman, 502 F.3d 61 (2d Cir. 2007); In re Baylis, 313 F.3d 9 (1st Cir. 2002).

[185] 133 S.Ct. 1754 (2013).

[186] Id. at 1759–60. This canon parades under the very fancy name of "*noscitur a sociis*," which is Latin meaning "known by its associates"; the point is that the meaning of a word in a statutory text can be gleaned by comparison to other words in the same statutory context.

terms in the same statutory phrase. We describe that state of mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."[187] The Court pointed out that this heightened standard requiring scienter would be especially beneficial to "*nonprofessional* trustees, perhaps administering small family trusts potentially immersed in intrafamily arguments that are difficult to evaluate in terms of comparative fault."[188] Furthermore, again as it had in *Neal* 135 years earlier, the Court gave the exclusion from discharge the most narrow possible reading, so as to preserve and promote the "fresh start" policy for the debtor's benefit, excepting only cases involving clear wrongdoing and fault.[189]

Randy Bullock was almost the perfect candidate for the Court to construe § 523(a)(4) in the most favorable way for debtors. He was a nonprofessional trustee of a small family trust (indeed, until the settlor asked him to take out a loan from the trust, he was not even aware that he was the trustee!), his only wrongdoing was technical self-dealing (borrowing from the trust in excess of the authorization specifically granted—and as noted, one of the loans was taken at the instance of the settlor, his father, and another was on behalf of his mother), and he repaid all monies borrowed, with interest! But in the finest Dickensian fashion, his greedy brothers had sued him successfully in Illinois state court for a breach of fiduciary duty under state law, and, even though that court acknowledged that Randy did not have a malicious motive, the brothers got a judgment imposing a constructive trust on the benefits the debtor obtained from the loans, over and above the principal and interest that he had fully repaid. When he could not pay off the judgment debt (in part because the Bank, the successor trustee, blocked him from selling one of the properties he had purchased with one of the loans), he filed bankruptcy and sought to discharge the Illinois judgment debt. The lower courts had all held that the debt was not dischargeable under the middle standard (objective recklessness), since Bullock "should have known that he was engaging in self-dealing."[190] Under the Supreme Court's heightened standard, though, it is highly likely that Randy Bullock will be able to discharge the debt. So too will many other debtors who find themselves technically cast in a fiduciary role (such as, for example, a building contractor) and who make some mistakes in exercising their duties, nevertheless still be able to obtain a discharge unless they knowingly breached those duties in a manner that substantiates a finding of clear fault.

It is worth noting that the Court's approach in *Bullock* is quite favorable to debtors, and strongly furthers the fresh start policy. Looking beyond the specific context of the decision, *Bullock* could be powerful authority for an expansive

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[187] Id. at 1755. The Court elaborated:

> Thus, where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong. We include as intentional not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. Thus, we include reckless conduct of the kind set forth in the Model Penal Code. Where actual knowledge of wrongdoing is lacking, we consider conduct as equivalent if the fiduciary "consciously disregards" (or is willfully blind to) "a substantial and unjustifiable risk" that his conduct will turn out to violate a fiduciary duty.

Id. at 1759. This meaning is similar to what the Court has required in the securities fraud area.

[188] Id. at 1761 (emphasis in original).

[189] Id. at 1760–61.

[190] 670 F.3d at 1166.

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interpretation of the reach of the fresh start policy and for a very narrow scope for exclusions therefrom. *Bullock*'s limitation of the discharge exception to cases involving knowing debtor fault mirrors its approach taken to other exceptions, such as, for example, its decision in *Kawaauhau v. Geiger*[191] requiring proof of a subjective intent to injure to constitute willful and malicious injury under § 523(a)(6). In other areas (e.g., the means test of chapter 7 and the best efforts test of chapter 13), the Court seems unsympathetic to the light of individual debtors. But *Bullock* suggests that the fresh start policy perhaps is not dead quite yet. Yet, having said that, the Court's more recent decision in *Ritz*,[192] extending the scope of the § 523(a)(2) fraud exception to discharge to include actually fraudulent transfers, suggests that the Court remains ready to read the Bankruptcy Code in a way, even if strained, that will treat debtors who act badly very harshly.

§ 10.20 Domestic Support Obligations

Bankruptcy is not a haven for debtors hoping to discharge obligations to support their family. Even before a specific exception to discharge embodied this principle, the Supreme Court refused to permit the discharge of such obligations.[193] Sections 523(a)(5) and 523(a)(15) subordinate the fresh start goal for the individual debtor to the policy that family support debts must be paid. Debts covered by § 523(a)(5) are even excepted from a chapter 13 full-compliance discharge, § 1328(a)(2), and may be enforced against the debtor's exempt property. § 522(c)(1).

In a new § 101(14A), the 2005 amendments introduced the new term "domestic support obligation," which is used throughout the Code, including in § 523(a)(5). Domestic support obligations are defined broadly to include almost all types of debts in the nature of alimony, maintenance, or support owed to the debtor's spouse or former spouse, child, parent or guardian of the debtor's child, or a governmental unit. However, unless voluntarily assigned by the debtor for the purpose of collection, a debt assigned to a non-governmental entity is not a domestic support obligation. § 101(14A)(D). Domestic support obligations can be established pursuant to a separation agreement, property settlement, divorce decree, or court order, and include debts accruing at any point before, on or after the order for relief, including all accrued interest. § 101(14A).

Before 1994 the most important scope limitation of the fifth exception was that the debt had to be "actually in the nature of alimony, maintenance, or support."[194] A property division or property settlement obligation is not excluded from discharge under § 523(a)(5), and until 1994 was always dischargeable. Also dischargeable before 1994 were "hold harmless" debts, in which the debtor spouse agreed to pay certain marital debts and hold the non-debtor spouse harmless from such debts. In the 1994 amendments Congress added § 523(a)(15), which makes property settlement debts and hold harmless agreements nondischargeable as well. Thus, the issue of whether a domestic debt is actually in the nature of alimony, maintenance, or support (and thus potentially within the fifth exception) now is less critical, given the possible fall-back of

[191] 523 U.S. 57 (1998). See also § 10.21.

[192] 136 S.Ct. 1581, 1586 (2016). See supra notes 128–30, 137–38 and accompanying text.

[193] Wetmore v. Markoe, 196 U.S. 68 (1904).

[194] Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, § 523(a)(5)(B), 92 Stat. 2549 (amended 1994).

the fifteenth exception. In 2005, BAPCPA amended 523(a)(15) to remove the affirmative defenses previously included, making all property settlements arising from divorce or separation nondischargeable. Note, though, that fifth exception debts are not discharged in chapter 13[195] and are enforceable against exempt property, but fifteenth exception debts enjoy neither benefit. The distinction between a marital debt that is covered by § 523(a)(5) and one that is only covered by § 523(a)(15) thus remains important, although considerably less so than before 1994.

Drawing the line between debts that are and those that are not actually in the nature of alimony, maintenance or support has proven difficult for courts. Most have resorted to consideration of a long laundry list of factors. It is important to determine that the obligation be based on an enforceable duty of support.[196] The intent of the parties at the time of the decree is important.[197] However, the label placed on the debt by the parties themselves or by the state court is not controlling. The bankruptcy court must determine the nature of the debt as a matter of *federal* law.[198] Of course, bankruptcy courts undoubtedly will borrow heavily from state domestic relations law in making this determination. Until 2005, the applicability of the fifteenth exception had to be litigated exclusively in the bankruptcy court, but that restriction was dropped in BAPCPA. Now, state courts have concurrent jurisdiction to decide whether either § 523(a)(5) or § 523(a)(15) applies. Thus, a creditor can wait to litigate the applicability of a marital debt until after bankruptcy, and proceed in state court.

One question is whether the bankruptcy court's inquiry extends to a consideration of changed circumstances. While the vast majority of courts look only at the nature of the debt at the time of the original decree, and thus refuse to take changed circumstances into account,[199] the Sixth Circuit in *In re Calhoun* held that the court should consider how the financial circumstances of the respective parties may have changed in the interim since that original decree.[200] Doing so would create a heavy burden for the bankruptcy courts, and likely would cause more debts to be discharged.

The final limitation of § 523(a)(5) (through § 101(14A)(C)) is that the debt must be based on a separation or property settlement agreement, a divorce decree, other court order, or a determination made by a governmental unit under applicable non-bankruptcy law. This makes dischargeable common law support obligations which are not embodied in one of the cited vehicles, as well as other contractual debts for

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[195] 11 U.S.C. § 1328(a)(2).

[196] See Audubon v. Shufeldt, 181 U.S. 575 (1901).

[197] See, e.g., In re Zamos, 300 Fed. Appx. 451, 452 (9th Cir. 2008); In re Evert, 342 F.3d 358, 368 (5th Cir. 2003); In re Brody, 3 F.3d 35 (2d Cir. 1993); In re Sampson, 997 F.2d 717 (10th Cir. 1993); In re Okrepka, 533 B.R. 327, 334–35 (Bankr. D. Kan. 2015); In re Waller, 525 B.R. 473, 480–82 (Bankr. D. Kan. 2014).

[198] See In re Brody, 3 F.3d 35, 39 (2d Cir. 1993); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 364 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6320; S. Rep. No.989, 95th Cong., 2d Sess., at 79 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5865.

[199] E.g., Forsdick v. Turgeon, 812 F.2d 801, 803 (2d Cir. 1987); In re Harrell, 754 F.2d 902, 906–07 (11th Cir. 1985); Rockstone Capital LLC v. Metal, 508 B.R. 552, 560–63 (E.D.N.Y. 2014).

[200] 715 F.2d 1103, 1109–10 (6th Cir. 1983). The Sixth Circuit itself has expressed regret that *Calhoun* has been read more broadly than intended, and relief that other jurisdictions have not taken that course. See In re Fitzgerald, 9 F.3d 517, 520 (6th Cir. 1993).

necessaries and the like not part of an actual separation or property settlement agreement.

§ 10.21 Willful and Malicious Injury

Ever since the passage of the Bankruptcy Act of 1898, Congress has excepted from discharge debts stemming from "willful and malicious" injuries by the debtor.[201] The current exception is § 523(a)(6). The bankruptcy court has exclusive jurisdiction (under § 523(c)(1)) to determine dischargeability issues under § 523(a)(6), although this exception (along with fraud) is a prime candidate for application of collateral estoppel. The section prevents the discharge of debts based on intentional torts ("willful") that contain some aggravating features ("malicious"). Exactly how aggravating has proven to be difficult to pin down. Punitive damages, which are often awarded on proof of malice, may be excepted from discharge under this section.[202]

Two elements must be proved to establish the § 523(a)(6) exception. First, the debtor's actions must have been *"willful,"* which, as the legislative history emphasizes, means "deliberate or intentional."[203] Cases allowing a "reckless disregard" standard to suffice were intended to be overruled by the 1978 Code. Behavior that is merely negligent (or even reckless) would not give rise to a nondischargeable debt under the sixth exception. For the most part, this part of the statutory formulation has caused relatively little trouble for the courts. Perhaps the most difficulty has come in the drunk driving cases. In 1984, however, Congress added a separate discharge exception for DUI debts for death or personal injury, § 523(a)(9), which does not require proof of intent.[204] In DUI property damage cases, however, to which (9) does not apply, subsection (6) remains important.

Most of the interpretive difficulty has come from the second element of § 523(a)(6), that the debtor's actions must have been *"malicious."* Until 1998, courts differed widely on the proper meaning of malice. The issue has arisen most often in three types of cases: (1) the debtor converts the secured creditor's collateral for the debtor's own benefit and then dissipates the collateral proceeds; (2) the debtor inflicts an injury driving a vehicle while intoxicated; and (3) a physician commits particularly egregious malpractice.

The question is whether the section requires proof of "*special* malice"—i.e., that the debtor *intended to injure* the creditor—or whether it is sufficient to prove "*implied* malice"—i.e., that the debtor intentionally committed an act knowing that the act was wrongful and was likely to harm the creditor, without just cause or excuse. The Supreme Court misleadingly framed the question in the leading 1998 case of *Kawaauhau v. Geiger* (one of the "bad doctor" cases) as follows: "We confront this pivotal question concerning the scope of the "willful and malicious injury" exception: Does § 523(a)(6)'s compass cover acts, done intentionally, that cause injury (as the

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[201] See Charles Jordan Tabb, The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate, 59 Geo. Wash. L. Rev. 56 (1990).

[202] See, e.g., In re Scarborough, 171 F.3d 638 (8th Cir. 1999); In re McNallen, 62 F.3d 619 (4th Cir. 1995).

[203] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 365 (1977); S. Rep. No. 95–989, 95th Cong., 2d Sess., at 79 (1978).

[204] See § 10.24.

[debtors] urge), or only acts done with the actual intent to cause injury?"[205] The Court opted for the latter reading. In so holding, the Court (if taken at its word) could have caused harm to intentional tort victims who will stand helpless as their debts are discharged, because they will be unable to prove that the debtor acted with the actual subjective intent to injure them, even though the debtor may have acted intentionally, knowing that what he did was wrong and was substantially certain to injure the creditor, but nevertheless was not motivated by any personal animus to the creditor.

The *Geiger* Court omitted a third plausible, and indeed preferable, interpretation (and one that had prevailed for almost a century): that the debtor intentionally committed an act that caused injury, knowing that the act was wrongful and substantially certain to cause injury, without justification or excuse. The important additions of this preferred interpretation to the Court's "straw man" first alternative (that the debtor intentionally committed an act that caused injury) are that the debtor (1) knew the act it committed was wrongful, (2) knew the act was substantially certain to cause injury, and (3) in so acting, had no justification or excuse. As will be discussed below, post-*Geiger*, many lower courts have "read" *Geiger* as allowing exception to discharge on proof of the elements of this third formulation.

In deciding *Geiger,* the Court was not writing on a clean slate. The original interpretation, in the 1904 Supreme Court case of *Tinker v. Colwell*, required only *implied* malice.[206] Thus, Charles Tinker was unable to discharge a $50,000 judgment based on "criminal conversation" (adultery) with Frederick Colwell's wife, irrespective of whether Tinker was driven by malevolence toward Frederick or just passion for Frederick's wife. Instead, according to the *Tinker* Court, "[m]alice, in common acceptation, means ill will against a person; but in its legal sense it means a wrongful act, done intentionally, without just cause or excuse."[207] Thus, the Court in *Tinker* concluded that a "wilful disregard of what one knows to be his duty, an act which is against good morals, and wrongful in and of itself, and which necessarily causes injury and is done intentionally, may be said to be done wilfully and maliciously, so as to come within the exception."[208]

While *Tinker* established that special malice need not be shown, the 1934 Supreme Court case of *Davis v. Aetna Acceptance Co.*[209] illustrated that not every intentional tort falls within the exception. The creditor objected to discharge of a debt

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[205] 523 U.S. 57, 61 (1998).

[206] 193 U.S. 473 (1904). The Court explained:

> There may be cases where the act has been performed without any particular malice towards the husband, but we are of opinion that, within the meaning of the exception, it is not necessary that there should be this particular, and, so to speak, personal malevolence toward the husband, but that the act itself necessarily implies that degree of malice which is sufficient to bring the case within the exception stated in the statute. The act is wilful, of course, in the sense that it is intentional and voluntary, and we think that it is also malicious within the meaning of the statute.
>
> In order to come within that meaning as a judgment for a wilful and malicious injury to person or property, it is not necessary that the cause of action be based upon special malice, so that without it the action could not be maintained.

Id. at 485.

[207] Id. at 485–86.

[208] Id. at 487.

[209] 293 U.S. 328 (1934).

following the debtor's conversion of the creditor's collateral. Even though the lower courts had found that the debtor's act did constitute a legal conversion, which indisputably is an intentional tort, the Court concluded that not every conversion was excluded from discharge, but that aggravating features were required.[210] In that case, the debtor mistakenly but innocently believed that he had authority to sell the collateral and use the proceeds. Such a technical conversion, while done intentionally, is not "malicious," the Court held, and the resulting debt was held to be dischargeable.[211]

In *Geiger*, the Supreme Court confronted a case in which the debtor, Dr. Paul Geiger, had committed particularly egregious malpractice by knowingly and admittedly prescribing a course of antibiotic treatment for an infection that he knew to be less effective than a viable alternative, and then cavalierly canceling that treatment altogether, causing Margaret Kawaauhau to have her leg amputated. Margaret argued that Geiger's knowing malpractice met the *Tinker* standard of "willful disregard of what one knows to be his duty, an act which is against good morals, and wrongful in and of itself, and which necessarily causes injury and is done intentionally."

The *Geiger* Court disagreed. Having framed the question of the section's scope as a false choice between the alternatives of encompassing every act done intentionally by a debtor that causes injury or only acts done with the intent to cause injury, the Court chose the latter. It held that "nondischargeability takes a deliberate or intentional *injury,* not merely a deliberate or intentional *act* that leads to injury."[212] The Court relied heavily on the statutory text, observing that "[t]he word 'willful' in (a)(6) modifies the word 'injury.' "[213] Thus, the Court held "that debts arising from recklessly or negligently inflicted injuries do not fall within the compass of § 523(a)(6)."[214] This last holding, standing alone, might not work mischief, but the earlier statement, that a "deliberate or intentional injury" is required, could.

The *Geiger* Court sought to limit subsection (6) to *intentional torts*,[215] which is a defensible interpretation of the section, but the way they did so—by also requiring an *intent to injure*—went too far, and much farther than needed to decide the case. By doing so they created the potential for unfair results in certain recurring cases (especially the collateral conversion cases), as explained below. The Supreme Court could have decided against Margaret Kawaauhau simply by saying that the debtor, Dr. Paul Geiger, did not commit a "willful" (or "intentional") tort, but at most acted with gross negligence (or even a "reckless disregard"). The 1978 legislative history, reacting to a spate of drunk driving cases that had gone against the debtor, makes clear that Congress thought that the section required an intentional tort.[216] Indeed, even in *Tinker* the Court had taken pains to note that a debtor who merely acts negligently, and not intentionally, would not come within the exception.[217] The way the Court in

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[210] Id. at 333.

[211] Id.

[212] Kawaauhau v. Geiger, 523 U.S. 57, 61 (1998).

[213] Id.

[214] Id. at 64.

[215] Id. at 61.

[216] See supra note 203 and accompanying text.

[217] 193 U.S. 473, 489 (1904).

Geiger read subsection (6), though, not only requires an intentional tort, but an intentional tort in which the debtor also intends to injure the victim. Taking the Court at its word, this further and entirely unnecessary elaboration effectively overturns the *implied malice* standard of *Tinker*, and puts a *special malice* standard in its place. The essence of "special" malice is a subjective intent to cause injury.

The Court in *Geiger* distinguished *Tinker* on the ground that *Tinker* involved an intentional tort.[218] Fair enough. But in finding that Dr. Geiger had not committed an intentional tort, the Supreme Court did not also need to throw out *Tinker's* implied malice standard and require proof of intent to injure. Indeed, under the new *Geiger* standard, Tinker's chances of receiving a discharge for his debt to the cuckolded husband would be much greater, since Colwell would have to show that Tinker *intended to injure* him by having an affair with his wife. That Tinker knew that what he was doing was wrong, knew that by doing so he was substantially certain to cause injury to Colwell, and knew that he had no justification for doing so, would not seem to suffice under *Geiger*.

The *Geiger* opinion seems to conflate the separate elements of willfulness and malice into a single unitary test of "intent to injure." Indeed, under the Court's formulation, it is entirely unclear what the word "malicious" adds. It is exceedingly difficult to think of many (any?) cases in which a debtor who inflicted a "willful . . . injury" (meaning, as the *Geiger* Court asserts, an "actual intent to cause injury") would not *also* have acted with malice.

After *Geiger*, we at least do know how to resolve two of the three types of common cases. Debts arising in the "bad doctor" cases involving horrific medical malpractice will be *discharged*, unless the victim can prove both that the doctor's malpractice rose to the level of an intentional tort (battery, perhaps?) *and* that the physician acted with an intent to injure the victim (or, as explained below, knew that his actions were substantially certain to cause injury). Debts arising from drunk driving will also fall outside the scope of the § 523(a)(6) exception (but § 523(a)(9) remains possibly available).

That leaves collateral conversion cases. Literally thousands of § 523(a)(6) cases involve the conversion by the debtor of a secured party's collateral.[219] There also have been a considerable number of cases involving misappropriation of trade secrets, which are similar to the conversion cases in that they also involve the taking of another's property. It is in these sorts of situations that *Geiger's* "intent-to-injure" formulation could work the most harm. The Supreme Court established early on that conversion cases could come within the exception,[220] although the Court also made clear, as noted above, that innocent conversions were not covered.[221] Prior to *Geiger,* a majority of courts applied the implied malice standard, and concluded that the conversion debt should not be discharged if the debtor acted with knowledge that the conversion was impermissible and had no justification or excuse,[222] as contrasted with an innocent

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[218] Geiger, 523 U.S. at 63.

[219] See Tabb, supra note 201, 59 Geo. Wash. L. Rev. 56.

[220] McIntyre v. Kavanaugh, 242 U.S. 138, 141 (1916).

[221] See Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934), supra note 206.

[222] The leading case was United *Bank of Southgate v. Nelson,* 35 B.R. 766 (N.D. Ill. 1983).

conversion, such as in *Davis v. Aetna Acceptance*.[223] So, for example, an ignorant consumer who sells his used refrigerator and keeps the proceeds, not realizing that doing so violates the security interest of the store that sold him the refrigerator on credit, is not acting with "implied malice" because he does not realize that his sale is unauthorized. His debt will be discharged.

After *Geiger,* the result in the innocent conversion cases will not change—those have always been dischargeable, even under an implied malice test—but the outcome in the *knowing* conversion cases might. What if, for example, a sophisticated business debtor takes the money from a secured creditor's collateral account and, instead of using that money to pay the secured creditor (as he knows he is supposed to under the terms of the security agreement) he wrongfully pays off other business debts with that money, but does so not with a malevolent desire to injure the secured creditor, but inspired by wishful thinking that he might thereby be able to save his business? Under an implied malice test, the debtor should not be able to discharge the debt to the secured creditor, because he knew that what he was doing was illegal and was substantially certain to harm the secured creditor, even though he was not driven by ill motives toward the secured creditor—just as Charles Tinker knew it was wrong to sleep with Frederick Colwell's wife, and was likely to harm Colwell, and accordingly was denied discharge of the resulting debt.[224] But under the *Geiger* approach, if the secured creditor must prove that the business debtor converted the collateral "with the actual intent to cause injury,"[225] the creditor could well lose—assuming that lower courts give effect only to what the Court actually said in *Geiger* and require proof of "actual intent to cause injury."

As it turns out, that assumption might be unwarranted. In *Geiger*, the Court relied on the definition of "intent" in § 8A of the Restatement of Torts, that the actor must "intend the consequences of an act."[226] However, the Court omitted the alternative meaning, also in § 8A: *"or that he believes that the consequences are substantially certain to result from it."*[227] Post-*Geiger,* many lower courts have adopted this alternative meaning of "intent" and have read *Geiger* as allowing an exception to discharge if the creditor can prove that the debtor acted knowing that his actions entailed an "objective substantial certainty of harm,"[228] even if the creditor could not prove that the debtor acted with a *subjective* motive to cause harm. Under this alternative formulation, a creditor can prevail *either* by showing that the debtor "will[ed] or desire[d] harm" *or* "believe[d] injury is substantially certain to occur as a result of his behavior."[229] This alternative reading gives the creditor whose collateral has been knowingly (rather than innocently) converted much more hope of blocking the discharge of the resulting debt. The key issues will be whether the debtor knew that

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[223] 293 U.S. 328 (1934). See supra notes 209 and 219 and accompanying text.

[224] Tinker v. Colwell, 193 U.S. 473 (1904).

[225] *Geiger*, 523 U.S.at 61.

[226] Id. at 61–62.

[227] Restatement (Second) of Torts § 8A (1965).

[228] See, e.g., In re Shcolnik, 670 F.3d 624, 629 (5th Cir. 2012); In re Williams, 337 F.3d 504, 508–09 (5th Cir.2003); In re Miller, 156 F.3d 598, 606 (5th Cir. 1998), cert. denied, 526 U.S. 1016 (1999); In re Scarbrough, 516 B.R. 897, 911–17 (Bankr. W.D. Tex. 2014). But see In re Su, 290 F.3d 1140 (9th Cir. 2002) (holding that the willful injury requirement of § 523(a)(6) is governed by a subjective standard).

[229] In re Markowitz, 190 F.3d 455, 465 n.10 (6th Cir. 1999).

the conversion was unauthorized and whether the debtor believed that his conversion was substantially certain to cause harm to the secured creditor. A showing of subjective personal malevolence toward the secured creditor would not be required. Even Charles Tinker would be likely to lose under the alternative reading, since he would have known that his affair with Frederick Colwell's wife was wrong and was substantially certain to harm Colwell. So, perhaps we have simply come full circle.

§ 10.22 Governmental Fines and Penalties, Criminal Restitution

Section 523(a)(7) excepts from discharge a debt that is (1) "for a fine, penalty, or forfeiture"; (2) is "payable to and for the benefit of a governmental unit"; and (3) "is not compensation for actual pecuniary loss." Although the section was drafted principally, although not entirely, to cover the dischargeability of tax penalties, the most interesting litigation has been with regard to criminal restitution obligations. The exception from discharge under § 523(a)(7) occurs automatically, without the need for the creditor to litigate the dischargeability issue in the bankruptcy court.

The dischargeability of a tax penalty is linked directly to the dischargeability of the underlying tax. § 523(a)(7)(A). Thus, if the underlying tax is discharged, then so too is the penalty. If the tax is not discharged under § 523(a)(1), then the penalty likewise is excepted from discharge. § 523(a)(7)(A). However, this discharge exception is subject to the further limitation that the penalty must relate to a transaction or event that occurred within three years of the bankruptcy filing.[230] The legislative history also makes clear that tax "penalties" that in reality are merely pecuniary loss penalties designed to collect the underlying tax are "compensation for actual pecuniary loss" and thus dischargeable.[231] Postpetition interest on a nondischargeable tax debt is excluded from the discharge.[232]

The unexpected problem that developed under the Code was whether *criminal restitution* obligations were nondischargeable under § 523(a)(7). At least two aspects of those obligations made application of § 523(a)(7) uncertain. First, the requirement that the penalty not be *compensation* for actual pecuniary loss was troublesome, especially in states where the restitution obligation was measured directly by the amount of loss the victim had suffered. Second, the limitation that the *government* be the payee and beneficiary of the penalty seemed to be a barrier, particularly under state statutes directing payment directly to the victim and giving the victim the right to enforce the restitution obligation in the civil courts.

Despite these problems, however, in 1986 the Supreme Court in *Kelly v. Robinson*[233] held that criminal restitution obligations are excepted from discharge under § 523(a)(7). The Court avoided a literalistic reading of the statute, and focused instead on the historical exclusion of such debts from the discharge, and on the state's overriding interest in implementing its criminal justice system unfettered by the constraints of bankruptcy. The semantic difficulties in applying § 523(a)(7) were

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[230] 11 U.S.C. § 523(a)(7)(B). See, e.g., In re Roberts, 906 F.2d 1440 (10th Cir. 1990).

[231] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 73 (1978).

[232] See, e.g., In re Burns, 887 F.2d 1541 (11th Cir. 1989); In re Monahan, 497 B.R. 642 (1st Cir. B.A.P. 2013).

[233] 479 U.S. 36 (1986).

answered by finding that the essential purpose of the state's restitution scheme was to further the state's "interests in rehabilitation and punishment," for the benefit of "society as a whole."[234]

Kelly v. Robinson did not completely end the problem, however. By declining to hold that the restitution obligation was not a debt, the Court left open the possibility that such an obligation could be discharged in a chapter 13 case, where (at that time) § 523(a)(7) did not apply if the debtor completed performance under the plan and received a discharge under § 1328(a). Exactly that scenario came before the Supreme Court in *Pennsylvania Department of Public Welfare v. Davenport*[235] in 1990, and the Court held that the restitution obligation was a debt and could be discharged in the chapter 13 case. Congress then moved immediately to reverse the result in *Davenport*, excepting criminal restitution obligations from a full-compliance chapter 13 discharge. § 1328(a)(3). Now a criminal debtor has no way to discharge such a restitution debt in bankruptcy.

Some courts have held, however, that restitution that is designed *solely* to compensate the victim does not come within the § 523(a)(7) exception, notwithstanding *Kelly*. In cases involving federal crimes some courts pointed out that the federalism rationale of *Kelly* does not apply, although most courts nevertheless refused to discharge federal restitution obligations. In 1994, Congress responded to these decisions by adding § 523(a)(13) to the list of discharge exceptions. The new exception covers a debt "for any payment of an order of restitution" issued under the federal Criminal Code, title 18. Thus, the new rule unequivocally makes all restitution obligations for federal crimes nondischargeable.

Not content with previous efforts to shore up the bankruptcy-immune status of fines and penalties, Congress acted again in 1996, adding a bankruptcy discharge exception to the federal Criminal Code as part of, intriguingly, the "Antiterrorism and Effective Death Penalty Act of 1996."[236] Under amended 18 U.S.C. § 3613(e), the bankruptcy discharge does not discharge "liability to pay a fine" owed to the United States. In addition, a lien filed with regard to such a fine cannot be avoided in bankruptcy.

§ 10.23 Educational Loans

Student loans are excepted from discharge, unless the debtor can demonstrate "undue hardship." § 523(a)(8). In addition, a number of other federal laws outside of the Bankruptcy Code make specific types of student loans under federal grant programs nondischargeable in bankruptcy, often under an even more demanding

234 Id. at 52–53.

235 495 U.S. 552, 564 (1990).

236 Pub. L. No. 104–132, 110 Stat. 1214 (1996).

standard for the debtor.[237] The policy behind the eighth exception (and its counterparts outside title 11) is to prevent abuse of the educational loan system.[238]

To explain this "abuse," the legislative history behind § 523(a)(8) illustrates Congress's concern about debtors with large amounts of educational loans, few other debts, and well-paying jobs, who then file for bankruptcy to discharge their educational loans shortly after school and before any loans become due.[239] The House Report further describes this concern, noting that because "more and more students are turning to the bankruptcy courts as a relatively easy way to solve their debt problems," then "[i]t is possible that if educational debts are the main reason for filing, and if this practice is allowed under the law, then it might create a disincentive for other student borrowers to repay their loans."[240]

Congress has been zealous in implementing this policy, continually amending § 523(a)(8) to make discharge of student loans more difficult. Among other changes, § 523(a)(8) now applies to except educational loans from discharge in chapter 13. § 1328(a)(2). Furthermore, as originally enacted, student loans were only nondischargeable for five years, but that time period was extended from five years to seven years, and then repealed altogether in 1998. Even for loans taken out prior to 1998, courts usually apply the current, less debtor-friendly statute to bankruptcy cases filed after the amendment to § 523(a)(8).[241] Finally, in 2005, Congress amended § 523(a)(8) to make student loans nondischargeable regardless of the type of lender if the loan debt is tax-deductible, meaning that most loans from non-governmental and profit-making organizations are nondischargeable.[242]

A student loan may be characterized in theory as an enabling loan to the debtor, helping her to make productive the human capital that the discharge permits the debtor to keep free from pre-bankruptcy creditors.[243] This enabling loan in fairness then should be repaid before permitting the debtor to enjoy the fruits of that enhanced human capital. To illustrate, a newly certified eye surgeon, who currently has no tangible assets but shortly will earn a six-figure income, should not be able to discharge the student loan that put her through medical school.

Section 523(a)(8) has two basic parts, an inclusive portion (in subsections (A) and (B)) and an exception for "undue hardship." Unless the debt falls within the inclusive

[237] See 42 U.S.C. § 292f(g) (Health Education Assistance Loan); 42 U.S.C. § 254o(d)(3) (National Health Service Corps loans); 37 U.S.C. § 301d(c)(3) (Armed Forces medical officers). To discharge a loan under HEAL or NHSC, a debtor must show that not discharging the debt would be "unconscionable," an even higher standard than "undue hardship" under § 523(a)(8). See also Mathews v. Pineo, 19 F.3d 121 (3d Cir. 1994).

[238] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 131–34 (1977).

[239] Id. at 133 ("A few serious abuses of the bankruptcy laws by debtors with large amounts of educational loans, few other debts, and well-paying jobs, who have filed bankruptcy shortly after leaving school and before any loans became due, have generated the movement for an exception to discharge.").

[240] Id. at 136.

[241] See, e.g., In re Lewis, 506 F.3d 927 (9th Cir. 2007) (rejecting the debtor's argument that they had a right to rely on the statute in effect when they took out loans, and holding that application of the current, harsher version of § 523(a)(8) applies).

[242] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109–8, 119 Stat. 23 § 220.

[243] Indeed, the legislative history in 1977 described student loans as "a mortgage on the debtor's future." See H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 133 (1977).

provision, there is no need to consider the undue hardship question. If, however, the debt is one of the types covered in subsection (A) or (B), the question of undue hardship then would be ripe.

The inclusive provision, which defines which educational loans are nondischargeable, is quite broad, and now covers most educational loans. First, an "educational loan" or an "educational benefit overpayment" is nondischargeable if made directly by or if insured or guaranteed by any governmental unit. § 523(a)(8)(A)(i). The definition of "governmental unit" includes state and local governments as well as the federal government. § 101(27). Second, dischargeability is denied for any loan made under a "program" funded at all by a governmental unit *or* by a nonprofit institution. § 523(a)(8)(A)(i). Additionally, a debtor may not discharge "an obligation to repay funds received as an educational benefit, scholarship, or stipend." § 523(a)(8)(A)(ii). Finally, 523(a)(8)(B) (which was added in 2005) provides that "any other educational loan that is a qualified educational loan" is nondischargeable if incurred by an individual debtor. A "qualified educational loan" means a loan debt that is tax-deductible under § 221 of the Internal Revenue Code.[244]

Some dispute has arisen over what constitutes a "governmental unit." For example, many courts have debated whether a credit union qualifies. The First Circuit held that a federal credit union is a governmental unit and thus protected from the discharge of student loans under the eighth exception, even though the credit union is not a nonprofit institution.[245]

Most courts have held that § 523(a)(8) applies to *debts,* and not to specific debtors.[246] In other words, the bankruptcy debtor to whom the section applies need not be the primary obligor on the educational loan (i.e., the student), or even receive the educational benefit of the student loan; discharge of a secondary liability on the loan is prevented as well. This issue comes up typically in the case of a parent who co-signs the loan and then files bankruptcy.[247] A minority of courts have disagreed, reasoning that the "enabling loan" policy does not apply to a debtor other than the student themself.

The most interesting and difficult issues under § 523(a)(8) are raised by the provision that an otherwise nondischargeable educational loan nevertheless may be discharged if not discharging that debt "would impose an undue hardship on the debtor

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[244] This statute defines a "qualified education loan" as any debt incurred solely to pay qualified higher education expenses: 1) incurred on behalf of the taxpayer, taxpayer's spouse, or any dependent of the taxpayer; 2) paid or incurred within a reasonable period of time before or after the debt is incurred; and 3) attributable to education received during a time when the recipient was an eligible student. Exceptions to qualified student loans include any debt owed to a person related to the debtor, or any loan under a qualified employer plan. 26 U.S.C. § 221(d)(1).

Note that the IRC definition requires that the loan be incurred on behalf of a taxpayer, or someone related to a taxpayer. This requirement lead the court in *In re LeBlanc* to conclude that a nonresident alien debtor from Canada was not a "taxpayer" as defined by the IRC because the debtor did not file a United States income tax return during the pertinent timeframe, and therefore the loans she received were not "qualified education loans" as defined by the IRC, and thus not subject to the Code's student loan discharge exception. 404 B.R. 793 (Bankr. M.D. Pa. 2009).

[245] TI Fed. Credit Union v. DelBonis, 72 F.3d 921 (1st Cir. 1995).

[246] In re Pelkowski, 990 F.2d 737 (3d Cir. 1993).

[247] See, e.g., Cockels v. Mae, 414 B.R. 149 (E.D. Mich. 2009) (holding student loan exception applies to parent co-signer).

and the debtor's dependents." The student loan exception thus specifies a standard of nondischargeability, rather than a rule. Curiously, Congress left the term "undue hardship" undefined, exposing the term to much debate in student loan cases. However, that statute's use of "undue" suggests that Congress viewed garden-variety hardships an insufficient excuse to discharge student loans.[248] Thus, the exception gives considerable discretion to the bankruptcy judge to tailor the fresh start policy of the Code to the vagaries of specific fact situations, and to find in effect that in the totality of the circumstances there was no abuse of the system. For example, the premise of abuse hardly would be sustained if the hypothetical eye surgeon referred to above suffered a career-ending illness or injury and then filed bankruptcy.

Courts are not, however, lenient to debtors in finding "undue hardship," to put it mildly. The debtor bears the burden of proof.[249] The leading test of "undue hardship" is the three-part test announced by the Second Circuit in *Brunner*:

1. That the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;
2. That additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
3. That the debtor has made good faith efforts to repay the loans.[250]

The Eighth and First Circuits are the only two circuits not to adopt the *Brunner* test. The Eighth Circuit has embraced instead a "totality of the circumstances" approach,[251] which it believes to be less restrictive than the *Brunner* test, and to give bankruptcy judges more discretion. The First Circuit made clear in *In re Nash* that it

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[248] See Educ. Credit Mgmt. Corp v. Frushour (In re Frushour), 433 F.3d 393, 399 (4th Cir. 2005); Rifino v. United States (In re Rifino), 245 F.3d 1083, 1087 (9th Cir. 2001); Brunner v. N.Y. State Higher Educ. Servs. Corp (In re Brunner), 46 B.R. 752, 753 (S.D.N.Y. 1985).

[249] See, e.g., In re Hixson, 450 B.R. 9, 19 (Bankr. S.D.N.Y. 2011); In re Wells, 360 B.R. 652, 658 (Bankr. N.D.N.Y. 2007); In re Lilly, 538 B.R. (Bankr. S.D. Cal. 2013).

[250] Brunner v. New York State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987). Accord, In re Mosko, 515 F.3d 319 (4th Cir. 2008); Educ. Credit Mgmt. Corp. v. Polleys, 356 F.3d 1302 (10th Cir. 2004); In re Gerhardt, 348 F.3d 89 (5th Cir. 2003); In re Cox, 338 F.3d 1238 (11th Cir. 2003), cert. denied, 541 U.S. 991 (2004); In re Pena, 155 F.3d 1108 (9th Cir.1998); In re Faish, 72 F.3d 298 (3d Cir. 1995), cert. denied, 518 U.S. 1009 (1996); In re Cheesman, 25 F.3d 356 (6th Cir.1994), cert. denied, 513 U.S. 1081 (1995); In re Roberson, 999 F.2d 1132 (7th Cir. 1993).

[251] In re Andrews, 661 F.2d 702 (8th Cir.1981). Even after virtually all other circuits had adopted *Brunner*, the Eighth Circuit has continued to reaffirm its totality test. See In re Reynolds, 425 F.3d 526 (8th Cir. 2005), cert. denied, 549 U.S. 811 (2006); In re Long, 322 F.3d 549 (8th Cir. 2003). The Eighth Circuit's "totality" test is as follows:

> "In evaluating the totality-of-the-circumstances, our bankruptcy reviewing courts should consider: (1) the debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of the debtor's and her dependent's reasonable necessary living expenses; and, (3) any other relevant facts and circumstances surrounding each particular bankruptcy case. Simply put, if the debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt—while still allowing for a minimal standard of living—then the debt should not be discharged. Certainly, this determination will require a special consideration of the debtor's present employment and financial situation—including assets, expenses, and earnings—along with the prospect of future changes—positive or adverse—in the debtor's financial position."

Id. at 554–55.

did not endorse a preferred method of identifying a case of "undue hardship."[252] Additionally, although the Tenth Circuit ultimately adopts the *Brunner* test over the totality of the circumstances approach, one court in the circuit noted that as applied, the *Brunner* test does not always further the "fresh start" policy for debtors, as courts apply it with undue restriction.[253] However, the same court also acknowledged that the totality of the circumstances approach may not fare better for debtors. In adopting the *Brunner* test, the court stated that, "[w]e do not read *Brunner* to rule out consideration of all the facts and circumstances,"[254] thus adopting a sort of hybrid of the two approaches.

The critical difference between the *Brunner* test and the "totality of the circumstances" approach to interpreting and applying the undue hardship standard in § 523(a)(8), is that for courts applying the *Brunner* test, the debtor must meet *all three* factors or the court will not find undue hardship and discharge the debtor's student loans. Conversely, in courts adopting the totality of the circumstances approach, no single factor is determinative, making the approach more flexible to allow or deny a student loan discharge in light of the facts. Regardless of the test or approach used in determining whether repayment of student loans would constitute undue hardship, at a minimum courts focus on two issues: (1) the economic prospects of the debtor, and (2) whether the conduct of the debtor disqualifies the debtor from taking advantage of the exception.[255]

An intriguing use of the court's equitable powers has come in cases in which the court has Solomonically "split the baby" by discharging part of the student loan under the undue hardship provision, concluding that an all-or-nothing approach is too restrictive. Smacking even more of unbridled judicial activism is the decision of the Sixth Circuit to *defer* the final dischargeability decision for 18 months, thus introducing the concept of a *suspended* discharge.[256] A related issue concerns the *res judicata* effect of a determination of no undue hardship. Should a debtor be permitted to reopen her case and relitigate the issue of undue hardship based on an allegation of changed circumstances since the first determination?

§ 10.24 DUI Debts for Death or Personal Injury

The national tragedy of drunk driving has spilled over into the bankruptcy courts. Drivers who cause injury or death while driving under the influence of alcohol or drugs have attempted to discharge the resulting liabilities in bankruptcy. Prior to 1984, drunk driving victims had to bring their nondischargeability complaint under § 523(a)(6), where they encountered considerable difficulty in proving that the debtor's actions had been both "willful" and "malicious."[257] The Supreme Court's 1998 decision

[252] In re Nash, 446 F.3d 188, 190–91 (1st Cir. 2006).

[253] Educ. Credit. Mgmt. Corp. v. Polleys, 356 F. 3d 1302 (10th Cir. 2004).

[254] Id. at 1308.

[255] In re Weir, 269 B.R. 710, 716 (Bankr. E.D. Va. 2002) (citations omitted).

[256] *Cheesman*, 25 F.3d 356.

[257] Compare In re Adams, 761 F.2d 1422 (9th Cir. 1985) (intentional act of driving while intoxicated both willful and malicious under § 523(a)(6)), with In re Compos, 768 F.2d 1155 (10th Cir. 1985) (intentional act of driving while intoxicated shows only reckless disregard for others, and thus is not within § 523(a)(6)).

in *Kawaauhau v. Geiger*,[258] which requires proof under (a)(6) that the debtor intended to injure the victim, now makes it extremely difficult for a creditor to prevail under that subsection in a drunk driving case.

To make it easier for drunk driving victims to avoid discharge, Congress in 1984 added § 523(a)(9) to the list of excepted debts. That section specifically precludes the discharge of DUI debts for death or personal injury without the necessity of proving either willfulness or malice; only unlawful intoxication must be established. Further amendments in 1990 rendered chapter 13 unavailable as a means to discharge these debts. § 1328(a)(2).

The 1990 amendments also cleared up the principal interpretive difficulty of the section as originally enacted in 1984, which was that debts could be excepted only if arising from "a judgment or consent decree entered in a court of record." This language apparently made a pre-bankruptcy judgment a condition of nondischargeability, which if given effect would enable a debtor to avoid the operation of the exception by the simple expedient of filing bankruptcy before final entry of such a judgment. Most courts simply ignored the plain language of the section and denied dischargeability even if no judgment had yet been entered, reasoning that Congress could not have meant what it said.[259] In 1990 Congress conformed the statute to the prevailing judicial interpretation by dropping the judgment or consent decree limitation.

To establish nondischargeability under § 523(a)(9), then, all that the creditor must prove is that (1) death or personal injury (2) was caused by the debtor's operation of a motor vehicle, vessel, or aircraft, (3) while unlawfully intoxicated from alcohol, drugs, or another substance. "Unlawful" intoxication is to be determined by reference to the applicable state law. Note that the creditor does not have to prove that the debtor's intoxication actually caused the injury, only that the injury was caused by the debtor's operation of a motor vehicle while intoxicated. A debtor's proof that he can "hold his liquor" would thus be irrelevant if his blood alcohol level exceeded legal limits.

Before the 2005 amendments, some courts questioned what qualified as a "motor vehicle." In other words, if a debtor gets drunk and drives a motorboat, snowmobile, or airplane, and kills someone, would § 523(a)(9) apply? In 2005, Congress settled this question by adding the words "vessel or aircraft" to § 523(a)(9) to indicate that the exception should apply broadly to all debts arising from "drunk driving," not just those debts related to the driving of automobiles.

In another important respect the ninth exception is limited. The 1990 amendments clarified that only debts for "death or personal injury" are excepted from discharge. This amendment excluded claims for damage to "property" alone, as well as debts for related items such as insurance surcharges and replacement rentals. For property damage claims the creditor is relegated to the willful and malicious injury exception under § 523(a)(6) which, as noted above, will be very hard to establish under the stringent requirements of the *Geiger* case. The ninth exception still should cover both compensatory and punitive damages if the injury suffered is death or personal injury.

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[258] 523 U.S. 57 (1998). See also § 10.21.

[259] E.g., In re Hudson, 859 F.2d 1418 (9th Cir. 1988).

Debts covered by this exception, like those for most nondischargeable taxes and for federal depository claims, also are given a statutory priority in distribution of the debtor's bankruptcy estate. § 507(a)(10). The tenth priority was added in 2005. Curiously (and inexplicably), the tenth priority does not include debts arising from the operation of an aircraft while unlawfully intoxicated, while the discharge exception in § 523(a)(9) does, as noted above.

§ 10.25 Debts from Prior Bankruptcy Case in Which Discharge Was Waived or Denied

A debtor only gets one bite at the discharge apple. If a debtor files a liquidation bankruptcy case and either waives his discharge or is denied a discharge (for any reason other than the time bar on successive discharges), then the debtor may not discharge in a subsequent bankruptcy case the debts that were not discharged in the first case. § 523(a)(10). In effect, the tenth exception imposes a statutory *res judicata* rule for discharge.

The operation of § 523(a)(10) is not all-encompassing. It does not apply when the second case is a chapter 13, although the court may consider the debtor's attempt to discharge previously undischarged debts as a factor in assessing the good faith of the debtor's chapter 13 plan under § 1325(a)(3). Nor will § 523(a)(10) operate to prevent the discharge of a specific debt that was reaffirmed in the first case. Furthermore, § 523(a)(10) does not apply to prevent the discharge in a second case of debts that were only *excepted* from discharge in a prior case. In most cases, however, that limitation is irrelevant; the other § 523(a) exceptions are still available, and collateral estoppel principles should prevent the discharge in the second case of most types of previously excepted debts.

Only in limited instances may a debt be discharged in a second case despite a prior determination of nondischargeability under § 523(a). Under § 523(b), the court may revisit in the second case dischargeability determinations under § 523(a)(1), (3), or (8). What explains these provisions? They cover situations where the exception in the first case depended on a time limit (e.g., taxes) which has expired by the time the second case is filed;[260] where the original discharge exception was for failure to schedule debts, a failing that is curable in a subsequent case; or where the discharge determination depends upon the court's assessment of the debtor's current circumstances (educational loans).

§ 10.26 Relating to Federal Depository Institutions

The 1980s crisis in the banking and savings and loan industries spawned legislation in 1990 seeking to shore up the position of the FDIC and other federal

[260] Section 523(b) continues to reference § 523(a)(8), an inclusion originally attributable to the fact that subsection (8) also contained a time limit on the exception to discharge. Thus, that time limit might have expired by the time a second bankruptcy case was filed, even if it had not when the first case was filed, and if so, then the educational loan debt would be discharged in the second case. Now, however, subsection (8) does not contain a time limit, so that justification for including the reference to subsection (a)(8) in § 523(b) no longer holds. However, there still may be reason to revisit the (a)(8) issue in the second case, in that the undue hardship assessment could be different in the second case than it was in the first.

agencies in bankruptcy cases.[261] In the dischargeability context, two new exceptions to discharge were created, subsections 523(a)(11) and (12), along with a host of explanatory definitions.

Section 523(a)(11) excepts from discharge debts arising from fiduciary fraud or defalcation in connection with an insured depository institution (defined in § 101(35)) or an insured credit union (defined in § 101(34)). Not all such debts are excepted, however, but only those provided for in a final judgment, unreviewable order, or consent decree of a court, or issued by a federal depository institutions regulatory agency (defined in § 101(21B)), or in a settlement agreement entered into by the debtor. This limitation creates the same interpretive problems raised by § 523(a)(9) before the 1990 amendments eliminated the "court order" restriction in that section. Courts are likely to respond in the same fashion, that is, by ignoring the statute.

The necessity of § 523(a)(11) is unclear. Section 523(a)(4) already excepted all debts for fiduciary fraud or defalcation, and would seem to cover all cases now covered by section (11). Nor does it appear that Congress intended to preclude the FDIC and others from asserting subsection (4), since specific reference to that subsection as it applies to federal depository institutions is made in § 523(c)(2) and § 523(e). The probable reason for the enactment of the 1990 law is to overrule those cases that narrowly construed the "fiduciary" element in § 523(a)(4) as applied to depository institutions, and thereby discharged the obligation. However, Congress achieved this result via § 523(e).

Procedurally, the federal agency is relieved in certain circumstances from the strict time limits and operation of § 523(a)(3)(B) and Rule 4007(c) regarding the filing of dischargeability complaints under subsections (2), (4), and (6). Section 523(c)(2) excuses compliance with those provisions if the federal agency did not have time reasonably to comply with the deadlines.

Debtors also are precluded from discharging certain debts arising from their failure to fulfill capital maintenance commitments made to a federal depository institutions regulatory agency with respect to an insured depository institution. § 523(a)(12). This failure must be "malicious or reckless" to fall within the section. An exception is made if the capital maintenance commitment would otherwise be terminated due to the act of the federal agency. This twelfth exception, unlike its companion eleventh exception, goes beyond any of the previously existing exceptions. Proof of fraud is not required (as it would be under subsection (2)), and merely reckless behavior will suffice (but would not under subsection (6)). The exception in § 523(a)(12) is self-executing, since it is not included in § 523(c) with those exceptions that must be litigated exclusively in the bankruptcy court. Debts covered by this exception, like those for most nondischargeable taxes and for DUI claims that result in death or personal injury, also are given a statutory priority in distribution of the debtor's bankruptcy estate. § 507(a)(9).

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[261] See Crime Control Act of 1990, Pub. L. No. 101–647, § 2522, 104 Stat. 4789, 4865–68 (1990). These mendments became effective on November 29, 1990.

§ 10.27 Other Exceptions

Congress cannot seem to resist the temptation to keep adding exceptions to the discharge. The subjects covered range widely across the imaginable spectrum. As of 2013, the official count in § 523(a) was twenty-one exceptions, and several other exclusions are scattered throughout the United States Code. One of the amendments, for fines owing to the United States, under 18 U.S.C. § 3613(e), is mentioned in the section on fines and penalties.[262] Yet another 1996 entry in the nondischargeable category is for the obligation to repay a "special pay" bonus received by a health care professional in the Selected Reserves, if the recipient does not serve the full time commitment promised in exchange for the bonus.[263]

In BAPCPA in 2005, Congress continued this trend, adding additional exceptions from discharge. The new exceptions are listed in § 523(a)(14A), which excepts from discharge obligations incurred to pay a nondischargeable tax to a governmental entity other than the United States, and § 523(a)(14B), which excepts fines or penalties incurred under Federal election law (but not under state law). The previous § 523(a)(18), which dealt with family support obligations, was also deleted and replaced with an unrelated exception. The new § 523(a)(18) provides that debts owed to retirement plans and employee benefit funds for permitted loans are not dischargeable.

Congress also tightened the screws on prisoners, as part of the Prison Litigation Reform Act of 1995.[264] That Act was intended to limit the perceived abuse of frequent (endless) federal court filings by prisoners. One way courts can attempt to cut down on such filings is to impose court costs and fees on prisoners, and to prohibit further filings until outstanding costs are paid; in short, only allow access to the court system for prisoners who "pay their own way." The concern that was addressed by § 523(a)(17) was that prisoners would simply file bankruptcy and discharge the debt to pay those court costs and fees. Section 523(a)(17) precludes the discharge of a debt "for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and expenses assessed with respect to such filing," and then makes clear that the exclusion applies "regardless of an assertion of poverty . . . or the debtor's status as a prisoner." In 2005, Congress added language to clarify that this exception is limited to prisoner cases, and does not apply to all debts for court costs, fees and expenses.

Congress added another discharge exception to the Code in 1994, for condominium or cooperative fees and assessments that come due after the filing of the bankruptcy petition and that relate to the postpetition period. § 523(a)(16). According to the legislative history, this amendment was necessary to prevent the discharge of those obligations, which would be unfair to other owners of the association.[265] Congress acted in response to a Seventh Circuit decision that had held that such postpetition fees and

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[262] See § 10.22.

[263] National Defense Authorization Act, Pub. L. No. 104–106, 110 Stat. 186 (1996), codified at 37 U.S.C. § 302g(d), (e).

[264] Pub. L. No. 104–140 (renumbered from 104–134), 110 Stat. 1327 (1996), codified at 11 U.S.C. § 523(a)(17).

[265] Section-by-Section Analysis, commentary on § 309 of the Bankruptcy Reform Act of 1994, 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994).

assessments constituted dischargeable prepetition claims, on the theory that they arose from the debtor's prepetition contract with the condominium association.[266]

Congress may have acted prematurely, however. In 1994 a competing line of case authority emerged that held that such postpetition assessments did not constitute dischargeable prepetition claims.[267] These cases reasoned that the claim did not arise prepetition, when the debtor signed the condominium contract, but only arose when assessed after the bankruptcy filing. As a postpetition claim, the obligation would not be dischargeable. These courts reached this result by treating the claim for fees and assessments as one rooted in the property itself, i.e., as an obligation that "runs with the land," rather than one based in contract.

The hasty action of Congress may not be harmless, either. Section 523(a)(16) is limited in its scope. Before BAPCPA, the discharge exception only applied if the debtor had received some tangible benefit from her ownership of the unit in the postpetition period, either by physically occupying the unit or by receiving rental payments. BAPCPA expanded this exemption somewhat, to include fees or assessments "for as long as the debtor or the trustee has a legal, equitable, or possessory ownership interest in such unit, such corporation, or such lot. . . ." § 523(a)(16). If no such interest exists, then the debt would still be dischargeable under the approach taken by the Seventh Circuit, which treats the postpetition assessment as a prepetition claim. Nothing in the 1994 amendment alters the time when the claim is deemed to arise. Of course, those jurisdictions that follow the competing view and deem the claim as arising postpetition still will not discharge the debt. However, because Congress in the 1994 legislative history also suggested that the Seventh Circuit view was correct,[268] other jurisdictions now may be hesitant to embrace the contrary line of cases.

D. PROCEDURES

§ 10.28 Procedures for Denial of Discharge in Chapter 7

An individual chapter 7 debtor does not have to take any affirmative steps to btain his discharge. In olden times a debtor had to apply for his discharge, but today ie onus is on others to object. Subject to some exceptions detailed in the Bankruptcy ules, the bankruptcy court will automatically grant an individual debtor a discharge orthwith" upon expiration of the time for filing objections to discharge or to move to smiss the case. Rule 4004(c)(1).

There are several exceptions to the automatic discharge entry rule in Rule 04(c)(1). The court may take judicial notice of the fact that the debtor is not an lividual, and thus not eligible for discharge, § 727(a)(1), and should not enter the charge order. Rule 4004(c)(1)(A). If the debtor has waived the discharge in a manner owed under § 727(a)(10), no discharge order will be entered. Rule 4004(c)(1)(C). Nor uld a discharge order be entered if there is a pending motion objecting to discharge, king to dismiss the case, or asking to extend the time to make either motion. Rule

[266] In re Rosteck, 899 F.2d 694 (7th Cir. 1990).

[267] E.g., In re Rosenfeld, 23 F.3d 833 (4th Cir. 1994).

[268] "Except to the extent that the debt is nondischargeable under this section, obligations to pay such vould be dischargeable." Section-by-Section Analysis, supra note 265.

4004(c)(1)(B), (D)–(F). The debtor also must have paid all required fees b receive his discharge. Rule 4004(c)(1)(G). The Rules, as revised throug 2011, also implement several aspects of the 2005 legislation as they r debtor's right to a discharge. The court should not enter the discharge debtor has not filed a statement that he has completed the course in person management, as required under § 727(a)(11). Rule 4004(c)(1)(H). In accor § 727(a)(12), the bankruptcy court may delay the entry of a discharge appears that a § 522(q) homestead exemption limitation proceeding is per 4004(c)(1)(I). The court also should delay entry of the discharge order if a pı has arisen that a reaffirmation agreement is an undue hardship under § 52 4004(c)(1)(J), or if the debtor has not yet filed all tax documents requi § 521(f). Rule 4004(c)(1)(K).

Standing to contest the discharge is limited to the trustee, creditors United States trustee. § 727(c)(1). The court itself may not act *sua sponte* to discharge, although if requested to do so it may order the trustee to invest merits of a discharge objection. § 727(c)(2). The trustee has a statutory duty to discharge if advisable. § 704(a)(6).

Most objections to discharge must be litigated in an adversary proceedir bankruptcy court. Rules 4004(d), 7001(4). The applicable rules are those in Pa the Federal Rules of Bankruptcy Procedure, which largely track the Federal Civil Procedure. The only exceptions are for objections under §§ 727(a)(8), 7 and 1328(f), which are handled as contested matters under Part IX and comme motion. Rule 4004(d). The complaint or motion must be filed in the court wh bankruptcy case is pending. Rule 5005(a).

Parties considering objecting to discharge have a very limited time to fil complaint: *60 days* after the first date set for the § 341 meeting of creditors 4004(a). The rule is strictly construed—the clock starts running from the first d for the creditors' meeting, even if it is not then held, and the complaint actually be *received* by the bankruptcy clerk by the deadline. The trustee and creditor receive at least 28 days notice of this bar date in the initial notice of the bankru Rules 4004(a), 2002(f)(4). The Rules were amended in 2011 to allow a party to m extend the time to object to discharge even after the time for objection has expired before the discharge is granted, in very limited circumstances: the objection is bas facts that would support revocation of discharge under § 727(d), and the movan not know of those facts in time to object. Rule 4004(b)(2).

Although the discharge objection deadline of Rule 4004(a) is stated in abso terms, the Supreme Court held in *Kontrick v. Ryan*[269] that the deadline is jurisdictional. In that case, the Court allowed the bankruptcy court to decide untimely discharge objection when the debtor failed to object in his responsive plead to the tardy filing.

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[269] 540 U.S. 443 (2004), limited by *Kay v. Sec'y of Health and Human Servs.*, 80 Fed. Cl. 601, (2008) (noting that to the extent *Kontrick* and similar cases "indicate that the issue of timeliness is properly a question of the court's jurisdiction in an action brought pursuant to a waiver of sover immunity, they unquestionably have been overruled by the Supreme Court's holding in *John R. San Gravel*").

Prior to the promulgation of Rule 4004(b)(2) in 2011, some courts had invoked their equitable powers to allow an objection to be filed after the deadline despite the language of the Rules upon proof of equitable defenses, such as (1) that the debtor fraudulently concealed the grounds for objection, or (2) that the clerk's office mailed an incorrect bar date notice.[270] Other courts, however, concluded that they possessed no discretion to permit a late filing.[271] It is unclear how the 2011 amendment to the Rules, adding a specific narrow exception allowing out-of-time motions under Rule 4004(b)(2), will impact this split in the case law. On one side, the argument will be that the enactment of a specific exception in the Rules now precludes the exercise of judicial discretion recognizing additional exceptions not embodied in the Rules, under an *expressio unius* theory. The counter-argument would be that judicial discretion is not constrained as to cases not covered by the new rule; instead, the Rules Committee simply wanted to make certain that cases that do fall within the exception are protected. In *Kontrick*, the Court made clear that it was *not* deciding whether an untimely discharge objection could be entertained based on equitable grounds;[272] it held only that the debtor waived his objection to untimeliness by failing to raise the defense in his responsive pleadings.

If a party needs more time to decide whether to file a discharge objection, it must apply for an extension of time within the original 60-day period, and the court then in its discretion may extend the time for filing the complaint. Rules 4004(b), 9006(b)(3). Merely filing the motion for the extension does not toll the bar date. Except as provided in the exception under Rule 4004(b)(2), discussed above, a party who files late may not receive an out-of-time extension to file, even upon proof of excusable neglect (although, as noted above, the possibility of equitable defenses remains an open question). Even if a complaint alleging some grounds for denial of discharge is timely filed, the 60-day bar still applies to any additional grounds for objection, which may not be added later by amendment.

If no complaints have been filed by the expiration of the 60-day period or any timely extensions thereof, the bankruptcy court "shall forthwith" grant the debtor a discharge, unless the debtor is not an individual or filed a waiver, or one of the new 2005 exceptions discussed above applies. Rule 4004(c)(1). However, the debtor may ask the court to defer granting the discharge for 30 days. Rule 4004(c)(2). A debtor might do this if he is negotiating a reaffirmation agreement, because a reaffirmation must be agreed to prior to the granting of the discharge. § 524(c)(1).

If an objection to discharge is timely filed, then the adversary proceeding is tried (or, for motions under §§ 727(a)(8), 727(a)(9), and 1328(f), a contested matter is heard). The Federal Rules of Evidence will apply at trial, Rule 9017, and the ultimate burden of proof at trial is on the plaintiff who is objecting to the debtor's discharge. Rule 4005. The issue of which party has the burden of going forward is left to case development. The burden of going forward might be placed on the debtor under § 727(a)(3), where

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[270] See, e.g., In re Themy, 6 F.3d 688 (10th Cir. 1993); In re Noll, 491 B.R. 550 (Bankr. E.D. Wis. 2013) (incorrect notice). See also Farouki v. Emirates Bank Intern., Ltd., 14 F.3d 244 (4th Cir. 1994) (fraudulent concealment).

[271] See In re Chalasani, 92 F.3d 1300 (2d Cir. 1996).

[272] 540 U.S. at 457–58.

the debtor may have to justify his otherwise inadequate books, and § 727(a)(5), where the debtor may have to explain losses.

Rule 4005 also says nothing about the *standard* of proof. The lower courts have divided over whether the appropriate standard is preponderance of the evidence or clear and convincing. The Supreme Court's 1991 decision in *Grogan v. Garner*, holding that *preponderance* is the proper standard in a § 523(a)(2) discharge exception case, has influenced many courts to adopt a preponderance standard in § 727 cases as well.[273] The court in *Grogan* stated in dictum that the proper standard under § 727(a)(4) was preponderance, relying on a statement in the legislative history.[274] On the other hand, courts may take the position that total denial of discharge under § 727 is a much more drastic penalty than exception of a single debt under § 523, thus rendering *Grogan* inapposite.

Once action has been taken either to grant or deny the discharge, creditors again are notified. A copy of the order of discharge is mailed to creditors. Rule 4004(g). This puts creditors on notice of the § 524(a) discharge injunction. The debtor may enforce the discharge nationwide, both by using nationwide service of process, Rule 7004, and by registering the discharge order in any federal district. Rule 4004(f). On the other hand, if the discharge is denied, the clerk must mail creditors a notice of no discharge. Rule 4006. This notice enables creditors to pursue collection of nondischarged debts in a timely manner. Statutes of limitations that had been tolled by the bankruptcy begin running again 30 days after the discharge is denied. §§ 108(c)(1), 362(c)(2).

§ 10.29 Procedures for Discharge Exceptions

The procedure governing the adjudication of a discharge exception depends initially on the subsection of § 523(a) within which the affected debt falls. Two basic categories exist: those that have to be litigated exclusively in the bankruptcy court, and those that do not. Section 523(c)(1) requires discharge exception actions under § 523(a)(2) (fraud), § 523(a)(4) (fiduciary fraud or defalcation, embezzlement, larceny), and § 523(a)(6) (willful and malicious injury), to be brought in the bankruptcy court in a limited time period or be discharged. Until the 2005 amendments, property settlement debts under § 523(a)(15) also had to be litigated in bankruptcy court, but BAPCPA dropped that restriction. All of the § 523(a) exceptions other than (2), (4), and (6) need not be litigated in the bankruptcy court. In effect they are self-executing, although litigation in a bankruptcy or a non-bankruptcy forum (most likely state court) ultimately may be required to settle a controversy.

Many of the procedures regarding the § 523(c)(1) discharge exceptions track the procedures for discharge objections. A complaint to determine dischargeability under § 523(a)(2), (4), or (6) must be filed in the bankruptcy court within 60 days of the first date set for the § 341 meeting of creditors, unless the court grants an extension pursuant to a motion filed within the 60-day period. Rule 4007(c). It has been held that the trustee has standing to obtain an extension under Rule 4007(c) for the benefit of all

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[273] See, e.g., In re Scott, 172 F.3d 959, 966–67 (7th Cir. 1999). See also In re Harwood, 637 F.3d 615, 619 (5th Cir. 2011); In re Pisculli, 408 F.App'x. 477, 479 (2d Cir. 2011); In re Adams, 31 F.3d 389 (6th Cir. 1994), cert. denied, 513 U.S. 1111 (1995).

[274] 498 U.S. 279, 289 (1991) (citing H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 384 (1977), and S. Rep. No. 95–989, 95th Cong., 2d Sess., at 98 (1978)).

Chapter 11

REORGANIZATION UNDER CHAPTER 11

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A. INTRODUCTION

§ 11.1 Theory and Purposes of Reorganization*

In both its original conception and in common parlance, "bankruptcy" connotes the idea of *liquidation* of the bankrupt debtor's present assets, and distribution of those assets to creditors on an equitable basis. Chapter 7 of the Code provides a statutory scheme for such a bankruptcy liquidation. However, while chapter 7 may be a fair and efficient means of liquidating and distributing the debtor's current assets, a bankruptcy liquidation may not always be the best approach to dealing with a debtor's financial distress. In some circumstances, a *reorganization* may be the better approach.

Chapter 11 is the general business reorganization chapter of the Code. The premise underlying chapter 11 is that everyone—creditors, the debtor, stockholders, employees, suppliers, the community—can benefit if a debtor's financial affairs are restructured at an acceptable cost. As the legislative history to the Code explained:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and provide a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.[1]

In essence, chapter 11 is based on the idea "that a business is worth more alive than dead—i.e., it is worth more as a going concern than in a forced sale liquidation."[2] Liquidation has solely a present "balance sheet" focus—debts and assets. But the

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[1] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 220 (1977).

[2] See Charles J. Tabb, The Future of Chapter 11, 44 S.C. L. Rev. 791, 804 (1993); see also Michelle M. Harner, The Value of Soft Variables in Corporate Reorganizations, 2015 U. Ill. L. Rev. 509 (2015); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 758 (1993).

There is considerable academic debate over who is entitled to capture this supposed "going concern surplus," especially as between secured creditors with blanket liens on the debtor's assets, on the one hand, and residual stakeholders, such as general unsecured creditors, on the other. Some scholars argue that non-bankruptcy priority rankings presumptively should be respected, with all value going to the senior secured creditors. See, e.g., Barry E. Adler, Priority in Going-Concern Surplus, 2015 U. Ill. L. Rev. 811 (2015). Other scholars, though, question whether secured creditors should enjoy an entitlement to anything over and above the liquidation value that they could capture under state law. See, e.g., Harner, supra, 2015 U. Ill. L Rev. 509; Edward J. Janger, The Logic and Limit of Liens, 2015 U. Ill. L. Rev. 589 (2015). For a general discussion of the problem, see Douglas G. Baird, The Rights of Secured Creditors After *Rescap,* 2015 U. Ill. L. Rev. 849 (2015).

financial value and worth of a debtor should not always be judged by the balance sheet alone; a debtor's projected income statement should be considered as well.

If the debtor's projected earnings exceed expenses, it might not make sense to liquidate that debtor's assets. As long as the debtor can utilize its assets profitably, to produce positive net income, economically it could be more efficient for the debtor to *reorganize* its business, i.e., to retain its property and produce profits through continued business operation. The focus is on *current* income and expenses; if *past* debts are taken into account, the debtor still may have negative net earnings. But what is past is past; in deciding how to deploy the debtor's assets most efficiently, only future profitability should matter. If the debtor can utilize those assets to produce positive earnings, creditors holding past debts can be paid out of those future earnings. Those creditors will benefit from a future payment plan if the present value of those payments equals or exceeds the amount that creditors would have received in an immediate liquidation. Of course, if the debtor is operating inefficiently, liquidation will be the most prudent course.

Reorganization, then, might offer an opportunity for a viable business to realize a "going concern" premium over liquidation value. Indeed, it is a condition of confirmation of a chapter 11 plan that unsecured creditors be paid at least as much as they would receive in a liquidation.[3] § 1129(a)(7)(A)(ii). Much of the negotiations that occur in chapter 11 are over how to *allocate* this premium between various stakeholders.

Opting for reorganization instead of liquidation may be a better solution for the debtor as well as for creditors. The debtor will be able to keep its property and its business, and this approach may preserve value for the residual owners. Individual debtors also are eligible for chapter 11 relief, and may benefit from it.[4] An individual debtor may opt for chapter 11 in order to keep more of her property, and also to maintain a better credit rating. However, with the increased debt ceilings for chapter 13 since 1994, and with chapter 13 generally more favorable to debtors than chapter 11, relatively few individual debtors are likely to file under chapter 11.[5] For example, in the 12-month period ending December 31, 2015, 301,705 cases were filed under chapter 13 (of which 299,515 were nonbusiness cases), while a mere 1,111 nonbusiness chapter 11 cases were filed.[6]

As mentioned, reorganization, rather than liquidation, also may benefit other constituencies beyond the debtor and the creditors. For example, employees of a business obviously have a strong interest in keeping their jobs, while suppliers want to

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[3] See § 11.26.

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

[5] Before 1994, a debtor was eligible to file for relief under chapter 13 only if she owed unsecured debts of no more than $100,000 and secured debts of no more than $350,000. Beginning in 1994, and as most recently indexed in 2016, those limits have been raised to $394,725 in unsecured debts and $1,184,200 in secured debts. § 109(e).

The 2005 amendments, which imported many of the negative (for individual debtors) aspects of chapter 13 into chapter 11, such as deferring the discharge and including postpetition property in the estate, make chapter 11 an even less appealing choice than before for individuals.

[6] United States Courts Statistics, U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-month Period Ending December 31, 2015, http://www.uscourts.gov/statistics/table/f-2/bankruptcy-filings/2015/12/31 (last visited Mar. 17., 2016).

keep a customer; the failure of a business inevitably has a negative ripple effect on those entities that did business with that debtor. More indirectly, the community in which the debtor operates may have an interest in keeping the business operating.[7]

In some cases it might be possible to obtain the benefits of a reorganization in a liquidation. As noted above, the basic premise underlying a reorganization is that the *going concern* value of the business exceeds the *liquidation* value, and reorganizing allows financially interested parties to capture that going concern premium. In theory, however, the debtor's assets possibly could be *sold* intact to a third party purchaser for a price that reflects the going concern value of the asset package.

Chapter 11 does authorize the debtor's assets to be sold, in part or in their entirety. In other words, partial or total liquidations are permitted in chapter 11. § 1123(b)(4). Furthermore, in recent years it has become quite common for all the debtor's to be sold under § 363 early in the case,[8] with the plan then devoted primarily to dividing up the sale proceeds. Some commentators have even argued for a *mandatory* auction system in this context.[9] These reformers are concerned about the inefficiencies of chapter 11, and have greater faith in the markets. However, it is not obvious that markets would work more efficiently than chapter 11 in allowing the realization of the going concern surplus.

Critics (especially those associated with the "law and economics" camp) attacked chapter 11 in the 1980s and 1990s, suggesting that chapter 11 might do more harm than good, and proposed various solutions, ranging from reform to repeal.[10] Despite the

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[7] See Karen Gross, Taking Community Interests Into Acount in Bankruptcy: An Essay, 72 Wash. U. L. Rev. 1031 (1994).

[8] See Ralph Brubaker & Charles Jordan Tabb, Bankruptcy Reorganization and the Troubling Legacy of *Chrysler* and *GM*, 2010 U. Ill. L. Rev. 1375 (2010). See also Barry E. Adler, A Reassessment of Bankruptcy Reorganization After *Chrysler* and *General Motors*, 18 Am. Bankr. Inst. L. Rev. 305 (2010); Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751 (2002); Stephen J, Lubben, No Big Deal: The *GM* and *Chrysler* Cases in Context, 83 Am. Bankr. L.J. 531 (2009) (hereafter "No Big Deal"); Stephen J. Lubben, The "New and Improved" Chapter 11, 93 Ky. L.J. 839 (2005) (hereafter "New and Improved"); Mark J. Roe & David Skeel, Assessing the *Chrysler* Bankruptcy, 108 Mich. L. Rev. 727 (2010); David A. Skeel, Jr., Creditors' Ball: The "New" New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 927 (2003). See generally § 5.17.

[9] See Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J. L. & Econ. 633, 634 (1993) (hereafter "Revisiting Auctions") ("[W]hen large, publicly traded firms enter Chapter 11, they should be put on the auction block and sold to the highest bidder. A speedy sale separates the question of how to use the assets from the question of how rights to them will be allocated among creditors, shareholders, and others."); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127, 139–45 (1986) (hereafter "Uneasy Case") (discussing the sale of assets under chapter 11); Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 218–24 (1986).

[10] The halcyon era of the "whither reorganization?" debate was from 1986 (begun with Jackson's and Baird's 1986 works, see supra note 9) through 1993, with the "end game" of that round of commentary being the 1992 article by Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 Yale L.J. 1043 (1992), and the ensuing replies (see infra note 11).

A second round of debate, focused on the notion of "contract bankruptcy," was triggered in 1992 by the publication of Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51 (1992), and ran through 1999, largely ending with a series of articles, replies, and surreplies in the Yale Law Journal by Alan Schwarz and Lynn LoPucki, cited below, and infra note 11.

Then, in 2003, Baird and Rasmussen questioned whether chapter 11 was even relevant anymore as a vehicle for effecting large corporate reorganizations. Baird & Rasmussen, supra note 8, 55 Stan. L. Rev. 751. LoPucki again responded. Lynn M. LoPucki, The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's *The End of Bankruptcy*, 56 Stan. L. Rev. 645 (2003).

critics, chapter 11 has had just as many devout defenders.[11] The academic furor now has largely subsided. While in some shape the debate probably will continue,[12] it is worth noting that, as of 2016, neither Congress nor the Supreme Court had ever endorsed any radical revisions to the basic shape of chapter 11 relief. Indeed, in recent years the most dramatic change in the reorganization landscape, especially evident in the aftermath of the 2008 economic debacle, has been the trend of large companies directly seeking bailouts from the federal government, in lieu of (or in addition to) seeking relief in the federal bankruptcy court.[13]

In addition to the foregoing, notable critics, some of whom suggest drastic reforms or alternatives to chapter 11, include: Barry E. Adler, A Theory of Corporate Insolvency, 72 N.Y.U. L. Rev. 343 (1997); Barry E. Adler, A World Without Debt, 72 Wash. U. L. Q. 811 (1994); Barry E. Adler, Finance's Theoretical Divide and the Proper Role of Insolvency Rules, 67 S. Cal. L. Rev. 1107 (1994); Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311 (1993); Barry E. Adler, Bankruptcy and Risk Allocation, 77 Cornell L. Rev. 439 (1992); Philippe Aghion et. al., The Economics of Bankruptcy Reform, 8 J.L. Econ. & Org. 523 (1992); Baird, supra note 9, Revisiting Auctions, 36 J. L. & Econ. 633; Baird, supra note 9, Uneasy Case, 15 J. Legal Stud. 127; Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988); James W. Bowers, Rehabilitation, Redistribution, or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses, 72 Wash. U. L. Q. 955 (1994); James W. Bowers, The Fantastic Wisconsylvania Zero-Bureaucratic Cost School of Bankruptcy Theory: A Comment, 91 Mich. L. Rev. 1773 (1993); James W. Bowers, Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097 (1990); Jackson, supra note 9, at 209–24; Thomas H. Jackson, Bankruptcy, Nonbankruptcy Entitlements and the Creditors' Bargain, 91 Yale L.J. 857 (1982); Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 Am. Bankr. Inst. L. Rev. 85 (1995); Robert K. Rasmussen, The Ex Ante Effects of Bankruptcy Reform on Investment Incentives, 72 Wash. U. L. Q. 1159 (1994); Robert K. Rasmussen, The Efficiency of Chapter 11, 8 Bankr. Dev. J. 319 (1991); Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganizations, 83 Colum. L. Rev. 527 (1983); Alan Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 Yale L.J. 1807 (1998); Alan Schwartz, Contracting About Bankruptcy, 13 J. L. Econ. & Org. 127 (1997); Alan Schwartz, Bankruptcy Workouts and Debt Contracts, 36 J.L. & Econ. 595 (1993); Michelle J. White, Does Chapter 11 Save Economically Inefficient Firms? 72 Wash. U. L. Q. 1319 (1994).

[11] See John D. Ayer, Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide, 72 Wash. U. L. Q. 883 (1994); John D. Ayer, Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case, 44 S.C. L. Rev. 863 (1993); Jean Braucher, Bankruptcy Reorganization and Economic Development, 23 Cap. U. L. Rev. 499 (1994); David Gray Carlson, Bankruptcy Theory and the Creditors' Bargain, 61 U. Cin. L. Rev. 453 (1992); Hon. Frank H. Easterbrook, Is Corporate Bankruptcy Efficient?, 27 J. Fin. Econ. 411 (1990); Christopher W. Frost, Bankruptcy Redistributive Policies and the Limits of the Judicial Process, 74 N.C. L. Rev. 75 (1995); Donald R. Korobkin, The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig, 78 Iowa L. Rev. 669 (1993); Donald R. Korobkin, Contractarianism and the Normative Foundations of Bankruptcy Law, 71 Tex. L. Rev. 541 (1993); Donald R. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 Colum. L. Rev. 717 (1991); Lynn M. LoPucki, Contract Bankruptcy: A Reply to Alan Schwartz, 109 Yale L.J. 317 (1999); Lynn LoPucki, Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig, 91 Mich. L. Rev. 79 (1992); Lawrence Ponoroff, Enlarging the Bargaining Table: Some Implications of the Corporate Stakeholder Model for Federal Bankruptcy Proceedings, 23 Cap. U. L. Rev. 441 (1994); Tabb, supra note 2, 44 S.C. L. Rev. 791; Elizabeth Warren & Jay Lawrence Westbrook, Contracting Out of Bankruptcy: An Empirical Intervention, 118 Harv. L. Rev. 1197 (2005); Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336 (1993); Elizabeth Warren, The Untenable Case for the Repeal of Chapter 11, 102 Yale L.J. 437 (1992); Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775 (1987); William C. Whitford, What's Right About Chapter 11, 72 Wash. U. L. Q. 1379 (1994).

[12] A useful review of the debate and a critique of the earlier reform proposals is found in David A. Skeel, Jr., Markets, Courts, and the Brave New World of Bankruptcy Theory, 1993 Wis. L. Rev. 465 (1993). The "contract bankruptcy" debate is assessed in Steven L. Schwarcz, Rethinking Freedom of Contract: A Bankruptcy Paradigm, 77 Tex. L. Rev. 515 (1999). See also Susan Block-Lieb, The Logic and Limits of Contract Bankruptcy, 2001 U. Ill. L. Rev. 503 (2001).

[13] For example, Chrysler, American Express, General Motors, Freddie Mac, Fannie Mae, are all among large companies that received a "bail-out" from the federal government. See Matthew Ericson, Elaine

In 2014, the American Bankruptcy Institute released the Final Report and Recommendations of its "Commission to Study the Reform of Chapter 11."[14] This monumental study likely will form the basis for the discussion of chapter 11 reform for years to come.[15]

One of the main criticisms of chapter 11 is that it failed to achieve its stated goals at an acceptable cost,[16] although more recent empirical scholarship has questioned that assertion.[17] Another critique, noted above, is that the going concern premium could be reaped in a market sale, obviating the need to resort to the inefficient processes of a court-supervised reorganization.[18] The increasingly ubiquitous use of all-asset § 363 sales allays this concern—where a sale is more efficient (and even sometimes where it is not), that path quite probably is already being followed.[19] Yet another criticism is that chapter 11 creates perverse incentives and encourages strategic risk-taking.[20] The redistributional tendencies of chapter 11 have been questioned.[21] Furthermore, some critics assert that "extraneous" interests (such as preserving jobs, aiding suppliers, and assisting communities) should not be taken into account, but that the only appropriate determinants of bankruptcy policy are value maximization and optimal asset deployment.[22] Finally, chapter 11 has been assailed as a weak "second-best" political compromise that should be replaced with a free market contract-based structure.[23]

Whatever the theoretical niceties, in the real world many financially troubled debtors try to restructure their debts, instead of just liquidating. Often this restructuring is accomplished outside of the bankruptcy court, in a workout agreement.[24] Perhaps the relevant question to ask is why a reorganization ever needs to take place under the protection of a court.[25]

He & Amy Schoenfeld, Tracking the $700 Billion Bailout, N.Y. Times, http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html (last visited Aug. 18, 2015).

[14] Commission to Study the Reform of Chapter 11: Final Report and Recommendations (American Bankruptcy Institute 2014) (hereafter "ABI Commission Report").

[15] The Study, over 300 pages long, issued detailed analyses and proposed recommendations for virtually all important aspects of chapter 11, including commencing the case (Part IV); administering the case (Part V); exiting the case (Part VI); small and medium-zied enterprises (Part VII); the standard of review and key definitions (Part VIII); and other issues relating to chapter 11 cases (part IX). See id. Many of the recommendations made will be discussed throughout this chapter.

[16] See Lawrence A. Weiss, Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. Fin. Econ. 285 (1990).

[17] See Stephen P. Ferris & Robert M. Lawless, The Expenses of Financial Distress: The Direct Costs of Chapter 11, 61 U. Pitt. L. Rev. 629 (2000).

[18] See supra note 9 and accompanying text.

[19] See supra note 8 and accompanying text. See also § 5.17.

[20] See John D. Ayer, Goodbye to Chapter 11: The End of Business Bankruptcy as We Know It, 5 Norton Bankr. L. Adviser 2 (2001).

[21] See Bruce A. Markell, Clueless on Classification: Toward Removing Artifical Limits on Chapter 11 Claim Classification, 11 Bankr. Dev. J. 1 (1995).

[22] For a discussion on these competing views, see Christopher W. Frost, The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations, 72 Am. Bankr. L.J. 103 (1998).

[23] See generally Robert J Keach & Albert Togut, Commission to Explore Overhauling Chapter 11, 30–JUN Am. Bankr. Inst. J. 36 (2011).

[24] See § 1.4; Stuart C. Gilson et al., Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default, 27 J. Fin. Econ. 315 (1990).

[25] For a fuller discussion, see Tabb, supra note 2, 44 S.C. L. Rev. at 804–07.

However, consensual out-of-court workouts do not always work. One reason is that dissenting creditors cannot be bound to the restructuring agreement. A dissenter is free to invoke its state law collection remedies against the debtor, such as levying against the debtor's assets. These actions might make it difficult for the debtor to continue in business. A "holdout problem" then arises: even if a workout would be better for the creditors as a group, the holdout dissenting creditor can "extort" more than its fair share from the debtor by threatening to undermine the whole reorganization.

Chapter 11 solves the holdout problem. The first necessary component of the solution is to enjoin dissenting creditors from exercising their state law collection remedies against the debtor. The second element is to bind the dissenters to the terms of the restructuring agreement. Some type of court process is needed to implement these two remedies. The original mechanism used was the equity receivership.[26] Today, chapter 11 does the job. A reorganization under chapter 11 enjoys the benefits of both a stay provision, § 362, and a rule binding dissenters to the terms of the plan agreed to by the necessary majority of creditors. § 1141(a).

§ 11.2 Historical Antecedents

Chapter 11 has three parents: chapter X, chapter XI, and chapter XII. These three chapters, offering different forms of reorganization relief, were enacted as part of the Chandler Act of 1938.[27] One of the most significant decisions Congress made in 1978 was to merge the three business reorganization chapters into a single chapter, chapter 11.[28]

Chapter X was intended to provide for the reorganization of large public companies. Enacted against a backdrop of perceived abuse of public creditors and investors under then-current reorganization laws, chapter X's overriding theme and purpose was paternalistic protection. The net result was an extremely cumbersome and expensive procedure. Some of the most salient features of chapter X were:

- The judge had to approve the petition, if satisfied that it complied with the chapter's requirements and was filed in good faith. Bankruptcy Act § 141.
- An independent trustee was appointed in every case, and management of the debtor was ousted. The only exception was if debts were less than $250,000. Bankruptcy Act § 156.
- Any party in interest could file a plan. Bankruptcy Act § 169.
- The court had to approve the plan after a formal hearing, *before* the plan could be submitted to creditors and stockholders for a vote. Bankruptcy Act §§ 169, 174.

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[26] See David A. Skeel, Jr., Debt's Dominion: A History of Bankruptcy Law in America 56–60 (2001); see also Garrard Glenn, The Basis of the Federal Receivership, 25 Colum. L. Rev. 434 (1925); Oliver H. Bassuener, Bankruptcy—Reorganizations—Equity Receiverships, 20 Marq. L. Rev. 156 (1936).

[27] Ch. 575, 52 Stat. 840 (1938).

[28] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 223 (1977).

- After the approval hearing, and before the court approved the plan, the Securities and Exchange Commission prepared and filed an "advisory" report on the plan. Bankruptcy Act § 172.

- The plan could only be confirmed if it was "fair and equitable." Bankruptcy Act § 221(2). The "fair and equitable" test was a term of art meaning that the plan satisfied the "absolute priority" rule. The absolute priority rule required full payment (but no more than full payment) of senior creditors before anything could be paid to junior creditors, and full payment (but no more) to junior creditors before anything could go to equity. In practice, to determine if the plan complied with the "fair and equitable" test, the court had to value the reorganized business.[29]

Chapter XI offered none of the laborious protections of chapter X, but at the same time did not offer as much relief.[30] Titled "Arrangements," the supposed purpose of chapter XI was to permit a smaller business to compose its *unsecured* trade debts. The definition of an "arrangement" spoke in terms of a "plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his unsecured debts." Bankruptcy Act § 306(1). The definitions of "creditors" and of "debts" referred only to unsecured debts. Bankruptcy Act § 307(1), (2). The plan under chapter XI could not affect secured debts or equity; the arrangement could only modify or alter the rights of unsecured creditors. Bankruptcy Act § 356.

So why did over 90% of all business debtors choose to proceed under chapter XI instead of chapter X?[31] In contrast to the unfavorable provisions of chapter X, chapter XI provided that:

- The debtor presumptively was continued as debtor in possession, Bankruptcy Act § 342, Rule 11–18(b); a receiver or trustee was only appointed if the need for one was established.

- The debtor had the exclusive right to file a plan as long as its chapter XI case was pending. Bankruptcy Act § 323, Rule 11–36.

- The plan of arrangement did *not* have to comply with the absolute priority rule; instead, it only had to be in the "best interests of creditors," Bankruptcy Act § 366(2), meaning that unsecured creditors would receive liquidation value under the plan. This meant that the debtor could retain the entire going concern surplus over liquidation value for itself.

In a nutshell, then, under chapter XI the debtor could (i) retain control of the business and the plan, (ii) capture the going concern surplus, to the exclusion of creditors, and (iii) do it all much more quickly and inexpensively. They just could not modify secured claims and equity. In addition to these features, there was a growing appreciation by professionals that in chapter XI cases, bankruptcy courts might

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29 See § 11.31.

30 See H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 225–26 (citing to relevant sections of the Bankruptcy Act, stating chapter XI plans were restricted in relief and did not permit adjustment of secured debt or of equity).

31 H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 222 (1977).

"liberally construe the bankruptcy law beyond its original intent," in the debtor's favor.[32] Little wonder, then, that even large public companies such as W.T. Grant sought relief under chapter XI instead of chapter X. Conversion from XI to X could be ordered, but even public corporations were not excluded automatically from chapter XI. According to the Supreme Court, the test for which chapter should be used turned on a nebulous "needs to be served" standard.[33]

Chapter XII, titled "Real Property Arrangements by Persons other than Corporations," was a peculiar vehicle designed for individuals or other noncorporate entities to deal with encumbered real estate. In form it was modeled after chapter XI, but the primary purpose of the plan was to alter or modify "debts secured by real property." Bankruptcy Act § 406(1). Chapter XII was enacted initially to accommodate a unique method of real estate financing in Chicago, Illinois.[34]

In the 1978 Bankruptcy Code, Congress decided to merge the three chapters, concluding that any justification for separate chapters had disappeared.[35] The goal in crafting the single reorganization chapter was to "adopt[ ] much of the flexibility of chapter XI of current law, and incorporate[ ] the essence of the public protection features of current chapter X."[36] As things stood when the current Bankruptcy Code was enacted, Congress observed that "chapter X has become an unworkable procedure, and chapter XI is inadequate to fill the void."[37] As will be discussed in subsequent sections, the single chapter 11 sought to take the middle ground between chapters X and XI, although favoring the flexibility of chapter XI, by including provisions such as:

- The debtor is presumptively continued as debtor in possession, §§ 1101(1), 1107(a), but may be replaced by a trustee for cause, § 1104(a).[38]
- The debtor is given the exclusive right to file the plan for an initial period of time, but not forever. § 1121.[39]
- The court does not have to preapprove the plan, and the role of the SEC is greatly reduced.[40]

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[32] Harvey R. Miller, Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960–2010), 19 J. Bankr. L. & Prac. 3 Art. 1 (2010) (listing the perceived advantages as bankruptcy courts construing the law to "(a) enjoin secured creditors from exercising remedial rights for extended periods of time; (b) enjoin all unsecured creditors and others from taking any actions against the debtor and its property [ ]; (c) construe rejection and assumption of executory contracts, including collective bargaining agreements and unexpired leases to favor debtors in possession or trustees, and (d) allow dilution of equity interests").

[33] Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956) ("The essential difference is not between the small company and the large company but between the needs to be served.").

[34] H.R. Rep. No. 95–595, 95th Cong., 1st Sess. 223–24 (1977).

[35] Id. at 223.

[36] Id. at 224.

[37] Id. at 223.

[38] See §§ 11.4, 11.6.

[39] See § 11.15.

[40] See § 11.9.

- The best interests liquidation test of chapter XI must always be satisfied, § 1129(a)(7),[41] but the absolute priority rule of chapter X is triggered only if a class votes against the plan, § 1129(b).[42] This compromise permits creditors and equity holders to bargain over the allocation of reorganization value.
- The interests of creditors and equity security holders are protected by (i) committee representation, §§ 1102, 1103;[43] (ii) the right to vote, § 1126;[44] (iii) limits on classification, §§ 1122, 1123(a);[45] and (iv) the right to receive an approved disclosure statement before voting. § 1125.[46]

Chapters X, XI, and XII were not the first reorganization provisions of the bankruptcy law. Composition agreements were introduced as early as 1874.[47] The 1874 law permitted the debtor to retain his property and to propose a plan that would pay creditors a stated percentage of the debts over time. If accepted by a majority in number and three-fourths in value of the creditors, the plan could be confirmed and would bind all creditors, even those who voted against the plan. This composition law died with the rest of the Bankruptcy Act when it was repealed in 1878.

A similar composition provision was included in § 12 of the Bankruptcy Act of 1898, which required a majority of creditors in number and value to accept the plan, and that the plan was in the best interests of creditors (the liquidation test), before a court could confirm it.[48] Confirmation of a composition agreement discharged a debtor from his debts, other than those debts a debtor failed to pay pursuant to the composition agreement. Bankruptcy Act § 14c.

During the Great Depression of the 1930s, several reorganization provisions were enacted by Congress before the adoption of chapters X, XI, and XII in 1938.[49] First, in 1933 Congress made compositions more widely available in § 74.[50] The same law authorized agricultural compositions[51] and railroad reorganizations.[52] The very next year, corporate reorganizations were authorized in § 77B.[53] A municipal reorganization law also was passed in 1934.[54] While the Supreme Court overturned this first municipal reorganization law,[55] a second such law, passed in 1937,[56] was upheld by the Court.[57] Congress sought to help farmers keep their farms in the Frazier-Lemke Act of

41 See § 11.26.

42 See §§ 11.30–11.34.

43 See § 11.8.

44 See § 11.21.

45 See § 11.17.

46 See § 11.20.

47 Ch. 390, § 17, 18 Stat. 182–84 (1874).

48 Ch. 541, § 12, 30 Stat. 544, 549 (1898).

49 For discussion, see Charles Jordan Tabb, The History of the Bankruptcy Laws in the United States, 3 Am. Bankr. Inst. L. Rev. 5, 28 (1995). See also Skeel, supra note 26, pt. 2, "The Great Depression and New Deal," 73–127.

50 Act of March 3, 1933, ch. 204, 47 Stat. 1467.

51 Id., 47 Stat. at 1470–74 (§ 75).

52 Id., 47 Stat. at 1474–82 (§ 77).

53 Act of June 7, 1934, ch. 424, 48 Stat. 911.

54 Act of May 24, 1934, ch. 345, 48 Stat. 798 (chapter IX).

55 Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936).

56 Act of Aug. 16, 1937, ch. 657, 50 Stat. 653.

57 United States v. Bekins, 304 U.S. 27 (1938).

1934,[58] but the Supreme Court held that act unconstitutional in 1935.[59] A revised version was enacted in just a few weeks,[60] which the Court then upheld.[61] Both the railroad reorganization provision, § 77, and the corporate reorganization section, § 77B, were amended in the same long summer of 1935.[62] The Supreme Court upheld the constitutionality of the railroad reorganization law in a critical decision.[63] In the Chandler Act of 1938, Congress split the corporate reorganization law into the tripartite scheme of chapters X, XI, and XII, a schism that was to be healed 40 years later.

A review of the historical treatment of the reorganization laws, and an appreciation of the roots of some modern provisions of chapter 11, also must take into account the heritage of the federal equity receiverships of the late nineteenth and early twentieth centuries.[64] Equity receiverships were used as a means of keeping the railroads running, and were extended to provide for corporate reorganization prior to the enactment of § 77B in 1934.[65]

A receivership normally was commenced by a creditor's petition to the federal court to exercise its equity jurisdiction and appoint a receiver to assume control of the debtor corporation's assets. The receiver would take title to the assets, halting creditor collection efforts. Furthermore, the receiver had the power to continue operating the debtor's business while searching for a buyer of the assets, thus preserving the ability to obtain going concern value for the assets. Creditors were paid out of the proceeds of the receiver's foreclosure sale of the assets.

Eventually insiders came to dominate receiverships, and abuses became pervasive.[66] Exorbitant fees were paid to professionals, many of whom were cronies of the debtor's managers. Old management would effectively retain control of the debtor by purchasing the debtor's assets through the guise of a "protective committee" which the insiders dominated. Several judicial doctrines were developed to limit such abuses. The most important for modern purposes was the "absolute priority" rule, which precluded old shareholders from retaining any interest in the debtor unless all creditors were paid in full.[67] This requirement that the transaction be "fair and equitable" was carried over in chapter X in 1938, and is incorporated in current chapter 11 if a class of unsecured creditors or equity holders does not accept the plan.[68] § 1129(b).

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[58] Ch. 869, 48 Stat. 1289 (1934) (amending § 75).

[59] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

[60] Act of Aug. 28, 1935, ch. 792, 49 Stat. 942.

[61] Wright v. Vinton Branch, 300 U.S. 440 (1937).

[62] Act of Aug. 27, 1935, ch. 774, 49 Stat. 911 (amending § 77); Act of Aug. 19, 1935, ch. 809, 49 Stat. 965 (amending § 77B).

[63] Cont'l Illinois Nat'l Bank & Trust Co. v. Chicago, Rock I. & P. Ry. Co., 294 U.S. 648 (1935).

[64] For discussion, see Tabb, supra note 49, 3 Am. Bankr. Inst. L. Rev, at 21–23; see also Skeel, supra note 26, ch. 2, "Railroad Receivership and the Elite Reorganization Bar," 48–70.

[65] See Garrard Glenn, The Basis of the Federal Receivership, 25 Colum. L. Rev. 434 (1925).

[66] See Jacob Trieber, The Abuses of Receiverships, 19 Yale L.J. 275 (1910).

[67] See N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

[68] See §§ 11.30–11.34.

§ 11.3 Planning: Weighing the Chapter 11 Alternative

Filing for relief under chapter 11 has become a business-planning tool of choice for many business debtors. But why? What are the merits and demerits of filing under chapter 11? To answer that question, one must compare chapter 11 with the alternatives a financially troubled debtor faces. Those alternatives include: (1) do nothing formal; (2) attempt an out-of-court workout; (3) liquidate; or (4) file for relief under another chapter of the Bankruptcy Code.

Chapter 11 versus "doing nothing"

Sometimes the best step to take is none at all. While chapter 11 can provide meaningful relief to many debtors, it poses risks and costs as well. A debtor might be able to avoid filing by persuading its most persistent creditors to hold off in collection efforts while the debtor restructures its business outside of court, sells off unprofitable divisions, refocuses marketing efforts, or the like. If enough creditors can be convinced to stay their hand, if the debtor's business problems are fixable, and if major debt restructuring is not required, doing nothing formal might work.

Chapter 11 versus an out-of-court workout

By the time a debtor gets to the threshold of actively considering chapter 11, the "do nothing" option usually will have been thoroughly exhausted. More drastic measures probably are necessary. Assuming that the debtor wants to continue business operations rather than liquidate, but needs to restructure its debts in order to survive both in the short term and the long term, the debtor has two primary choices: reorganize under the supervision of a court in chapter 11, or attempt an out-of-court workout. Studies have shown that about half of the major business debt reorganizations are accomplished out of court, and about half in court. What are the pros and cons of each?

The primary benefits of chapter 11 over an out-of-court workout are:

- Automatic stay of all creditor collection efforts is in place while a debtor is reorganizing, and until the debtor emerges from bankruptcy. § 362. This prevents creditors from upsetting the applecart by levying on the debtor's assets during the restructuring.
- Dissenting creditors are bound to the terms of a confirmed plan.[69] § 1141(a). This rule overcomes the "holdout" problem that plagues out-of-court workouts.
- Plan may be confirmed over objection of an entire class. § 1129(b). This power is known as "cram down."[70]
- Payment of current interest is suspended during case. § 502(b)(2). Not having to pay interest during the pendency of the case gives the chapter 11 debtor a significant competitive advantage.[71]

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[69] See § 11.35.

[70] See §§ 11.30–11.34.

[71] See Tabb, supra note 2, 44 S.C. L. Rev. at 837–38.

- Unwanted contracts can be rejected or assigned. § 365(a).[72] The debtor's rejection power even extends to collective bargaining agreements.[73] § 1113.
- Financing can be obtained on favorable terms, and prior liens can be subordinated.[74] § 364.
- Avoiding powers of the trustee[75] can be exercised by the debtor acting as debtor in possession. § 1107(a). For example, a debtor in possession may set aside unperfected liens, § 544(a), and also avoid and recover preferential transfers. §§ 547, 550.
- Debtor's management retains control (at least initially).[76] The debtor will be continued as debtor in possession,[77] §§ 1101(1), 1107(a), and will be permitted to use, sell, or lease property of the estate in the ordinary course of business without court oversight.[78] § 363(c)(1). However, transactions out of the ordinary course require bankruptcy court approval, whereas such a limitation would not constrain a workout (although creditors may ask for similar oversight privileges). § 363(b). The bankruptcy court will give substantial deference to the business judgment of the debtor's management.[79]
- Property may be sold free and clear of liens and interests, either outside of the plan or pursuant to the plan.[80] §§ 363(f), 1123(a)(5)(D).
- An acceleration can be reversed, defaults cured, and the original terms of an obligation reinstated.[81] § 1124(2).

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[72] One study sampling large, public company filings between 1991 and 2004 showed that firms with relatively high levels of leased assets were more likely to file for chapter 11 than restructure out of court, suggesting the ability to reject leases incentivized decisions to file. Yung-Yu Ma & Elizabeth Tashijan, Executory Contracts and Chapter 11 Restructuring Incentives (Working Paper, Jan. 28, 2015), available at http://ssrn.com/abstract=2170132.

[73] See §§ 8.11–8.12.

[74] See § 11.10.

[75] See § 6.2.

[76] See, e.g., In re Bayou Grp., LLC, 363 B.R. 674, 686 (S.D.N.Y. 2007), aff'd, 564 F.3d 541 (2d Cir. 2009) ("The management of a bankrupt entity that filed in Chapter 11 is automatically authorized to act as the debtor-in-possession, since under the Bankruptcy Code, the term "debtor-in-possession" quite simply means debtor." (citing 11 U.S.C. § 1101(1))).

[77] See § 11.4.

[78] See §§ 5.16–5.18, 11.13.

[79] See, e.g., In re Spansion, Inc., 426 B.R. 114, 142 (Bankr. D. Del. 2010) ("Absent some demonstrable impropriety in the confirmation process, it is not for the Court to supplant the Debtor's business judgment with its own."); In re Taub, 427 B.R. 208, 224 (Bankr. E.D.N.Y. 2010) ("A debtor-in-possession should be permitted to operate within the broad parameters of sound business judgment, and the debtor-in-possession's performance should not be assessed solely with the benefit of hindsight.").

[80] In certain circumstances, a § 363 sale may also shield an asset-buyer from any successor liability that might otherwise arise. See, e.g., In re Grumman Olson Indus., Inc., 467 B.R. 694, 703 (S.D.N.Y. 2012) ("Section 363(f) can be used to sell property free and clear of claims that could otherwise be assertable against the buyer of the assets under the common law doctrine of successor liability.").

[81] See § 11.18.

- Debtor retains the exclusive right to propose a plan for a limited period of time.[82] § 1121.
- Dramatic restructuring may be effected through the plan. The scope of relief possible in a plan is extremely broad, including sales of assets, corporate mergers, the issuance of stock, modification of claims or curing of defaults, and so forth.[83] § 1123(a)(5).
- Confirmation of plan discharges pre-bankruptcy obligations (except for individual debtors). § 1141(d).
- Centralized venue and supervision by an experienced bankruptcy judge who is likely to have marked "pro-debtor" tendencies.
- The foregoing benefits might be realized expeditiously through a "prepackaged" plan, in which acceptances of the plan are solicited prior to bankruptcy, and then used to confirm a chapter 11 plan.[84] § 1126(b).

With so many factors pointing to the benefits of chapter 11, one can readily see why so many debtors have taken that route. Before jumping in with both feet, however, debtors should weigh the potential downsides of filing chapter 11, and the relative benefits of attempting an out-of-court workout:

- Workout is likely to cost less. In chapter 11, a plan must provide full payment for administrative expenses. §§ 1129(a)(9), 507(a)(2), 503(b). These include professional fees for the debtor *and* all official committees. §§ 327, 330, 1103. The United States trustee's fee also must be paid. 28 U.S.C. § 1930(a)(6). In large cases, administrative expenses may run into the millions of dollars. By engaging in a workout rather than filing chapter 11, professional fees will be reduced due to avoided reporting requirements and extraneous litigation that otherwise accompanies a chapter 11.
- Workout is likely to take less time. Even though chapter 11 is more streamlined than old chapter X,[85] it still can be a relatively cumbersome procedure compared to an out-of-court workout.[86]
- The "hassle" factor is much higher in chapter 11. A chapter 11 debtor must: file voluminous schedules and statements of financial affairs at the outset of the case; be subjected to an examination at an initial meeting of creditors, § 341, and potentially at examinations under Rule 2004; file numerous reports with the United States trustee's office every month; and obtain court approval for many types of business transactions, § 363(b), as well as for most forms of legal relief sought.
- Filing chapter 11 may trigger hostile reactions from trade creditors, banks, labor unions, or other interested parties. A bankruptcy filing, and the negative publicity and fear that follow, could hurt the debtor's business prospects and scare away customers.

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[82] See § 11.15.

[83] See § 11.16.

[84] See § 11.23.

[85] See § 11.2.

[86] For example, an out-of-court workout avoids the need to obtain court approval for various conduct, as required in chapter 11. See 11 U.S.C. §§ 363, 364, 1125(b), 1129; Fed. R. Bankr. P. 2002, 3017, 3018.

- The court must approve the plan as "feasible," even if all classes of creditors and equity holders approve the plan.[87] § 1129(a)(11). Thus, a workout may offer parties more freedom to negotiate.
- The debtor's management risks losing control in chapter 11. Against the debtor's wishes, any of the following scenarios are possible, although none are mandatory: (1) case might be converted to chapter 7, § 1112(b); (2) trustee could be appointed and debtor's management ousted, § 1104(a);[88] (3) hostile plan could be filed, § 1121(c), and confirmed; (4) takeover could be effected through purchase of claims; or (5) equity interests could be forfeited through application of absolute priority rule in cram down, § 1129(b).

Chapter 11 versus liquidation

Preliminarily, a common misconception needs to be put to rest: a debtor is *not* required to reorganize in chapter 11. Liquidation *is* permitted in chapter 11. § 1123(a)(5)(D). A debtor might choose to liquidate in chapter 11 in order to retain control over the liquidation process. For example, Lehman Brothers, the largest bankruptcy case ever filed (in 2008), filed chapter 11 with the purpose of liquidation, not reorganization. Assuming, though, that the choice is reorganization versus liquidation, what factors should influence a debtor's selection?

If the debtor is solvent, even on a liquidation valuation, so that the residual ownership interests of equity retain some value, but the debtor's business prospects are not favorable, the debtor might consider cashing out up front so that it can realize that value. Otherwise, a prolonged and unsuccessful attempt at reorganization under chapter 11 could dissipate the residual value of the company. For example, the Eastern Airlines debacle, in which hundreds of millions of dollars in value were frittered away in chapter 11, is a leading case in point, demonstrating that even chapter 11 cannot salvage a business that is not operationally viable.

Chapter 11 versus chapter 12 or chapter 13

Some debtors will be eligible for relief under both chapter 11 and chapter 12, or both chapter 11 and chapter 13. For debtors of substantial size, the debt limits in chapter 13[89] and chapter 12[90] will preclude relief under those chapters. However, assuming the debtor is eligible, and wants to reorganize, it then must decide which chapter to use. In the vast majority of cases, debtors will prefer either chapter 12 or 13 to chapter 11.[91] Those chapters are much more streamlined and impose fewer burdens on the debtor, allow only the debtor to file a plan, do not allow creditors to vote, and do not have the absolute priority rule. Chapter 13 also offers debtors a broader discharge. § 1328(a).

Chapter 11 may be preferable in some situations, although for individual debtors many of these advantages were taken away in 2005. First, consider the advantages

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[87] See § 11.28.

[88] See § 11.6.

[89] A debtor is only eligible for chapter 13 relief if she has noncontingent, liquidated unsecured debts of no more than $394,725 and secured debts of no more than $1,184,200. § 109(e).

[90] The debt limit in chapter 12 is $4,153,150 in the aggregate. § 101(18).

[91] See § 12.3 (chapter 13 compared to chapter 11), § 13.2 (chapter 12 compared to chapter 11).

prior to 2005. Unlike chapters 12 and 13, the discharge in chapter 11 was not deferred until the completion of the plan, but was entered upon confirmation of the plan. § 1141(d)(1). Furthermore, chapter 11 did not require debtors to commit all projected disposable income to the plan for three to five years, as do chapters 12 (§ 1225(b)) and 13 (§ 1325(b)). Although the debtor retains his property, a trustee is appointed and oversees the debtor in every case under chapter 12 or chapter 13. §§ 1202(a), 1302(a). Conversely, in chapter 11, a trustee is appointed only in rare situations. § 1104(a). The debtor must move much more rapidly to file and obtain confirmation of her plan in chapter 12 or 13, and in chapter 13 must even start paying on the plan prior to confirmation. § 1326(a)(1). Modification of the plan after confirmation may be ordered by the court on the request of a party other than the debtor in chapters 12 or 13, §§ 1229(a), 1329(a), but not in chapter 11. § 1127. Finally, chapter 11 enables a debtor to effect a much more comprehensive restructuring than in chapter 12 or 13. § 1123(a)(5).

In 2005, Congress changed several of the foregoing rules for *individual debtors* to bring chapter 11 more into line with chapter 13, thus reducing the chapter 11 advantage. However, the benefits of chapter 11 versus chapter 12, as discussed above, still apply for corporate or partnership debtors.

The first 2005 change that was prejudicial to individual debtors in chapter 11 concerned postpetition property. Prior to 2005, an individual debtor in chapter 11 could retain for himself property acquired postpetition, including all earnings arising from postpetition services, whereas in chapter 13 such property would come into the estate. § 1306(a). In 2005, however, Congress added § 1115, which essentially copies the chapter 13 rule, bringing all postpetition property into the estate in an individual chapter 11, including earnings from services performed by the individual debtor. § 1115(a).

A second 2005 change that eliminated a chapter 11 advantage over chapter 13 for individuals concerns the discharge rule. Prior to 2005, all chapter 11 debtors received a discharge upon confirmation of the plan, whereas in chapter 13, discharge is deferred until the debtor completed performance under the plan. § 1328(a). In 2005, the rule was amended for individual chapter 11 debtors, who now receive a discharge only upon completion of plan performance, just as in chapter 13, rather than upon confirmation. § 1141(d)(5).

A third change regards the "projected disposable income" test for confirmation. Until 2005, as noted, a chapter 13 debtor had to commit all of his projected disposable income to plan payments in certain circumstances, § 1325(b), whereas an individual debtor in chapter 11 faced no such requirement for confirmation. The 2005 amendments also took away this chapter 11 advantage, adding a projected disposable income test to chapter 11 for individual debtors. § 1129(a)(15). Under this test, if the holder of an allowed unsecured claim objects to confirmation, either: (1) the plan must provide for their payment in full, i.e., the value of the claim as of the effective date of the plan of property to be distributed on account of the claim cannot be less than the amount of such claim; or (2) the value of property to be distributed under the plan is not less than the projected "disposable income" of the debtor (defined in § 1325(b)(2)) to be received during the five-year period beginning the date the first payment is made, or during the period provided by the plan, whichever is longer.

Fourth, the 2005 amendments also altered the plan modification rules for individual debtors, to bring those rules more in line with chapter 13 practice. Now, an individual debtor's plan may be modified at the request of any party in interest, at any time after confirmation, whether or not the plan has been substantially consummated, as long as all payments have not been completed. § 1127(e). The plan may be modified to increase or reduce the amount of payments, extend or reduce the time period for payments, or alter the amount of distribution to a creditor. § 1127(e).

B. CONTROL AND MANAGEMENT OF THE REORGANIZATION CASE

§ 11.4 Two Hats: Debtor and Debtor in Possession

The leading character in the chapter 11 drama is the "*debtor in possession*." The debtor in possession, commonly known as the DIP, is a hybrid creature. The debtor in possession is defined as "debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case." § 1101(1). In plain English, that means that the DIP *is* the chapter 11 debtor (and *vice versa*), but *also* must perform the duties of the bankruptcy trustee. Upon the filing of a chapter 11 case, the debtor schizophrenically assumes two roles. The first is as debtor-*qua*-debtor; the second is as debtor-*qua*-trustee.[92] The debtor is itself, obviously, and is also the fiduciary representative of the bankruptcy estate.[93] All duties, rights and powers of the trustee (except investigating the debtor!) are to be exercised by the debtor as the DIP.[94] § 1107(a). The debtor ceases to be DIP only in the relatively rare event that an independent trustee is appointed under § 1104(a).[95] One of the critical policy decisions that Congress made in the 1978 Code was to leave the debtor in possession as the norm.[96] In doing so, Congress adopted the approach of old chapter XI and rejected the requirement of an independent trustee imposed by old chapter X.[97]

In its dual status as debtor and DIP, the debtor must carry out at least three distinct functions: (1) operate the business; (2) administer the estate; and (3) seek to confirm a plan.

First, the debtor will continue to run the business. A central premise of chapter 11 is to permit financially interested parties to capture the going concern value of the debtor's business; therefore, that value must be preserved before it can be parceled out to creditors and equity holders. In chapter 11, continued operation of the debtor's

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92 The ramifications of the debtor's dual role are explored in Daniel B. Bogart, Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back—Something May be Gaining on You," 68 Am. Bankr. L.J. 155 (1994). See also the discussion in the ABI Chapter 11 Study Commission's Report. See ABI Commission Report, supra note 14, at 21–25. Professor Lubben has thoughtfully examined the impact of fiduciary duties under state corporate law on the board's decision to pursue a bankruptcy strategy. Stephen J. Lubben, The Board's Duty to Keep Its Options Open, 2015 U. Ill. L. Rev. 817 (2015).

93 See, e.g., In re Reliant Energy Channnelview LP, 594 F.3d 200, 210 (3d Cir. 2010) ("[D]ebtors-in possession have a fiduciary duty to maximize the value of the estate. . . ."); In re Grasso, 490 B.R. 500 (Bankr. E.D. Pa. 2013) (discussing the debtor's violation of his fiduciary obligations as a DIP).

94 See S. Rep. No. 95–989, 95th Cong., 2d Sess., at 116 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 404 (1977).

95 See § 11.6.

96 H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 232–34 (1977).

97 See § 11.2.

business is the norm. § 1108.[98] No court order is needed to authorize business operation; if a party in interest wants to curtail the debtor's power to continue the business, that party bears the burden of going into court and requesting the court to impose limits. § 1108. Nor will the debtor in its capacity as business operator need court authority to engage in transactions in the ordinary course of business. § 363(c)(1). Again, a party in interest must obtain a court order to restrain the debtor from entering into ordinary course business transactions. And obtaining such an order will not be easy; the court will give substantial deference to the debtor's business judgment.[99] Only if the complainant can show clear mismanagement, a significant risk of injury to creditors, or abuse of discretion will the court enter a limiting order. Thus, the debtor will be able to continue flying planes, or selling violas, or servicing computers—whatever its business entails.

The debtor also may enter into transactions out of the ordinary course, but only after notice and a hearing. § 363(b). This does not necessarily mean that an actual hearing will be held, but only that notice of the proposed action will be sent to interested parties, who then will have an opportunity to object. If no objection is timely filed, the court may go ahead and approve the requested action without holding a formal evidentiary hearing. § 102(1). The power to make non-ordinary business decisions can be crucial to the debtor's reorganization attempt. Not only may the debtor need to modify its legal obligations through the chapter 11 plan, but the debtor may need to restructure its business operations as well. All of the debt revision in the world will not save the debtor if the underlying business is not made healthy. Perhaps an unprofitable division needs to be sold, or a product line refocused, or a labor agreement renegotiated, or layoffs made. Whatever needs to be done to the business can be done while under court supervision in chapter 11.

As the DIP, the debtor carries out the functions of a trustee. § 1107(a). The trustee is the fiduciary officer of the estate who is charged with primary responsibility for performing the *administrative* tasks relating to the case. § 1106(a). Thus, the DIP must keep accounts of all property, file reports, examine proofs of claims and object to ones it believes are improper, file tax returns, and respond to requests for information. §§ 704, 1106(a), 1107(a). The DIP is the representative of the estate, with the power to sue and be sued. § 323. Furthermore, the DIP as the "trustee" has primary standing to bring avoidance actions, such as contest preferential transfers (§ 547), set aside unperfected liens (§ 544(a)), and challenge fraudulent transfers (§§ 544(b), 548). In carrying out its administrative responsibilities, which is the *second* major role of the DIP, the debtor should be able to count on the local office of the United States trustee for assistance and guidance. 28 U.S.C. § 586(a)(3).

The restructuring of the debtor's business and the administration of the estate are only part of the challenge facing the debtor, however. Presumably (or hopefully) business revision efforts are already underway, or at least in contemplation, by the

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[98] Note that § 1108 permits DIPs to continue operations, and also allows them to modify or cease operations if appropriate under the circumstances. See, e.g., In re Saint Vincents Catholic Med. Ctrs. of New York, 429 B.R. 139, 151 (Bankr. S.D.N.Y. 2010).

[99] See, e.g., In re Dilley, 378 B.R. 1, 7 (Bankr. D. Maine 2007) ("A court will not entertain objections to a trustee's conduct of the estate where that conduct involves a business judgment made in good faith, upon a reasonable basis, and within the scope of his authority under the Code.").

time the debtor arrives at the chapter 11 door. By that time, though, the debtor needs a more radical form of surgery than mere business revision can accomplish. The debtor needs to reorganize not only its business, but also its legal obligations. The plan of reorganization is the means by which the debtor's debts and equity interests are reordered. Confirmation of a plan replaces the old obligations with the new. § 1141. The *third* principal task facing the debtor as DIP, then, is to restructure debt and equity. To do this the debtor must file a plan, §§ 1106(a)(5), 1107(a), 1121, and get the plan confirmed. § 1129. Pragmatically, the ultimate goal of chapter 11 is to confirm a plan. The debtor as DIP has the duty to try to bring that goal to fruition.

In seeking to confirm a plan, the debtor will not have unfettered authority. Most significantly, the debtor must *negotiate* the terms of the plan with the official committee of unsecured creditors, and any other official committees that are appointed, §§ 1102(a), 1103(c)(3), and with the major secured creditors. Although a "cram down" plan is possible, at bottom, chapter 11 is based on the ideal of *consensus*. If the debtor's exclusive period to file a plan under § 1121 expires, other parties in interest may file a hostile plan. § 1121(c). Furthermore, the debtor's management has to be aware that in chapter 11, perhaps more than anywhere else, "uneasy lies the head that wears a crown."[100] The managers could be fired by the board of directors. Studies have shown a very high rate of turnover for the managers of a chapter 11 debtor.[101] Alternatively, the shareholders could replace the board itself[102]—and the new board then could fire the managers. Finally, the court might decide to oust the debtor as DIP and appoint an independent trustee.[103] § 1104(a).

The debtor in its fiduciary capacity as DIP is subject to several duties, as defined by state corporate law.[104] First, the DIP is bound by a duty of *care* owed to its creditors, to exercise the care, diligence and skill of a reasonably prudent person acting under similar circumstances. Second, the debtor has a duty of *loyalty*.[105] Thus, the debtor as DIP must avoid conflicts of interest, refrain from self-dealing, treat all parties fairly, and attempt to maximize the value of the estate. Some courts have held, however, that the duty of loyalty is measured by the "corporate fiduciary" standard, rather than the more stringent "common law trustee" standard.[106] Thus, a circuit court held that a DIP did not violate his fiduciary duties to creditors when he sold property to his parents for the appraised price of $7,000 pursuant to § 363(b), without first disclosing that he had

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[100] William Shakespeare, Henry IV, part 2, Act III, scene 1, line 30.

[101] See Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Coproate Ownership and Control when Firms Default, 27 J. Fin. Econ. 355 (1990); Stuart C. Gilson, Management Turnover and Financial Distress, 25 J. Fin. Econ. 241 (1989); Lopucki & Whitford, supra note 2, 141 U. Pa. L. Rev. 669.

[102] See § 11.5.

[103] See § 11.6.

[104] See, e.g., In re Brook Valley VII, Joint Venture, 496 F.3d 892, 900 (8th Cir. 2007) (fiduciary obligation consists of duty of care and duty of loyalty); In re McConville, 110 F.3d 47, 50 (9th Cir. 1997) (stating that DIPs are "fiduciaries of their own estate owing a duty of care and loyalty to the estate's creditors,"), cert. denied, 522 U.S. 966 (1997).

[105] Wolf v. Weinstein, 372 U.S. 633 (1963).

[106] See, e.g., In re Schipper, 933 F.2d 513 (7th Cir. 1991). See also In re Engman, 395 B.R. 610, 626 (Bankr. W.D. Mich. 2008) ("[C]ourts implicitly, if not explicitly, pass upon the trustee's separate fiduciary duty of loyalty whenever a trustee affirmatively represents, as he must, that he has no personal interest. . . .").

received a higher offer that had then been withdrawn (for $45,000) from a third party prior to bankruptcy.[107]

In proposing a plan, the debtor's dual roles as "debtor" and as "DIP" cannot easily be reconciled.[108] The debtor acting as debtor is and arguably should be free to pursue and promote its own parochial interests. But how then can that role be harmonized with the debtor-as-DIP's supposed fiduciary duty of loyalty to unsecured creditors? Realistically, it cannot.[109] The ABI Study Commission recommended clarifying "that the debtor acting as plan proponent should not be considered a fiduciary for the creditors."[110] If that approach is embraced, of course, then the unsecured creditor body is relegated to a weaker negotiating position than if an independent trustee is appointed, who would have a fiduciary duty in proposing a plan to be loyal to the interests of the unsecured creditors. Permitting a debtor to pursue unapolgetically its own parochial interests in propounding a plan also is relevant to the rights and powers of its equity security holders, discussed in the following section.

§ 11.5 Corporate Governance and the Role of Shareholders

Chapter 11 is based in part on the premise that the reorganization of a viable business under court protection might preserve a going concern premium over and above liquidation value.[111] The game then is to allocate that premium in the plan of reorganization between the various financially interested parties—different classes of creditors and equity holders. Since the "debtor" is presumptively left in control as "debtor in possession,"[112] §§ 1101(1), 1104(a), 1107(a), and as such is given wide discretion to make business decisions, as well as the power to negotiate with creditors and the initial exclusive right to propose the plan,[113] § 1121, the debtor's management plays a crucial role in shaping the distribution of reorganization value. Who has the power to select those managers thus assumes considerable importance.

Outside of bankruptcy, shareholders have ultimate control of a corporation. They elect the board of directors, which in turn selects the managers of the corporation. But outside of bankruptcy, a corporate debtor normally is beholden only to itself, and for the most part is free to promote its own selfish interests as it sees fit. In bankruptcy, as discussed in the previous section, the debtor has a dual role as both debtor and debtor in possession, and in the latter role is a fiduciary for the body of creditors. Does this dual role negate or minimize the presumptive control of corporate shareholders? Stated otherwise, to what extent does the filing of chapter 11 interfere with the normal processes of corporate governance?[114]

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[107] *Schipper*, 933 F.2d 513.

[108] See discussion in ABI Commission Report, supra note 14, at 198–200. See In re Water's Edge Ltd. P'ship., 251 B.R. 1, 7–8 (Bankr. D. Mass. 2000).

[109] See *Water's Edge*, 251 B.R. at 8.

[110] ABI Commission Report, supra note 14, at 200.

[111] See § 11.1.

[112] See § 11.4.

[113] See § 11.15.

[114] Many excellent articles have been written on this topic. See Edward S. Adams, Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results, 73 Boston U.L. Rev. 581 (1993); Bogart, supra note 92, 68 Am. Bankr. L.J. 155; Mark E. Budnitz, Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting be Canceled

The general rule is that the non-bankruptcy state law rules regarding matters of corporate governance continue to apply in a chapter 11 reorganization.[115] Included is the right of shareholders to hold an annual meeting of shareholders, or to call special meetings, and elect a new board of directors. Presumptively, then, a chapter 11 debtor's shareholders would have the right to call a meeting and elect a new board that the shareholders believe would better serve their interests.

As with all general rules, however, exceptions exist. In chapter 11, the bankruptcy court has the power to enjoin a shareholders meeting if it finds that holding the meeting would be a "clear abuse" and is likely to cause "irreparable injury."[116] The question then, of course, is what constitutes "clear abuse" and "irreparable injury."

Note, though, that whatever board is serving, be it the "old" board or a newly elected board, it is subject to the fiduciary duties of care and loyalty, to whatever extent they obtain. While shareholders thus might be able to elect a new board during a chapter 11 case, they do *not* have the right to put a board in place that can shed its DIP hat, along with the fiduciary duties towards creditors, and act solely to promote the parochial interests of the shareholders, no matter what. Having said that, though, as explained in the prior section, courts have recognized the difficulty (impossibility?) of holding a debtor to a fiduciary duty of loyalty to creditors in the context of proposing a reorganization plan, and accordingly some courts have concluded that no such duty exists with regard to proposing a plan.[117] If that view is followed, the legitimacy of upholding the state law governance rights of stockholders even in bankruptcy is significantly strengthened.

The leading case addressing these issues is the Second Circuit's opinion in *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*.[118] The *Manville* case involved an attempt to deal with billions of dollars in liability for asbestos-related injuries. It was one of the most complex chapter 11 cases in history. More than three years into the case, after endless negotiations, a "fragile consensus" was reached and the debtor filed a plan. The debtor's exclusive right to file a plan had been kept in place. The debtor's shareholders, however, did not like the plan. They wanted to call a meeting of shareholders and elect a new board that would file a plan that the shareholders believed would be more favorable to them. Under state corporate law the shareholders had a right to call the meeting. The management of the debtor sought to enjoin the meeting. The bankruptcy court granted the injunction and the district court affirmed. These courts concluded that the Equity Committee,

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Altogether?, 58 Geo. Wash. L. Rev. 1214 (1990); Anna Y. Chou, Corporate Governance in Chapter 11: Electing a New Board, 65 Am. Bankr. L.J. 559 (1991); Christopher W. Frost, Running the Asylum: Governance Problems in Bankruptcy Reorganizations, 34 Ariz. L. Rev. 89 (1992); LoPucki & Whitford, supra note 2, 141 U. Pa. L. Rev. 669 Thomas G. Kelch, Shareholder Control Rights in Bankruptcy and the Withering Mirage of Corporate Democracy, 52 Md. L. Rev. 264 (1993).

[115] See Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 801 F.2d 60, 64 (2d Cir. 1986); In re J.P. Linahan, Inc., 111 F.2d 590 (2d Cir. 1940); In re Bush Terminal Co., 78 F.2d 662 (2d Cir. 1935); In re Saxon Indus., Inc., 39 B.R. 49 (Bankr. S.D.N.Y. 1984); In re Lionel Corp. 30 B.R. 327 (Bankr. S.D.N.Y. 1983); Saxon Indus., Inc. v. NKFW Partners, 488 A.2d 1298 (Del. 1985).

[116] See *Manville*, 801 F.2d at 64, 68; *Linahan*, 111 F.2d 50.

[117] See, e.g., *Water's Edge*, 251 B.R. at 7–8. This is the recommendation urged in the ABI Commission Report, supra note 14, at 199–200.

[118] 801 F.2d 60 (2d Cir. 1986).

representing the debtor's shareholders, was willing to threaten to "torpedo" the reorganization in order to advance their own selfish desire to grab a larger share of the pot.

The Second Circuit reversed the summary judgment granting the injunction and remanded for further findings. In its opinion, the Second Circuit emphasized that the bankruptcy court should be very reluctant to enjoin a shareholders' meeting.[119] The Equity Committee's desire to obtain more bargaining power in the formulation of the plan, standing alone, was not sufficient to show "clear abuse," as to authorize a bankruptcy court to enjoin a shareholder meeting.[120] This held true even if the shareholders wanted to force the reorganization to "take an entirely different turn." Nor was the three-year delay in requesting a meeting plainly abusive, although delay could be a factor in proving abuse.[121] In short, the *Manville* court made very clear that a debtor's shareholders have a strong presumptive right to elect a board of directors that continues in reorganization, even if their motivation is selfish and could result in delaying the reorganization process.[122]

So what *would* constitute a clear abuse (and, at the same time, indicate the likelihood of irreparable injury)? The focus, the *Manville* court said, should be on the seriousness of the threat to the viability of the reorganization itself, rather than simply whether the reorganization would be delayed. If the reorganization was "seriously threatened," or put in "real jeopardy," an injunction against the shareholders meeting would be warranted.[123] The same circuit in 1979 had approved an injunction of a shareholders meeting in a case where the showing was that holding the meeting could sound the "death knell" for rehabilitation.[124] Delay is permissible, apparently, but death is not.

On remand, the bankruptcy judge in *Manville* entered the injunction.[125] He found that holding the shareholders meeting would in fact seriously jeopardize the reorganization. Years had been devoted to achieving a delicate and fragile consensus on a plan in a case involving billions of dollars and people's health at stake. Thus, the shareholders' desire to enforce their state law rights and attempt to get a bigger slice of the pie had to yield to the reorganization imperative at this late date.

An intriguing question was broached but not decided by the Second Circuit in the *Manville* case: what happens to the shareholders' right to call a meeting and elect a board if the debtor is *insolvent*? In such a situation, the stock would be worthless. Does it then make any sense for the primary agents of the reorganization (the management of the debtor, acting as DIP) to be selected by a group that has little if any financial interest in the outcome? A group that comes in last in the distribution line, and whose shares are usually cancelled in the reorganization plan? In dictum, the Second Circuit

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[119] Id. at 64.

[120] Id. at 64–65. The court cited with approval the earlier Second Circuit decision in *In re Bush Terminal Co.*, 78 F.2d 662 (2d Cir. 1935).

[121] 801 F.2d at 66 & n.7.

[122] Indeed, the court even stated that, "the shareholders' natural wish to participate in this matter of corporate governance be respected." Id. at 64.

[123] Id. at 66, 67, 69.

[124] In re Potter Instrument Co., 593 F.2d 470 (2d Cir. 1979).

[125] 66 B.R. 517 (Bankr. S.D.N.Y. 1986).

suggested not; if the debtor were insolvent, the court opined that denying the right to call a meeting would be proper, because the shareholders would not then be "real parties in interest."[126]

But is that assertion correct? It might be *if* the "absolute priority" rule were always enforced in a reorganization case. But it is not.[127] Creditors who receive less than 100% of their claims can waive the absolute priority rule, and approve a reorganization plan that gives something to equity holders. Only if a class of creditors votes against the plan is the absolute priority rule triggered. § 1129(b). Even for a debtor that is obviously insolvent, then, equity holders have the right to negotiate with creditors to seek a waiver of the absolute priority rule. And that assumes that the debtor's insolvency could easily be ascertained. If an "insolvency exception" exists to the shareholder's presumptive right to call a meeting under state corporate law, the bankruptcy court would be forced to value the company to determine whether the debtor is solvent. That, however, flies directly in the face of the congressional decision to eliminate the need for a valuation of the debtor in reorganization unless a class votes against the plan. Other courts have disagreed with the rationale underlying the *Manville* dictum, and have stated that the debtor's insolvency does not automatically negate the shareholder's right to call a meeting.[128]

§ 11.6 Appointment and Role of a Trustee

One of the most fundamental decisions Congress made in the 1978 Bankruptcy Code was not to require an independent trustee in every case. Instead, the norm is for the debtor to continue in possession, and to fulfill the fiduciary role of the trustee.[129] § 1107(a). A trustee will only be appointed if the requisite need is shown. § 1104(a).

Under the prior Act, a trustee was required in chapter X in cases where the debts exceeded $250,000. Bankruptcy Act § 156. In chapter XI, however, the debtor was continued as debtor in possession. Protection of the public interest and the interests of creditors was the watchword in chapter X, while chapter XI promoted flexibility for the benefit of creditors and debtors.[130] In merging the two chapters into the single chapter 11, Congress had to decide which it deemed more important. Flexibility won. The need to protect public creditors from insider abuses or debtor mismanagement was not perceived to be pervasive enough to warrant requiring a trustee in every case, as the

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[126] 801 F.2d at 65 n.6. The rationale supporting this dicta also applies to cases like *In re Williams Communications Group, Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002), which hold that "hopelessly insolvent" debtors' shareholders' are not entitled to having an equity committee appointed.

[127] See Lynn M. LoPucki, The Myth of the Residual Owner: An Empirical Study, 82 Wash. U. L. Rev. 1341 (2004).

[128] See, e.g., Saxon Indus., Inc. v. NKFW Partners, 488 A.2d 1298 (Del. 1985). See also In re Saxon Indus., 39 B.R. 49 (Bankr. S.D.N.Y. 1984) ("However, the issue of whether the insolvency of Saxon and the proximity to confirmation should preclude the holding of shareholders' meeting is not before the court at this time. This court will not preclude the equity committee from resorting to all available legal remedies. . . .").

[129] See § 11.4. See also H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 234 (1977) ("[T]he Bill adopts the flexible approach of leaving the debtor in possession of the business unless a request is made for the appointment of a trustee."). For discussion of the trustee's role, see ABI Commission Report, supra note 14, at 26-31.

[130] See § 11.2. See also H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 232 (1977) ("The twin goals of the standard for the appointment of a trustee should be protection of the public interest and the interests of creditors, as contemplated in current chapter X, and facilitation of a reorganization that will benefit both the creditors and the debtors, as contemplated in current chapter XI.").

"serious abuses of the 1930's" had largely been cured by the adoption and enforcement of other laws.[131] Instead, problem cases could be dealt with individually, Congress thought, by having the court appoint a trustee only when needed.[132] The Senate had wanted to require a trustee for all public companies,[133] but the House position providing for the purely discretionary appointment of a trustee ultimately prevailed.

One uninitiated in reorganization practice might assume that routinely appointing a trustee to take the place of the existing management of the debtor would be a wise idea. After all, current management led the debtor into bankruptcy in the first place, whether by incompetence, fraud, or neglect. Is it really a sound idea to retain the very managers who were responsible for the debtor's descent into bankruptcy, and give them the leading role in reorganizing the debtor? Furthermore, if managers know that they will not lose their jobs or control of the company if they drive the debtor into bankruptcy, might they not be encouraged *ex ante* to take excessive business risks, knowing that if things do not work out a soft landing waits in bankruptcy court? Proponents of this line of reasoning assert that the factors that drive a company into bankruptcy court might be more likely to be attributable to endogenous decisions than to exogenous forces if management survival is the norm.

Congress, however, concluded after careful deliberation that the costs of a mandatory trustee system outweighed the benefits. First, Congress discounted the degree of management fault, observing that "simple business reverses" often caused the debtor's need for reorganization, rather than "fraud, dishonesty, or gross mismanagement."[134] Chapter X had been enacted in 1938, in a climate where reorganization abuses were viewed as widespread. In 1978, Congress perceived that the landscape had fundamentally changed, and abuses no longer were commonplace. Furthermore, even where the debtor's management was to blame, the "bad guys" often had *already* been replaced by new managers *before* the bankruptcy filing, and it made no sense to throw out the replacement team. In short, the *benefits* of a mandatory trustee appointment could fairly be questioned.

Second, the *costs* of a mandatory trustee regime would be substantial.[135] The direct costs would be significant; the trustee and the trustee's professionals all have to be paid. In addition, the indirect costs of a trustee must be taken into account. An independent trustee would take time to learn the debtor's business. While the new trustee is working her way through the learning curve, the debtor's already troubled business might die on the vine. Existing debtor management, while perhaps not candidates for the business "hall of fame," at least would already know the nuances of the business, and would not miss a beat while the reorganization was progressing. For these reasons, Congress stated that, "very often, the creditors will be benefited by

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[131] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 233 (1977) ("The serious abuses of the 1930s have largely been cured by the adoption of the securities laws, and their vigorous enforcement by the Securities and Exchange Commission. Most often today, the need for reorganization results from business cycles or honest mismanagement of the company.").

[132] Id. at 232–34.

[133] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 115 (1978).

[134] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 233 (1977).

[135] Id.

continuation of the debtor in possession."[136] And, if existing management were in fact stupid or dishonest, they could be replaced for cause.

A further indirect cost of a mandatory trustee system would be that debtors would be *deterred* from filing for chapter 11 relief in the first place.[137] No one likes to put themselves out of a job. Congress noted that debtors flocked in droves to chapter XI, where the management retained possession, in preference to chapter X, where they would be replaced. In short, if the debtor's management had some assurance that they would be able to keep their jobs, they might be willing to file for chapter 11 relief while the debtor's business was still salvageable.

The end result in the 1978 Code was a congressional decision that a court should only appoint a trustee and oust the debtor from possession on a case-by-case basis, "if the protection afforded by a trustee is needed and the costs and expenses of a trustee would not be disproportionately higher than the value of the protection afforded."[138] Under § 1104(a), one of two showings must be made to support the appointment of a trustee:[139]

1. "*Cause*" exists, "including *fraud, dishonesty, incompetence, or gross mismanagement* of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause." § 1104(a)(1) (emphasis added). Note that the statute goes on to expressly negate as "cause" any bright-line test based on the number of securities holders of the debtor or the amount of the debtor's assets or liabilities.

2. Appointment would be "in the *interests*" of creditors, equity security holders, or other interests. § 1104(a)(2).

In addition, § 1112(b)(1) provides that if cause is shown to convert or dismiss the case under § 1112, the court has the discretion instead to appoint a trustee or an examiner if doing so is in the "best interests of creditors and the estate."[140] § 1112(b)(1).

If the expressed desire for a trustee is based on the perception that the debtor's financial affairs need to be investigated, the preferred course is not to appoint a trustee, but to appoint an examiner instead under § 1104(c).[141] The examiner will not displace the debtor, but can perform the more limited investigatory role.[142] § 1106(b). The standards for determining whether to order the appointment of an examiner are

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[136] Id.

[137] Id. at 233–34.

[138] Id. at 234.

[139] See generally Barry L. Zaretsky, Trustees and Examiners in Chapter 11, 44 S.C. L. Rev. 907 (1993).

[140] In 2005, Congress added a third ground, § 1104(a)(3), providing for the appointment of a trustee when "grounds exist to convert or dismiss the case" under § 1112, but the court determines instead that the appointment of a trustee or an examiner is in the "best interests of creditors and the estate." In 2010, though, in the Bankruptcy Technical Corrections Act, Congress reversed course and deleted § 1104(a)(3), but at the same time transferred that same principle to § 1112(b)(1), providing there that if cause is shown, the case must be either converted or dismissed "unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate." Pub. L. No. 111–327, 111th Cong. 2d Sess., 124 Stat. 3557, 3560–61 (2010).

[141] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 234 (1977).

[142] See § 11.7.

the same as those for appointment of a trustee: the protection must be needed and the cost not disproportionately high."[143]

The congressional intention to provide for the discretionary appointment of a trustee in chapter 11 cases where needed has been perverted by the courts. In practice it is extremely difficult to succeed in having a trustee appointed. Courts announce and apply a very strong presumption against appointing a trustee, proclaim that naming a trustee is an "extraordinary" remedy, and insist that "clear and convincing" evidence must be presented.[144] Some degree of incompetence or mismanagement is magnanimously forgiven by the courts.[145] But it is not clear that Congress intended for the bar to be set so high in trying to get a trustee appointed; in 1978 Congress simply decided that a system of *mandatory* trustees would be unwise. If the creditors and equity holders would be better off with a trustee than with current management, a trustee arguably should be appointed. The debtor's management has no vested right to maintain control.

In some egregious cases a trustee might be appointed under § 1104(a). For example, if the evidence showed outright fraud by the debtor's managers, a trustee would be warranted.[146] In the Eastern Airlines case, a trustee eventually was appointed (albeit too late).[147] The debtor's management in that case had underestimated ongoing losses by hundreds of millions of dollars, and completely lost the confidence of the creditors. Note too that the list of possible factors in § 1104(a)(1) is not exclusive; other reasons, such as an irremediable conflict of interest, or a failure to keep proper books and records, might support the appointment of a trustee.

In 2005 Congress added a new rule, providing that the United States trustee is *required to move* for the appointment of a trustee if there are "reasonable grounds to suspect" that current members of management "participated in actual fraud, dishonesty, or criminal conduct" in managing the debtor or the debtor's public financial reporting. § 1104(e). This was passed in response to the uproar caused by notorious scandals such as Enron and WorldCom. Even before Congress added subsection (e), if a court found the facts of a case to support the appointment of a trustee, the court was without discretion, and must appoint a trustee.[148]

Although there has been considerable debate on the question, the better view is that the court may act *sua sponte* to order the appointment of a trustee.[149] The bankruptcy judge will not actually make the appointment; that task is left to the

[143] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 234 (1977).

[144] See, e.g., In re Bayou Grp., LLC, 564 F.3d 541 (2d Cir. 2009). But see In re Veblen W. Dairy LLP, 434 B.R. 550, 555–56 (Bankr. D.S.D. 2010) ("[A] party seeking the appointment of a chapter 11 trustee bears the burden of persuasion by the preponderance of the evidence, not by clear and convincing evidence."); In re Keely & Grabanski Land P'ship, 455 B.R. 153 (B.A.P. 8th Cir. 2011) (same).

[145] Indeed, § 1104(a)(1) only requires appointment of a trustee for "gross mismanagement," rather than mere mismanagement. See In re Soundview Elite, Ltd., 503 B.R. 571, 583 (Bankr. S.D.N.Y. 2014) ("Displacing a debtor in possession—such as appointing a chapter 11 trustee—is extraordinary relief, and I don't take it lightly. . . . I have no faith that the Debtor's current managers are capable. . . .").

[146] See, e.g., In re Bibo, Inc., 76 F.3d 256 (9th Cir.), cert. denied, 519 U.S. 817 (1996).

[147] In re Ionosphere Clubs, Inc., 113 B.R. 164 (Bankr. S.D.N.Y. 1990).

[148] 11 U.S.C. § 1104(a) ("[T]he court *shall* order the appointment of a trustee . . ." (emphasis added)).

[149] See, e.g., In re Basil St. Partners, LLC, 477 B.R. 856 (Bankr. M.D. Fla. 2012); Allen v. King, 461 B.R. 709 (D. Mass. 2011); In re U.S. Mineral Prods. Co., 105 Fed.Appx. 428 (3d Cir. 2004); *Bibo*, 76 F.3d 256.

United States trustee, subject to the court's approval. § 1104(d). In 1994, Congress amended the Code to allow for the *election* of a trustee by creditors in lieu of appointment by the United States trustee. § 1104(b). The election would only occur, though, if the court first ordered the appointment of a trustee under § 1104(a).[150]

The trustee's appointment is not necessarily permanent. The court has the authority to order the debtor to be restored to possession and management of property of the estate and of the operation of the business. § 1105. This would typically only be done based on a showing of a significant change in circumstances since the trustee appointment was initially ordered, or if new evidence becomes available that shows the decision to appoint a trustee was improvidently made.[151]

If a chapter 11 trustee is appointed or elected, the trustee takes over for the debtor in possession. As such the trustee has two overriding responsibilities. The first is to operate the debtor's business during the pendency of the case. § 1108. Second, the trustee has the duty to file a plan of reorganization "as soon as practicable," or explain why he is not filing a plan. § 1106(a)(5). In putting together a plan, the trustee should consult with creditors and other interested parties, in the hope of forging a consensual plan.[152] In order to perform these duties, the trustee may investigate the debtor's business and financial affairs, and is to file a report of his findings. § 1106(a)(3), (4). The trustee also must perform the administrative tasks incident to the processing of the bankruptcy case, such as filing reports and tax returns, examining claims, and the like. § 1106(a)(1), (2), (6)–(8). As representative of the estate, the trustee has the power to sue and be sued, § 323, and to bring avoidance actions on behalf of the estate.

Section 1116 was added in 2005, applying exclusively to small businesses. A debtor in possession or trustee must, in addition to the other duties required by chapter 11, append all recent financial statements, attend all bankruptcy proceedings scheduled by the court (unless otherwise excused), file all postpetition financial and other reports, timely file all tax returns and other government filings and allow the United States trustee to inspect its business including the premises and records.[153] §§ 1116, 308(b). A "small business case" is one involving a "small business debtor," § 101(51C), and a "small business debtor" is one with less than $2,566,050 in noncontingent liquidated secured and unsecured debt. § 101(51D)(A).

§ 11.7 Appointment and Role of an Examiner

In chapter 11 an examiner may be appointed instead of a trustee.[154] § 1104(c). The examiner's fees and expenses will be paid out of the estate as an expense of

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[150] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 234 (1977) ("If the court determines that a trustee is to be appointed in the case, the bill separates the court from the appointment process.").

[151] See id. at 403 ("This section would permit the court to reverse its decision to order the appointment of a trustee in light of new evidence."); In re Taub, 441 B.R. 211, 215–16 (Bankr. E.D.N.Y. 2010).

[152] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 404 (1977).

[153] Note that in 2012–2013, a bill was pending in the Senate, which if passed, would, *inter alia*, relax these reporting requirements in small business cases. Small Business Reorganization Efficiency and Clarity Act, S. 2370, 112th Cong. (2012). However, the bill died in Congress.

[154] See Jonathan C. Lipson, Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies, 84 Am. Bankr. L.J. 1 (2010); Clifford J. White & Walter W. Theus, Jr., Chapter 11 Trustees and Examiners after BAPCPA, 80 Am. Bankr. L.J. 289 (2006); Zaretsky, supra note 139,. 44 S.C.L. Rev. 907.

administration. §§ 330(a), 503(b)(2). The examiner's duty usually is to perform an investigation of the debtor as directed by the court.[155] § 1106(b). For example, examiners have been appointed in a number of high-profile cases to investigate the possible existence of fraudulent conveyance or other clawback actions that could be brought on behalf of the estate.[156]

In carrying out this investigative role, an examiner may obviate the need for a trustee. Congress concluded in the 1978 reforms that where the primary need was to *investigate* the debtor, the preferred course would be to forego appointing a trustee at the outset, and to appoint an examiner instead for the limited purpose of carrying out the investigation.[157] The costs and dislocation attendant to the appointment of a trustee thus could be avoided, yet pre-bankruptcy misdeeds would not escape undetected.

If the examiner does uncover evidence of "fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor," § 1104(c), the court might then choose to appoint a trustee under § 1104(a). Otherwise, the debtor would be left in possession. The examiner herself is barred from serving as trustee in the case, however, § 321(b), nor may the examiner be employed by the trustee. § 327(f). Congress wanted to ensure the absolute impartiality of the examiner, by eliminating any temptation for the examiner to suggest that a trustee was needed so that she could obtain lucrative employment for herself.

The Code specifies two grounds for the appointment of an examiner. One is discretionary and general, the other mandatory and specific. The discretionary ground is that an examiner may be appointed if "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." § 1104(c)(1). This broad standard obviously gives the court considerable discretion. The legislative history explained that the court should make the appointment if "the protection [is] needed, and the costs and expenses [would] not be disproportionately high."[158] While the cost-benefit balancing task is the same in principle as that for the appointment of a trustee, the application will be different for an examiner, because the examiner normally would have a more limited role than a trustee.

The second ground for the appointment of an examiner is that the court "shall order" the appointment if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000." § 1104(c)(2). This apparently mandatory directive to appoint an examiner in large cases is part of the 1978 compromise in which Congress decided not to require the appointment of a trustee in every such case, which had been the practice under chapter X and which the Senate wanted to continue. The deal that was struck was that an examiner initially would be appointed in large cases (as defined by the amount of debt), and that a trustee would be appointed only if the examiner's report showed a need for a trustee in the case.

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[155] See ABI Commission Report, supra note 14, at 35–36.

[156] These cases include Lehman Brothers, Enron, Residential Capital, Tribune Company, Revco, and Caesar's Entertainment.

[157] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 402–03 (1977).

[158] Id. at 403.

Notwithstanding the expressed intention of Congress that an examiner always be appointed if the unsecured debt threshold is crossed, many courts have refused to enforce the command of § 1104(c)(2). Hoping to avoid the costs or delay of an examiner in cases where the judge sees no need for one, courts grasp onto the straw of other parts of § 1104(c) to read "*shall* order" as "*may* order."[159] These courts point out that the appointment is only to be made on the request of a party in interest, after notice and a hearing, and that the examiner is only to make such investigation "as is appropriate." What purpose is to be served by the hearing, the courts ask, if appointment of an examiner is required? And what if the "appropriate" degree of investigation, considering the costs and benefits, is *no* investigation? Did Congress really want to force courts to appoint an examiner, and then direct the examiner not to do anything at all?

The foregoing arguments can be answered in two ways. First, the statute is constructed so that the qualifying and explanatory language about the examiner appointment process and the scope of the investigation modifies *both* the discretionary *and* the mandatory appointment grounds. All of that language is directly relevant and important to the implementation of the discretionary ground, and thus is neither superfluous nor absurd. Furthermore, the statutory reference to the need for a party in interest to request the appointment of an examiner does *not* preclude the court from making the appointment on its own motion.[160] § 105(a).

Second, the language of the Code is plain, and the Supreme Court repeatedly has instructed that courts are not free to rewrite what they perceive to be unwise statutes; § 1104(c)(2) clearly states without qualification that "the court shall order the appointment of an examiner . . . [if the] fixed, liquidated, unsecured debts . . . exceed $5,000,000." The legislative history reinforces that Congress really meant what it said in the statutory language, emphasizing that "an examiner is required to be appointed" in cases exceeding the debt limits.[161] Some courts have recoiled against the revisionist trend and have held that the plain language of § 1104(c)(2) must be enforced as written.[162] That an examiner must be appointed, however, does not dictate the *scope* of the examiner's investigation; the bankruptcy court still retains "the authority to limit examiner investigations to 'appropriate' subjects, methods, and duration."[163]

As noted, the normal role for an examiner is to conduct an "appropriate" investigation of the debtor and to report her findings. § 1106(b), (a)(3), (4). What is "appropriate" is determined by the bankruptcy court. The examiner does not usually

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[159] See, e.g., In re Dewey & LeBoeuf LLP, 478 B.R. 627 (Bankr. S.D.N.Y. 2012); In re Residential Capital, LLC, 474 B.R. 112 (Bankr. S.D.N.Y. 2012); In re Wash. Mutual, Inc., 442 B.R. 314 (Bankr. D. Del. 20110); In re Spansion, Inc., 426 B.R. 114 (Bankr. D. Del. 2010).

[160] See, e.g., In re Michigan BioDiesel, LLC, 466 B.R. 413 (Bankr. W.D. Mich. 2011); In re Pub. Serv. Co., 99 B.R. 177 (Bankr. D.N.H. 1989); In re UNR Indus., Inc., 72 B.R. 789 (Bankr. N.D. Ill. 1987).

[161] 124 Cong. Rec. 34,003 (1978) (remarks of Sen. DeConcini); 124 Cong. Rec. 32,400 (1978) (remarks of Rep. Edwards).

[162] See, e.g., In re Revco D.S., Inc., 898 F.2d 498 (6th Cir. 1990); Walton v. Cornerstone Ministries Invs., Inc., 398 B.R. 77 (N.D. Ga. 2008); In re UAL Corp., 307 B.R. 80 (Bankr. N.D. Ill. 2004).

[163] *UAL*, 307 B.R. at 86. See also In re Erickson Retirement Communities, LLC, 425 B.R. 309, 312 (Bankr. N.D. Tex. 2010) ("This court agrees with such courts that, where the $5 million unsecured debt threshold is met, a bankruptcy court ordinarily has no discretion. The only judicial discretion that comes into play is in defining the scope of the examiner's role/duties. The court can make the scope of an examiner's duties very broad or very narrow.").

operate the debtor's business, negotiate or file a plan, or otherwise carry out any of the duties of the debtor in possession. Unlike the appointment of a trustee, the appointment of an examiner does not divest the debtor from its status as debtor in possession.

The Code also gives the court considerable flexibility to expand and tailor the examiner's duties to fit the needs of the particular case. To explain, the examiner may perform "any other duties of the trustee that the court orders the debtor in possession not to perform." § 1106(b). Furthermore, the investigation may inquire into "any other matter relevant to the case or to the formulation of a plan." § 1106(a)(3). Thus, in some large cases, courts have appointed an examiner to facilitate and mediate the formulation of a reorganization plan.[164] Examiners have been authorized to bring suits on behalf of the estate, including the power to seek the recovery of preferences and fraudulent conveyances.[165] The ABI Study Commission recommended abandoning the "examiner" title and replacing it with "estate neutral" so as to better capture the more flexible nature of the possible roles said party, by whatever name, might play in a chapter 11 reorganization.[166]

§ 11.8 Creditors' Committees and Equity Committees

The norm in chapter 11 cases is to leave the debtor in control as debtor in possession, or DIP.[167] §§ 1101(1), 1107(a). Appointment of an independent trustee is the exception, not the rule.[168] § 1104(a). Nor is an examiner appointed in every case.[169] § 1104(c). Does this scheme mean that the debtor as DIP is left free to act alone as an unchecked benevolent chapter 11 dictator? No. Congress is not that foolish. A counterweight to the DIP is needed for the chapter 11 system to function fairly and for the interests of creditors and other interested parties to be properly represented in the formulation of the plan and other matters.

That role is filled by the official committee of unsecured creditors.[170] Other than the DIP, the unsecured creditors' committee often is the most important player in the chapter 11 game. The creditors' committee negotiates with the debtor over the plan and generally monitors the progress of the case. § 1103(c). The members of the creditors' committee are fiduciaries to the constituents they represent.[171] As a designated participant in the chapter 11 scheme, the committee is paid for out of the estate. §§ 330(a), 503(b)(2).

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[164] See, e.g., In re A.H. Robins Co., 828 F.2d 1023 (4th Cir. 1987), cert. denied, 485 U.S. 969 (1988); In re Pub. Serv. Co., 99 B.R. 177 (Bankr. D.N.H. 1989).

[165] See Williamson v. Roppollo, 114 B.R. 127 (W.D. La. 1990). See also In re Carnegie Int'l Corp., 51 B.R. 252 (Bankr. S.D. Ind. 1984).

[166] ABI Commission Report, supra note 14, at 32.

[167] See § 11.4.

[168] See § 11.6.

[169] See § 11.7.

[170] See Michelle M. Harner & Jamie Marincic, Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations, 64 Vand. L. Rev. 749 (2011); Kenneth N. Klee & K. John Shaffer, Creditors' Committees Under Chapter 11 of the Bankruptcy Code, 44 S.C.L. Rev. 995 (1993). See also Daniel J. Bussel, Coalition-Building Through Bankruptcy Creditors' Committees, 43 UCLA L. Rev. 1547 (1996).

[171] See In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993); In re Commercial Mortg. & Fin., Co., 414 B.R. 389 (Bankr. N.D. Ill. 2009).

The Code mandates the appointment of an unsecured creditors' committee in all chapter 11 cases. § 1102(a)(1). The only exception is for "small business"[172] cases, in which the court is given the discretion to dispense with the creditors' committee for "cause."[173] § 1102(a)(3). In small cases, having a committee might be an unwarranted expense for the estate.

Additional committees of creditors or equity security holders may be appointed as well. The United States trustee has broad discretion to appoint such additional committees as he "deems appropriate." § 1102(a)(1). The court may order the appointment of additional committees "if necessary to assure adequate representation of creditors or of equity security holders." § 1102(a)(2). In all events, the actual members on all officially sanctioned committees, mandatory and optional, are appointed by the United States trustee, not the court.

In 2005 Congress amended the Code to make clear that the court not only has the power to order the appointment of additional committees, but also has the power to order the United States trustee to *change the membership* of an existing committee if necessary to ensure adequate representation of creditors or equity security holders. § 1102(a)(4). Factors a court considers when deciding whether to change membership of an existing committee include: (1) the ability of the committee to function; (2) the nature of the case; (3) standing and desires of the various constituencies; (4) ability for creditors to participate in the case without the official committee; (5) possibility that classes would be treated differently under plan and require representation; (6) motivations of movant; and (7) whether the committee members have any conflicts of interest.[174]

The court may also order the United States trustee to increase the number of members on a committee to include a creditor that is a small business concern. § 1102(a)(4). These 2005 amendments closed a serious and confounding statutory gap that the repeal of a prior authorizing provision in 1986 created.[175] Still left open after

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[172] A "small business" is defined as one with less than $2,566,050 in noncontingent, liquidated debts. § 101(51D). Businesses whose primary activity is owning or operating real property are excluded from the definition, even if they satisfy the debt ceiling.

[173] See In re Haskell-Dawes, Inc., 188 B.R. 515 (Bankr. E.D. Pa. 1995), for a discussion of what constitutes cause to do away with the creditors' committee.

[174] E.g., In re ShoreBank Corp., 467 B.R. 156, 160–61 (Bankr. N.D. Ill. 2012).

[175] Until 1986, the court's power to abolish or reconstitute an existing committee was plainly conferred by § 1102(c). However, in 1986 § 1102(c) was repealed as part of the expansion of the United States trustee system, in which administrative matters (such as the appointment of committees) were vested exclusively in the United States trustee's office. Prior to 2005, the courts took three divergent views on the issue of the court's residual power to revise or abolish appointed committees. One view was that the repeal of § 1102(c) left the court powerless to interfere with the composition of committees, save only the remaining statutory authority in § 1102(a)(2) to order the appointment of additional committees. See, e.g., In re New Life Fellowship, Inc., 202 B.R. 994 (Bankr. W.D. Okla. 1996). At the opposite extreme was the view that the court inherently retained plenary authority to review the decisions of the United States trustee, and to alter or eliminate committees. See, e.g., In re Pub. Serv. Co., 89 B.R. 1014 (Bankr. D.N.H. 1988). The third approach, as one might suspect, took the middle ground—the court had authority, but only to correct actions by the United States trustee that were "arbitrary and capricious," and represented an "abuse of discretion." See, e.g., In re Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996); In re Columbia Gas Sys., Inc., 133 B.R. 174 (Bankr. D. Del. 1991). For example, this high standard might be met if the United States trustee's actions were based on a clear legal error (such as appointing a non-creditor to the committee), had no evidentiary support in the record, or were "patently unreasonable, arbitrary, or fanciful." See, e.g., *Barney's*, 197 B.R. at 439.

2005 is the question whether the court also has the power to *abolish* an existing discretionary committee that it previously had ordered to be created.[176] Regardless, the court would not have the power to dispense with the mandatory official unsecured creditors' committee. With regard to additional committees, the better view is that the court does enjoy the power of abolition, as a logical and necessary corollary to the court's power to order the creation of new committees in order to ensure adequate representation.

Whether additional committees should be appointed usually comes down to a comparison of costs and benefits.[177] The costs are clear: all official committees are paid for out of the estate. A committee is allowed to hire counsel and other professionals, and those professional fees are allowable administrative expenses. §§ 1103(a), 330(a), 503(b)(2). The expenses of the committee members are also accorded administrative expense status. § 503(b)(3)(F). In addition, creating another official committee can delay the plan negotiation process. The reason for appointing the committee in the first place is to give a voice to a group that previously had not been adequately represented, so that new committee will have to be given a seat at the bargaining table, and is likely to make new demands on behalf of their constituency.

The countervailing benefit that would justify appointing a committee in the face of these costs will be that a separate committee is needed to assure the *"adequate representation"* of a particular group.[178] In the case of unsecured creditors, the question is whether the subject group is not being adequately served by the official unsecured creditors' committee, and whether the need for a voice could be satisfied by the appointment of a member to that committee, instead of appointing an entirely new committee. Conflicts in reorganization goals between different groups do not necessarily dictate creating a separate committee for each group; some tension on the official committee is expected and acceptable.

Despite the Code's grant of discretion to appoint additional official committees, courts are hesitant to grant creditors such relief. Thus, the burden imposed on parties moving for an additional committee has been described as a "high standard," even

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[176] By restoring the court's power to reconstitute a committee and to increase the number of members of the committee in 2005, but by saying nothing about the power of abolition, which had been present in pre-1984 § 1102(c), Congress left open the possibility that courts will find that courts still lack the abolition power. As stated in the text, though, the better view is that the power to abolish committees is tied up in the creation power.

See also In re Dewey & Leboeuf LLP, No. 12-12321 MG, 2012 WL 5985325, at *5 (Bankr. S.D.N.Y. Nov. 29, 2012) ("[T]he Court need not reach the issue whether section 1102 implicitly confers on the Court the authority to order an official committee appointed by the UST to be disbanded based on subsequent changed circumstances, or whether sections 105 and 1102 when applied together provide such authority. . . .").

[177] See, e.g., In re Eastman Kodak Co., No. 12-10202, 2012 WL 2501071 (Bankr. S.D.N.Y. June 28, 2012); In re Spansion, Inc., 421 B.R. 151 (Bankr. D. Del. 2009); In re Pilgrim's Pride Corp., 407 B.R. 211 (Bankr. N.D. Tex. 2009); In re Wang Labs., Inc., 149 B.R. 1 (Bankr. D. Mass. 1992); In re Orfa Corp., 121 B.R. 294 (Bankr. E.D. Pa. 1990).

[178] See In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993); In re Budd Co., Inc., 512 B.R. 910 (Bankr. N.D. Ill. 2014).

requiring moving parties to show that an additional committee is "absolutely required," "essential," or "indispensable."[179]

For equity security holders, the unsecured creditors' committee obviously will not represent their interests. The management of the debtor might, however—and it is possible for shareholders to oust the board and replace it with a group that will be more responsive to shareholder needs.[180] The debtor, though, as DIP may be required to act as a fiduciary for all creditors, and thus is not always free entirely to represent only the selfish desires of equity. With creditors permitted to waive the absolute priority rule in favor of equity holders, an equity committee could play an important role in negotiating a share of reorganization value for equity interests.[181] But equity committees usually are only appointed in large and complex cases with numerous shareholders, or in the event of a debtors' possible solvency.[182]

Given the importance of the official unsecured creditors' committee and other committees in the chapter 11 process, parties who are interested in influencing the outcome of the reorganization may have a strong desire to serve on an official committee—or to have other entities removed. The United States trustee plays the primary role in determining committee composition, although under § 1102(a)(4) the bankruptcy court can order a change in membership. As noted above, the United States trustee actually appoints the members of all committees. § 1102(a)(1), (2). The members of the unsecured creditors' "ordinarily" will consist of the seven unsecured creditors holding the largest claims who are willing to serve. § 1102(b)(1). The rationale for this presumption is that the largest creditors (i) will be the most interested in the case because of their financial stake and (ii) will need to be on board for a plan to be confirmed. To identify these creditors, the United States trustee will look at the list of the 20 largest unsecured creditors that the debtor must file. Rule 1007(d). A *prepetition* committee may be continued as the official bankruptcy committee if that committee was "fairly chosen" and is "representative." Appointing such a committee, which already has been negotiating with the debtor over the terms of a workout, may be efficient. For equity committees, the United States trustee will examine the list of equity security holders, Rule 1007(a)(3), and will "ordinarily" appoint the seven largest holders who are willing to serve.

The statute appears to require that only "creditors" may serve on the unsecured creditors' committee. A creditor is an entity that has a "claim" against the debtor, § 101(10), and a "claim" is a "right to payment." § 101(5). This means that agents of a creditor, such as an attorney, might be able to serve on a committee in their representative capacity, but should not be permitted to serve themselves as committee

[179] See, e.g., In re Residential Capital, LLC, 480 B.R. 550, 558 (Bankr. S.D.N.Y. 2012); In re Eastman Kodak, No. 12-10202, 2012 WL 2501071, at *2 (Bankr. S.D.N.Y. June 28, 2012); In re ShoreBank Corp., 467 B.R. 156, 164–65 (Bankr. N.D. Ill. 2012); In re Oneida Ltd., 351 B.R. 79, 83 (Bankr. S.D.N.Y. 2006).

[180] See § 11.5.

[181] See Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125 (1990).

[182] See In re Pilgrim's Pride Corp., 407 B.R. 211, 216 (Bankr. N.D. Tex. 2009) (applying the following factors to determine whether to appoint an equity committee: "(1) whether Debtors are likely to prove solvent; (ii) whether equity is adequately represented by stakeholders already at the table; (iii) the complexity of the Debtors' cases; and (iv) the likely cost to Debtors' estates of an equity committee").

members.[183] In one prominent case, the Third Circuit held that a labor union as the collective bargaining representative had a "right to payment" and thus could serve on a committee.[184] Notwithstanding the clear statutory limitation to creditors, some courts have allowed agents to serve as committee members. Note, though, a "claim" may be a "contingent" right to payment, and that the holder of such a contingent claim should be eligible for committee membership.[185]

Since committee members are fiduciaries to their constituents, an entity who labors under a serious conflict of interest should not be appointed to (or if appointed, should be removed from) a committee. Having said that, courts do not mandate that every member of a committee speak with a single voice; discordant and dissenting views are permitted and even encouraged. Indeed, the fact that a committee member might urge the liquidation of the debtor is not disqualifying; that might even be the best course. But if liquidation is urged because that would enhance the competitive position of the entity, a conflict arises.

Committees serve their constituents in a representative role. As such, they should take whatever steps are appropriate in the circumstances to keep their constituents apprised of developments and obtain the input of class members. These duties were codified in 2005 in § 1102(b)(3), which requires that a committee both provide access to information to and solicit and receive comments from class members who are not on the committee. Also, of course, the committee must comply with any court order that compels any additional reports or disclosures to be made to class members.

The duties of an official chapter 11 committee are broad. § 1103(c). The trustee (or DIP) is required by statute to meet with the committee as soon as practicable after the committee is appointed "to transact such business as may be necessary and proper." § 1103(d). The most important role for the committee is to "participate in the formulation of the plan, advise those represented by such committee of such committee's determination as to any plan formulated, and collect and file with the court acceptances or rejections of a plan." § 1103(c)(3). In most chapter 11 cases in which a plan is confirmed, the debtor and the official committees reach a consensus on the terms of the plan, and the committees then send out the plan and ballot to the body of creditors or interest holders with a recommendation to vote in favor of the plan. If the unsecured creditors' committee does not agree with the debtor's plan, cram down under § 1129(b) is the only realistic possibility to confirm that plan.

The duties of committees are not limited to the plan negotiation and confirmation process. They also may consult with the DIP or trustee, § 1103(c)(1), and have standing to appear and be heard on any issue in the case. § 1109(b). The bankruptcy judge normally gives considerable weight to the position of official committees. A committee is entitled to obtain information from the DIP, especially with regard to proposed non-ordinary transactions.[186]

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[183] See In re Dow Corning Corp., 194 B.R. 121 (Bankr. E.D. Mich. 1996), rev'd on other grounds, 194 B.R. 121 (E.D. Mich. 1997); In re Charter Co., 42 B.R. 251, 253 (Bankr. M.D. Fla. 1984).

[184] In re Altair Airlines, Inc., 727 F.2d 88 (3d Cir. 1984).

[185] See In re Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996).

[186] See, e.g., In re Structurlite Plastics Corp., 91 B.R. 813 (Bankr. S.D. Ohio 1988).

Committees may investigate the debtor's business and financial affairs. § 1103(c)(2). The possibility of a preliminary committee investigation may persuade the court to refrain from appointing an examiner up front, waiting instead for the results of the committee's inquiry. Based upon that investigation, the committee may seek the appointment of a trustee or examiner, §§ 1103(c)(4), 1104, move that the case be dismissed or converted to chapter 7, § 1112(b), seek permission to file their own plan, § 1121(c), (d), or take other action.

Committees are vested with a catch-all authority to "perform such other services as are in the interest of those represented." § 1103(c)(5). The fact that the estate foots the bill for committee work dictates, however, that the "other services" be limited to activities directly related to the bankruptcy case itself. For example, in the *Dow Corning* breast implant case, the court declined to permit the tort claimants' committee to lobby for changes in the law to benefit the tort victims.[187]

An issue that sometimes arises is whether a committee has standing to bring an action, such as an avoidance action, on behalf of the estate. Direct standing appears to be foreclosed by the language of the Code, which only authorizes the "trustee" (which would include the DIP, § 1107(a)) to bring actions on behalf of the estate. That the statute means what it says here is supported by the Supreme Court's decision in another context in *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, that the plain language of § 506(c) does indeed limit standing to a "trustee."[188]

But what if the estate appears to have a meritorious action, and the trustee or DIP refuses to sue? Committees have been granted *derivative standing* to sue on behalf of the estate in one of two ways—without the consent of the trustee or DIP, or with it. Nothing in *Hartford* should preclude allowing derivative standing; indeed, the Supreme Court made clear that it was not deciding that question.[189] To obtain derivative standing against the DIP's or trustee's wishes, the committee must show: (1) that the estate has a colorable claim; (2) demand to sue was made on the DIP or trustee; (3) the DIP or trustee unjustifiably refused to bring the action; and (4) the court granted leave to the committee to bring the action.[190] But if the committee brings an action without obtaining leave of court, the members of the committee might be sanctioned.[191] Additionally, consensual derivative standing requires proof that: "(1) the committee has the consent of the debtor in possession or trustee, and (2) the court finds that suit by the committee is (a) in the best interest of the bankruptcy estate, and (b) is 'necessary and beneficial' to the fair and efficient resolution of the bankruptcy proceedings."[192]

Much of the committee's work is conducted through professionals retained by the committee, particularly through the committee's counsel. § 1103(a). The professionals retained by the committee are paid out of the bankruptcy estate on an administrative

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[187] See In re Dow Corning Corp., 199 B.R. 896 (Bankr. E.D. Mich. 1996).

[188] 530 U.S. 1, 6, 13 (2000).

[189] Id. at 13 n.5.

[190] See, e.g., In re First Capital Holding Corp., 146 B.R. 7 (Bankr. C.D. Cal. 1992). Accord Fogel v. Zell, 221 F.3d 955, 965 (7th Cir. 2000); In re Gibson Grp., Inc., 66 F.3d 1436, 1438 (6th Cir. 1995).

[191] See In re Gen. Homes Corp., 181 B.R. 870 (Bankr. S.D. Tex. 1995).

[192] In re Commodore Int'l, Ltd., 262 F.3d 96, 100 (2d Cir. 2001). See also Plan Comm. v. PricewaterhouseCoopers, LLP, 335 B.R. 234 (D.D.C. 2005).

priority basis. §§ 503(b)(2), 330(a). An attorney or accountant employed by the committee is prohibited from representing another entity with an "adverse interest" in connection with the bankruptcy case. § 1103(b). However, the mere fact that the attorney or accountant represents one or more individual creditors in the represented class does not as a *per se* matter constitute a disqualifying adverse interest.[193]

The members of a committee have qualified immunity with regard to actions taken within the scope of their authority. However, the immunity does not extend to protect committee members in the case of "willful misconduct," or with regard to *ultra vires* actions.[194]

§ 11.9 Securities and Exchange Commission

Under chapter X of the prior Bankruptcy Act, the Securities and Exchange Commission played a very important role. Before the court would approve a plan of reorganization, the SEC would file an advisory report on the merits of the plan. Bankruptcy Act § 172. The SEC's primary concern was to protect the interests of public creditors and public investors. If the SEC had any problems with the plan, revisions probably would have to be made before the court would approve the plan. The plan would not even be sent out for a vote until the laborious approval process, including the preparation of and reaction to the SEC's report, was concluded. This process was very cumbersome, slow, and costly.

In the 1978 Code, Congress decided to jettison in large part the chapter X approach. Replacing the chapter X paradigm of paternalistic protection (by the trustee, court, and SEC) was the concept of "informed suffrage." The SEC no longer files an advisory report, the court does not preapprove the plan, and an independent trustee is not always appointed. Instead, the heart of the protective process under the current law is that a court-approved disclosure statement is sent to creditors and equity holders before they vote. That disclosure statement must contain "adequate information."[195] § 1125. As the legislative history explained:

> The premise underlying the consolidated chapter 11 of this bill is the same as the premise of the securities law. If adequate disclosure is provided to all creditors and stockholders whose rights are to be affected, then they should be able to make an informed judgment on their own, rather than having the court or the Securities and Exchange Commission inform them in advance of whether the proposed plan is a good plan.[196]

What role is left for the SEC today in reorganization cases? The SEC is given the power to raise any issue and appear and be heard on any issue in a chapter 11 case, but does not have standing to appeal. § 1109(a). Nor is the SEC a "party in interest,"

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[193] See, e.g., In re Enron Corp., No. 01-16034, 2002 WL 32034346, at *6 (Bankr. S.D.N.Y. May 23, 2002) ("Section 1103(b) is the only statutory provision that concerns the committee's right to select counsel. . . . This section does not require an attorney to cease representing creditors in matters that (i) are unrelated to the bankruptcy case, (ii) are not adverse to the committee's interests in the bankruptcy case, or (iii) per-date the professional's employment by the committee").

[194] See Luedke v. Delta Air Lines, Inc., 159 B.R. 385 (S.D.N.Y. 1993); In re Walnut Equip. Leasing Co., Inc., 2000 WL 1456951 (Bankr. E.D. Pa. Sept. 22, 2000).

[195] See § 11.20.

[196] H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 226 (1977).

meaning, for example, that it has no right to file a plan. § 1121(c). Notices that are required to be sent to creditors must be sent to the SEC if the Commission has filed a notice of appearance in the case or a written request to receive notices. Rule 2002(j)(1). The proposed plan and disclosure statement must be mailed to the SEC before the disclosure statement approval hearing. Rule 3017(a). In practice, in cases involving public debt or equity, the SEC may scrutinize the plan and disclosure statement and make any objections it deems proper at the disclosure statement hearing. The court typically will give substantial weight to the Commission's comments, and often will send the disclosure statement back to the proponent with instructions to respond to the SEC's concerns.

The Commission has determined as a matter of policy, however, not to get involved in the chapter 11 process in particular cases as a matter of course. Instead, it has decided to leave to committees and the United States trustee the responsibility to represent the interests of diverse public creditors and investors in most cases, and to ensure the fair operation of the disclosure and solicitation process. Only if the committee structure leaves a protective gap in a case, or if broader legal or policy issues are at stake, will the Commission get deeply involved.

C. OPERATING THE BUSINESS IN CHAPTER 11

§ 11.10 Obtaining Financing and Credit: § 364

The trustee (or DIP, § 1107(a)) is authorized to obtain credit and to incur debt, i.e., to borrow money, or accept goods on credit, on behalf of the estate. § 364. It is difficult to operate any business without working capital, and chapter 11 debtors are no exception. Indeed, the very financial problems that drove the debtor to chapter 11 may make the chapter 11 debtor's need especially acute. Obtaining financing normally is one of the first matters a DIP must attend to after filing for reorganization. "DIP financing" has become one of the most important practical tools in large chapter 11 reorganizations.[197] Section 364 of the Code "governs all obtaining of credit and incurring of debt by the estate."[198]

Prepetition loan agreements cannot be assumed by the DIP.[199] § 365(c)(2). A creditor must voluntarily agree to extend new credit to a chapter 11 debtor, and is not bound by any pre-bankruptcy promises. The debtor can, however, obtain authorization from the court to use "cash collateral" as a form of working capital without the creditor's consent, § 363(c)(2), but then must provide the creditor with "adequate protection" of its lien interest.[200] Trade creditors perhaps can be ordered to continue

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[197] See David A. Skeel, Jr., The Past, Present, and Future of Debtor-in-Possession Financing, 25 Cardozo L. Rev. 1905 (2004); David A, Skeel, Jr., Creditors' Ball: The "New" New Corporate Governance in Chapter 11, 152 U. Penn. L. Rev. 917 (2003). For an excellent analysis of DIP financing, see George G. Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 Vand. L. Rev. 901 (1993).

[198] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 57 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 346 (1977).

[199] See § 8.20. See also In re Sun Runner Marine, Inc., 945 F.2d 1089 (9th Cir. 1991).

[200] See § 5.18.

shipping goods to the debtor, but only on a C.O.D. (cash (or collect) on delivery) basis.[201]

In many cases, then, the debtor must persuade lenders and creditors to make new loans and extend new credit to the debtor operating as DIP in chapter 11. One might wonder why any creditor would take the seemingly foolish step of loaning new money to a debtor who is already in bankruptcy court. Three general concerns arise from a lender's standpoint regarding postpetition financing: (1) if also a prepetition lender, protection of the prepetition security interest and adequate protection; (2) financing terms on the postpetition loan, including an agreement on exit financing, or full payment upon confirmation; and (3) what the postpetition lender's rights and remedies upon default will be.

Not surprisingly, Congress designed § 364 to overcome any initial reluctance of creditors to extend credit to a chapter 11 debtor, by offering a progressive hierarchy of inducements, and at the same time to protect existing creditors from the debtor improvidently incurring excessive new debt. The latter objective is addressed by requiring all borrowing or obtaining of credit out of the ordinary course of business to be approved by the court, after notice to creditors and the opportunity for a hearing. § 364(b)–(d). Ordinary course transactions do not require separate court approval; the authorization to operate the business carries with it the implied authority to engage in ordinary course transactions. § 364(a).

Section 364 offers significant incentives to entice lenders to loan money, or otherwise extend credit to a DIP operating its business in chapter 11. The most basic carrot held out to a prospective creditor or lender is an administrative priority, on a par with other second priority claims.[202] § 364(a), (b). If the offer of an administrative priority is not a big enough carrot, the new lender may be granted a "superpriority," i.e., a priority even over all other administrative claims.[203] § 364(c)(1). Furthermore, liens may be granted on unencumbered property or equity in property of the estate to secure chapter 11 loans.[204] § 364(c)(2), (3). If even a superpriority and liens on available property are not enough to prompt a necessary postpetition loan, the new chapter 11 lender may be given a "priming" lien on estate property, i.e., a first lien that subordinates prior lienholders.[205] § 364(d). Some form of "adequate protection" must then be given to the displaced lienholder. § 364(d)(1)(B). All of these incentives are buttressed by the provision for statutory "mootness": an appellate reversal of the grant of a priority or lien under § 364 will not affect the validity of the debt incurred or the priority or lien awarded if the lender acted in good faith, assuming that the financing order was not stayed pending appeal.[206] § 364(e).

In some cases prospective chapter 11 lenders have sought benefits not expressly authorized by the terms of § 364. An example of a controversial practice is "cross-

[201] See, e.g., In re Docktor Pet Ctr., Inc., 144 B.R. 14 (Bankr. D. Mass. 1992) (finding adequate protection in § 365(b)(1)(C) met when debtor assumed and assigned contract, and the trade creditor dealt with the debtor's assignee on collect on delivery terms).

[202] See § 11.10.a.

[203] See § 11.10.b.

[204] See id.

[205] See § 11.10.c.

[206] See § 11.10.d.

collateralization."[207] Cross-collateralization gives the chapter 11 lender a lien on property of the *post*-petition estate to secure not only the postpetition loan, but also the lender's unsecured *pre*-petition claim. The legality of cross-collateralization is uncertain.[208]

Closely related to cross-collateralization, and also controversial and of uncertain legality, are "roll-ups." In a roll-up, some or all of the pre-petition debt effectively is converted into post-petition debt (and concomitantly blessed with the liens and priorities available under § 364) by having the debtor repay the pre-petition debt with proceeds of the chapter 11 DIP loan.[209] If the lender is improving its position (e.g., the rolled-up debt was not fully secured), or if very little new money is advanced, courts are more reluctant to approve the roll-up. To give an example, in the Radio Shack bankruptcy, of the $285 million roll-up DIP financing, only $35 million was new money. The ABI Study Commission recommended narrowly limiting approval of roll-ups in situations where the benefit to the estate is clear, no feasible alternatives are available, and substantial new credit is being extended.[210]

a. Administrative Priority

The first inducement that may be offered to postpetition credit extenders is an administrative priority. § 364(a), (b). This grant of second priority may be authorized in two ways, one implicit and one explicit. First, if the DIP is authorized to operate its business, which is the presumptive norm in chapter 11, § 1108, the DIP may obtain unsecured credit or incur unsecured debt in the *ordinary course* of business. § 364(a). Second, if general business operation is not authorized, or if the credit extension or loan is not in the ordinary course of business, the court may approve the transaction after notice and a hearing. § 364(b).

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[207] See § 11.11.

[208] The only court of appeals decision squarely on point held that cross-collateralization is illegal. In re Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992); see also In re Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716 (S.D. Fla. 2010). Other circuit courts have implicitly found that cross-collateralization is not illegal per se, in holding that the appeal of a cross-collateralization order was moot under § 364(e), as the lenders and debtor acted in good faith regarding the postpetition lending transaction. See In re Ellingsen MacLean Oil Co., 834 F.2d 599 (6th Cir. 1987), cert. denied, 488 U.S. 817 (1988); In re Adams Apple, Inc., 829 F.2d 1484 (9th Cir. 1987). See also In re Texlon Corp., 596 F.2d 1092, 1098 (2d Cir. 1979) ("In order to decide this case we are not obliged, however, to say that under no conceivable circumstances could 'cross-collateralization' be authorized."); In re Revco D.S., Inc., 901 F.2d 1359 (6th Cir. 1990) (regarding the adequate protection requirement when the DIP lenders receive a superpriority lien, subordinating prepetition liens from them and another creditor, and the DIP financing agreement provides for the DIP lender to receive prepetition interest).

The position adopted by the Eleventh Circuit in *Saybrook* was advocated by the author of this book in a series of articles, including Charles J. Tabb, Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma, 50 Ohio St. L.J. 109 (1989) (hereafter "Lender Preference Clauses"); Charles J. Tabb, A Critical Reappraisal of Cross-Collateralization in Bankruptcy, 60 S. Cal. L. Rev. 109 (1986) (hereafter "Critical Reappraisal").

[209] See generally David Griffiths, Roll-up, Roll-up, Read All About It, http://business-finance-restructuring.weil.com/dip-financing/roll-up-roll-up-read-all-about-it/ (Oct. 6, 2010) (last consulted March 30, 2016); Davis Polk & Wardwell, Key Developments and trends in DIP Financing, http://www.davispolk.com/sites/default/files/kenstein.chrobert.practical.law.finance.article.03.24.15.PDF (last consulted March 30, 2016).

[210] ABI Commission Report, supra note 14, at 77–78.

The implied authorization for a DIP to obtain credit or incur debt in the ordinary course of business inheres in the general grant of authority to operate the business. In effect it is a "lesser included" power. The efficiency of allowing the debtor to enter into ordinary course transactions without express court approval was recognized in equity receiverships and in reorganizations under the prior Act.[211] The important question under § 364(a) will be whether a loan or credit extension was in the ordinary course of business.

Since the "ordinariness" of the transaction in subsection (a) substitutes for notice to creditors and court approval in subsection (b), the test for whether a transaction qualifies as ordinary should turn on whether notice to creditors and court oversight of this particular transaction would serve a useful purpose. If approval would be virtually automatic, there is no point in incurring the time and expense of sending out notices. If the only objections creditors might interpose speak to the threshold question of the wisdom of continued business operations, their concerns should be aired in a general motion to restrict operations, not in objections to transactions ordinarily incident to the running of the business.

Courts have used a two-prong test to ascertain whether a transaction is in the ordinary course of business.[212] There is some dispute whether *both* prongs must be satisfied, or whether either will suffice; the prevailing view appears to require that both be met.[213] The first prong is the "*vertical dimension*" test, which focuses on the reasonable expectations of a hypothetical creditor: is this type of transaction one that such a creditor would expect a debtor in this business to enter into, or would that transaction expose such a creditor to economic risks of a different nature than generally accepted? For example, a major loan might not be ordinary, but routine credit extensions from a longtime trade supplier would be. The second prong of the test looks at the "*horizontal dimension*" of the transaction in the context of the industry, by comparing the debtor's business to other businesses in the same industry: is this type of loan or credit normal for similarly situated businesses? If so, that supports a finding of ordinariness.

Some courts reject the two-prong test, and instead adopt the "*reasonable expectations*" test,[214] which closely resembles the "*vertical dimension*" test from the two-prong test. Under this test, courts contemplate the reasonable expectations of a

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[211] See Chicago Deposit Vault Co. v. McNulta, 153 U.S. 554 (1894); In re Avorn Dress Co., 78 F.2d 681, modified, 79 F.2d 337 (2d Cir. 1935).

[212] See, e.g., Braunstein v. McCabe, 571 F.3d 108 (1st Cir. 2009); In re Straightline Inv., Inc., 525 F.3d 870, 879 (9th Cir. 2008).

[213] Compare In re Enron Corp., No. 01-16034, 2003 WL 1562202, at *16 (Bankr. S.D.N.Y. 2003) ("[B]oth elements of this inquiry must be satisfied in order for a transaction to be within the ordinary course of business." (citing In re Crystal Apparel, Inc., 220 B.R. 816, 831 (Bankr. S.D.N.Y. 1998))), with In re Husting Land & Dev., Inc., 255 B.R. 772, 780 (Bankr. D. Utah 2000) (rejecting the horizontal test, and only requiring a party to meet the vertical dimension test).

[214] These courts reject the two-prong test, specifically the "horizontal dimension" test, as a matter of statutory construction when comparing § 364(a) with § 547(c)(2). In short, § 547c)(2), prior to 2005, required a creditor to prove that three elements fell within the ordinary course of business: (1) the underlying debt; (2) the debtor's payment, subjectively, between the parties; and (3) the debtor's payment, objectively, as compared to industry standards. By contrast, § 364(b) only requires proof of one of those elements—that the underlying debt was incurred in the ordinary course of business. See, e.g., In re 211 Waukegan, LLC, 479 B.R. 771 (Bankr. N.D. Ill. 2012); In re Ockerlund Const. Co., 308 B.R. 325, 328 n.1 (Bankr. N.D. Ill. 2004); In re Garofalo's Finer Foods, Inc., 186 B.R. 414, 429 (N.D. Ill. 1995).

creditor who deals with the debtor as to the types and terms of transactions into which the debtor might enter.[215] To make this determination, the court's primary focus is the debtor's prepetition conduct, as a means to inform and develop expectations of its postpetition conduct.[216]

If the transaction falls outside of the ordinary course of business, court approval must be obtained, after notice and a hearing.[217] § 364(b). Rule 4001(c) governs motions to obtain credit. The hearing cannot be held on less than 14 days' notice, except to deal with an emergency. If no objections to the proposed loan or credit are filed, court approval is typically routine.

If the transaction is not in the ordinary course of business, but prior approval is not obtained, the creditor may request *nunc pro tunc* approval of the transaction. The standard for obtaining such approval is quite stringent,[218] and usually such relief is denied, leaving the lender with a general nonpriority claim. Courts consider four factors when determining whether to exercise its equitable discretion to grant *nunc pro tunc* approval of postpetition financing: (1) whether the financing transaction benefits the bankruptcy estate; (2) whether the creditor has adequately explained its failure to seek prior authorization, or proves it otherwise acted in good faith; (3) whether there is full compliance with the requirements of § 364; and (4) whether the circumstances of the case present a rare situation in which retroactive authorization is appropriate.[219]

Since § 364(a) and (b) specifically authorize the granting of an administrative priority under § 503(b)(1), as a threshold matter, the credit or debt must meet the requirements of § 503(b)(1). That means that the credit be extended, or the debt incurred, for the actual and necessary costs and expenses of "preserving the estate," which has been construed to include operation of the debtor's business. Benefit to the estate and a transaction with the DIP must be shown.

6. *Superpriority and Non-Priming Liens*

The promise of an administrative priority may not be enough to induce a creditor or lender to extend credit or make a loan to a chapter 11 debtor.[220] The prospective credit extender may consider the possibility of administrative insolvency to be too great a risk. If so, and if the financing is necessary to the debtor's business, the court after notice and a hearing may approve even greater protection for the credit extender. § 364(c). The court may approve: (1) a "superpriority" for the debt or credit, with priority over all administrative expenses under § 503(b) and § 507(b); (2) a lien on unencumbered estate property; or (3) a lien on the equity in property of the estate that is already subject to a lien.

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[215] See *211 Waukegan*, 479 B.R. at 779.

[216] *Garofalo's Finer Foods*, 186 B.R. at 425.

[217] In re Azevedo, 485 B.R. 596, 601 n.6 (Bankr. D. Idaho 2013) (describing the § 364(b) option as the "fail-safe" approach for a creditor to protect its rights).

[218] See In re Am. Cooler Co., 125 F.2d 496 (2d Cir. 1942); In re Living Hope Sw. Med. SVCS, LLC, 450 B.R. 139 (Bankr. W.D. Ark. 2011).

[219] E.g., In re Harbin, 486 F.3d 510, 523 (9th Cir. 2007).

[220] See, e.g., In re Mayco Plastics, Inc., 379 B.R. 691, 698 (Bankr. E.D. Mich. 2008) ("However, in many instances the benefits afforded by the Bankruptcy Code to the holder of an allowed administrative expense claim under § 503(b)(1) are not sufficiently attractive to induce a party to make a loan or extend credit to a Chapter 11 debtor.").

Before approving a superpriority or liens, the court must be convinced that the necessary loan or credit cannot be obtained simply on the promise of an administrative expense.[221] Furthermore, the debtor must show why the funds are needed, and for what purpose. At bottom, the debtor must establish that the proposed financing is in the best interests of creditors. This general showing can be made by proof that the debtor has reasonable prospects for reorganization with the financing, and that the requested credit or debt is the most prudent way to preserve that possibility. Courts examine whether the relief requested in § 364(c) is an appropriate exercise of the debtor's business judgment.[222]

The provision for a superpriority in § 364(c)(1) adopts the practice that developed under chapter XI of the Act.[223] The new lender is entitled to be repaid out of the unencumbered assets of the estate before all other administrative expenses, including the superpriority under § 507(b) for "inadequate" adequate protection.

Note, though, that even a superpriority does not guarantee repayment. The estate still must have sufficient free assets to repay the debt. If all estate property is subject to liens, the superpriority debt will not be paid.[224] Furthermore, if the case is converted to chapter 7, most courts have held that under § 726(b) the administrative expenses incurred in the superseding chapter 7 case have priority over the pre-conversion expenses, even those under § 364(c)(1).[225] Another risk a postpetition creditor takes is that the court will allow interim payment of professional fees under § 331, leaving nothing for the superpriority creditor.[226] Other courts have held, however, that interim fees cannot trump a § 364(c)(1) superpriority claim.[227]

Courts are especially reluctant to approve superpriority loans, and unsecured creditors may oppose such a grant. The problem is that once a superpriority is granted, it may be difficult for the estate to persuade later creditors to do business with the estate on a simple administrative expense basis, because the superpriority debt must be repaid first. That creates a risk that the debtor's reorganization will fail. Thus, approval might be granted only if failure *without* the superpriority loan would be likely. Some courts have insisted that the superpriority lender agree to a "carve-out" from its superpriority for the fees and expenses of professionals, because otherwise the administration of the estate might grind to a halt.[228] It is not clear, however, that a

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[221] See, e.g., In re Los Angeles Dodgers LLC, 457 B.R. 308, 313 (Bankr. D. Del. 2011) ("The Court 'may not approve any credit transaction under [§ 364(c)] unless the debtor demonstrates that it has attempted, but failed, to obtain unsecured credit under § 364(a) or (b).' ").

[222] See In re AMR Corp., 485 B.R. 279, 287 (Bankr. S.D.N.Y. 2013).

[223] See White Chem. Co. v. Moradian, 417 F.2d 1015 (9th Cir. 1969).

[224] See In re Mayco Plastics, Inc., 379 B.R. 691, 701 (Bankr. E.D. Mich. 2008) ("[T]here is nothing in § 364(c)(1) that states that such debt is secured by an interst in property of the estate, in stark contrast to debt authorized to be secured under § 364(c)(2) or (3) or § 364(d).").

[225] See, e.g., In re Visionaire Corp., 290 B.R. 348 (Bankr. E.D. Mo. 2003). On appeal the Eighth Circuit Bankruptcy Appellate Panel affirmed the part of the order that gave priority to § 726(b) over § 364(c)(1), but reversed in part on other grounds. 299 B.R. 530 (B.A.P. 8th Cir. 2003). See also In re Summit Ventures, Inc., 135 B.R. 478 (Bankr. D. Vt. 1991).

[226] See In re Callister, 15 B.R. 521 (Bankr. D. Utah 1981), appeal dismissed, 673 F.2d 305 (10th Cir. 1982), aff'd, 1984 WL 249787, 13 B.C.D. 21 (10th Cir. 1984).

[227] See In re Flagstaff Foodservice Corp., 739 F.2d 73 (2d Cir. 1984).

[228] See In re Ames Dep't Stores, Inc., 115 B.R. 34 (Bankr. S.D.N.Y. 1990).

carve-out in favor of a selected group of administrative claimants to the exclusion of others in the same priority class is permissible.

In addition to or in lieu of granting a superpriority, § 364(c)(1), the court may approve the granting of a senior lien on unencumbered property of the estate or a junior lien on encumbered property. § 364(c)(2), (3). These liens "do not interfere with existing property rights."[229] Liens give an added measure of protection to the lender. If the chapter 11 case succeeds, the priority will suffice, because all second priority claims must be paid in full on the effective date of the plan. § 1129(a)(9)(A). However, if the chapter 11 case fails, the lender's lien will survive dismissal or conversion of the case. Furthermore, the lender whose claim is secured will be entitled to adequate protection of that secured claim throughout the bankruptcy case. The downside for unsecured creditors is that previously unencumbered property is removed from the estate. The question is whether the upside, the influx of new money to the estate to assist the debtor in operating the business, is worth the price.

c. *Priming Liens*

Even a superpriority or liens on equity or on unencumbered property under § 364(c) may not be sufficient to entice a lender to make a loan to a chapter 11 DIP or trustee. For example, if most of the assets of the estate are already subject to valid liens, the new loan would be subordinate to the prior liens, and would not be assured of repayment. In such cases, where the DIP needs to borrow money, but the inducements of § 364(c) are not enough to enable the DIP to obtain credit, the final possibility is to grant the new lender a "priming" lien. Under § 364(d), the court, after notice and a hearing, may authorize the DIP to obtain credit or incur debt "secured by a senior or equal lien on property of the estate that is subject to a lien."

In other words, the bankruptcy court has the power to subordinate a preexisting, prepetition senior lien in favor of the postpetition lender, granting the postpetition lender the senior, or first lien. The new senior lien is said to "prime" the prior first lien, which now is relegated to junior lien status. For example, assume that when Debtor files chapter 11, First Bank has a perfected first lien on all of Debtor's property, including Blackacre. Second Bank agrees to make a postpetition loan to Debtor, but only if it is granted a first lien on Blackacre. Notwithstanding the minor inconvenience that First Bank *already* has a first lien on Blackacre, § 364(d) permits the court to grant Second Bank the first lien on Blackacre as security for the postpetition loan, and to demote First Bank's lien to junior status below Second Bank's lien.

What showing must be made to support such a dramatic intrusion on the legal rights of the subordinated lienholder? Pre-Code law also permitted the practice of granting priming liens, although courts differed markedly over the strength of the proof needed to support the grant.[230] Under § 364(d), a priming lien may be awarded: (1) only with court approval, after notice and a hearing; (2) if the DIP is unable to obtain credit under § 364(c); and (3) if the subordinated lienholder's interest is

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[229] S. Rep. No. 95–989, 95th Cong., 2d Sess., at 58 (1978); H.R. Rep. No. 95–595, 95th Cong., 1st Sess., at 347 (1977).

[230] See In re Chicago, R.I. & P. R.R. Co., 545 F.2d 1087 (7th Cir. 1976); Melniker v. Lehman (In re Third Ave. Transit Corp.), 198 F.2d 703 (2d Cir. 1952); In re Prima Co., 88 F.2d 785 (7th Cir. 1937).

"adequately protected." Courts will only grant postpetition financing on a priming basis as a last resort.[231]

The "inability" requirement usually is established by introducing evidence that the debtor made unsuccessful efforts to obtain a necessary postpetition loan under § 364(c), i.e., solely on the promise of a superpriority, liens on unencumbered property, or junior liens on encumbered property. Only reasonable good faith efforts to obtain such financing need be established. The debtor does not have to contact every conceivable lender, especially if time is of the essence.[232] Given that most lenders insist on a first lien position, if the debtor's assets are heavily encumbered, proof of inability often will not be difficult.

The real crux of the § 364(d) dispute will be on the issue of *adequate protection* of the primed lender's interest. In the above hypothetical, the Debtor would have to show that First Bank's interest is adequately protected, even though its lien on Blackacre is demoted from first to second position, behind the Second Bank lien. The DIP has the burden of proof on the adequate protection issue. § 364(d)(2). How can this be done? In practice, priming liens are granted most often in two types of cases: first, where the debtor has a sizable equity cushion, sufficient to cover both the priming lien and the primed lien;[233] and second, where the debtor persuades the court that the new money will enable the debtor to enhance the value of the collateral, so that both liens will be fully secured.[234]

To illustrate the first situation, assume that First Bank's claim is $75,000, and that Second Bank will loan the DIP $50,000. If the Debtor can show that the collateral, Blackacre, has a value of substantially more than $125,000, adequate protection may be established. The trick, of course, is fixing the value of Blackacre, which requires the court both to weigh the credibility of competing expert appraisals, and to decide whether to value the property at a higher going concern value or a lower liquidation value. The court also must decide how much cushion to give First Bank.

To demonstrate the second common scenario in which adequate protection is found under § 364(d), assume the same debts ($75,000 for First Bank, and $50,000 for Second Bank), but that the collateral, Blackacre, is worth only $100,000 at the time of the new loan. At that value, First Bank's lien would not be adequately protected if subordinated. However, the Debtor may offer proof that it will use the $50,000 to be borrowed from Second Bank to make improvements on Blackacre, which it asserts will

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[231] In re YL W. 87th Holdings I LLC, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010).

[232] See, e.g., In re Snowshoe Co., 789 F.2d 1085 (4th Cir. 1986); Suntrust Bank v. Den-Mark Const., Inc., 406 B.R. 683 (E.D.N.C. 2009).

[233] See, e.g., In re Dunes Casino Hotel, 69 B.R. 784 (Bankr. D.N.J. 1986); In re Strug-Division LLC, 380 B.R. 505, 513 (Bankr. N.D. Ill. 2008) ("An 'equity cushion' seems to be the preferred test of adequate protection required to prime a first mortgage under 11 U.S.C. § 364(d)(1)."). Note, though, the mere presence of an equity cushion alone will not be determinative of whether there is adequate protection. See, e.g., In re Olde Prairie Block Owner, LLC, 448 B.R. 482 (Bankr. N.D. Il. 2011); In re Stoney Creek Techs., LLC, 364 B.R. 882 (Bankr. E.D. Pa. 2007).

[234] See, e.g., In re Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716, 753–54 (S.D. Fla. 2010) (noting that there is adequate protection if a priming lien would enhance the value of assets in a greater amount than the decrease in value of a creditor's interest in the property caused by the priming lien); In re 495 Cent. Park Ave. Corp., 136 B.R. 626 (Bankr. S.D.N.Y. 1992).

increase the value of Blackacre by more than enough to cover First Bank's subordinated lien in full.

Courts grant relief sparingly under § 364(d), because of the obvious risk to and interference with the property rights of the primed lienholder. But even with such judicial caution taken as a given, one can argue that § 364(d) logically makes no sense, and is internally inconsistent. Substantively, two critical proofs must be made: that no one will make the loan voluntarily without being granted a first lien, and that the lienholder who is relegated to second lien status is adequately protected. Consider those two points. Taken together, they reveal that the primed lienholder is being made to accept as "adequate" protection that which no voluntary lender would accept. The only other possibility is that other lenders would have been willing to accept a subordinated position—but then the "inability" test would fail. In our example, if the lending market believed that the equity cushion in Blackacre that presently existed or that would be generated was ample to cover both the $75,000 debt of First Bank and the $50,000 new loan, a voluntary loan should have been obtainable under § 364(c)(3).

d. Mootness

Lenders who are considering making a loan to a chapter 11 DIP obviously care about the priority and security for the repayment of the debt. But granting the lien or priority in the financing order is not enough. If the lender is at risk of losing its priority or lien if an appellate court reverses the financing authorization, no rational lender would be willing to advance funds until all appeals had been exhausted. Otherwise the lender could be out the money, but with no priority or security for the debt. As the Seventh Circuit observed, "[i]f creditors fear that the rug will be pulled out from under them, they will hesitate to lend."[235] In the meantime, the desperate debtor might die for lack of necessary funds. The problem, then, is how to protect the rights of other creditors and financially interested parties to challenge a financing order that they believe was entered in error, and yet not kill any hopes that the debtor might have for reorganizing.

The resolution of this dilemma is found in § 364(e).[236] Under that section, the reversal or modification on appeal of a financing order does not affect the validity of the debt incurred, or the validity of any priority or lien granted, if the lender acted in good faith, *unless* the financing order was *stayed* pending appeal. In other words, a creditor who wishes to challenge a financing order has the burden of obtaining a stay of the order while the appeal is pending. If the financing order is stayed, the lender will not advance funds, and thus incurs no risk. If no stay is obtained, and the lender advances funds, the appeal will effectively be mooted, and the lender will be protected. The statutory mootness rule of § 364(e) is a powerful weapon in the debtor's arsenal, because in practice it is extremely difficult to persuade a court that has just granted the debtor's motion to obtain necessary financing to turn around and stay that order.

[235] Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1355 (7th Cir. 1990).

[236] See Tabb, supra note 208, Lender Preference Clauses, 50 Ohio St. L.J. 109.

The safe harbor of § 364(e) is not inviolable, however. First, it offers no protection for a lender who has acted in bad faith. An explicit finding of good faith is required.[237] In a leading case, the Seventh Circuit held that a lender who *knew* that the loan and priority were illegal, but proceeded anyway in the hope that the transaction would slide through, failed the good faith test, and thus lost the protection of § 364(e).[238] Second, § 364(e) might not apply to protect the lender with regard to illegal "extra-statutory" provisions, such as cross-collateralization. The courts of appeals have gone both ways on this question of whether subsection (e) may protect transactions not otherwise authorized by § 364.[239] Finally, an appellate court may review a financing order and fashion partial relief that does not interfere with the lender's priority or lien for funds advanced.[240]

§ 11.11 Obtaining Financing: Cross-Collateralization

Obtaining financing and credit is a critical need for a reorganizing debtor. Section 364 responds to this need by enabling the debtor in possession to obtain credit or to incur debt.[241] Under § 364, prospective postpetition lenders or creditors can be offered a wide range of enticements to extend credit or make a loan to the DIP, progressing from an administrative priority,[242] § 364(a), (b); to a superpriority or a lien on unencumbered property or on equity in property already subject to a lien,[243] § 364(c); and finally to the granting of a "priming" lien ahead of an existing lien.[244] § 364(d). Postpetition creditors are given additional comfort by the statutory mootness rule that the grant of a priority or lien under § 364 to a good faith lender cannot be disturbed unless the financing order is stayed. § 364(e).[245]

But what if the prospective lender demands more? What if the debtor desperately needs money to stay afloat, and the only lender who will deal with the debtor refuses to make the postpetition loan unless the debtor not only secures and grants priority for the *post*-petition loan, but also secures and grants priority for the lender's unsecured *pre*-petition claim as well? May the court approve a grant of collateral or priority out of the estate for an unsecured prepetition claim, in exchange for a postpetition loan? The practice of granting a lien on collateral out of the postpetition bankruptcy estate to secure a lender's prepetition unsecured claim is referred to as "*cross-*

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[237] See, e.g., In re Cooper Commons, LLC, 430 F.3d 1215 (9th Cir. 2005); In re Swedeland Dev. Group, Inc., 16 F.3d 552 (3d Cir. 1994); In re Revco D.S., Inc., 901 F.2d 1359 (6th Cir. 1990).

[238] In re EDC Holding Co., 676 F.2d 945 (7th Cir. 1982).

[239] Compare In re Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992) (section 364(e) does not protect illegal extra-statutory provisions), with In re Ellingsen MacLean Oil Co., 834 F.2d 599 (6th Cir. 1987), cert. denied, 488 U.S. 817 (1988), and In re Adams Apple, Inc., 829 F.2d 1484 (9th Cir. 1987) (section 364(e) applies to all parts of financing order, even those provisions not authorized by § 364). The Ninth Circuit has reaffirmed its position in *Adams Apple*, and rejected the contrary view of *Saybrook*. In re Cooper Commons, LLC., 430 F.3d 1215 (9th Cir. 2005). For discussion, see Tabb, supra note 208, Lender Preference Clauses, 50 Ohio St. L.J. 109 (arguing for the "no mootness" position later adopted in *Saybrook*).

[240] See In re Swedeland Dev. Group, Inc., 16 F.3d 552 (3d Cir. 1994). See also In re Fountainebleau Las Vegas Holdings, LLC, 434 B.R. 716 (S.D. Fla. 2010).

[241] See § 11.10.

[242] See § 11.10.a.

[243] See § 11.10.b.

[244] See § 11.10.c.

[245] See § 11.10.d.

collateralization."[246] Debtors agree to such clauses because they have no choice; if they want the money, cross-collateralization is the cost.

Cross-collateralization has been extremely controversial under the Code; the legality of the practice is in doubt.[247] Some local bankruptcy rules specifically state that absent compelling circumstances, courts will deny provisions granting cross-collateralization.[248] At a minimum, many local rules require debtors to locate, highlight, and justify provisions that grant cross-collateralization.[249]

Two examples, taken from leading circuit court cases, will illustrate the operation of cross-collateralization. In each, the essence is that postpetition assets secure a prepetition unsecured claim. The first case is the 1979 Second Circuit case, *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*.[250] In *Texlon*, decided under the prior Bankruptcy Act, a cross-collateralization order in favor of the prepetition lender was entered *ex parte* on the day the debtor filed for relief under chapter XI. The lender was granted a security interest in the inventory, equipment, and accounts of the debtor's bankruptcy estate to secure the postpetition advances *and* the lender's unsecured prepetition claim. During the ten weeks that the debtor remained in chapter XI before converting to a liquidation case under chapter VII, the lender advanced $667,000 to the debtor. In that short time, enough assets were generated to repay the $667,000 in full, with another $267,000 left over. The effect of the cross-collateralization clause would have been to give this entire $267,000 to the lender for its prepetition claim, in preference to all other unsecured creditors. Absent the cross-collateralization provision, all prepetition unsecured claims would have shared the $267,000 on a pro rata basis.

The second example is the 1992 Eleventh Circuit case of *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.)*.[251] In *Saybrook*, the debtor's prepetition lender had a total claim of $34 million, of which only $10 million was secured, leaving an unsecured prepetition claim of $24 million. The lender agreed to advance $3 million to the debtor in the chapter 11 case, and in return was granted a security interest in all of the debtor's assets to secure both the postpetition loan *and* the prepetition debt. At the time the financing order was entered, the debtor's estate had $2 million in unencumbered inventory, which by virtue of the cross-collateralization clause became collateral for the lender's prepetition and postpetition claims. The immediate effect of the cross-collateralization order thus was to decrease

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[246] Sometimes this practice is specifically referred to as "forward cross-collateralization," distinguishable from mere cross-collateralization, which might just be securing post-petition debts with pre-petition assets. However, unless otherwise noted, the term cross-collateralization generally refers to the practice of securing a pre-petition debt on post-petition assets.

[247] For an in-depth discussion and criticism of cross-collateralization, see Tabb, supra note 208, Critical Reappraisal, 60 S. Cal. L. Rev. 109; Tabb, supra note 208, Lender Preference Clauses, 50 Ohio St. L.J. 109; Charles J. Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations, 65 Am. Bankr. L.J. 75 (1991) (hereafter "Emergency Preferential Orders"); Charles J. Tabb, Requiem for Cross-Collateralization, 2 J. Bankr. L. & Prac. 109 (1993) (hereafter "Requiem"). See also Karen M. Gebbia & Lawrence E. Oscar, *Saybrook Manufacturing*: Is Cross-Collateralization Moot?, 2 J. Bankr. L. & Prac. 163 (1993).

[248] See, e.g., M.D. Fla. Bankr. L. R. 2081–1(e)(1)(ii)(1).

[249] See, e.g., Del. Bankr. L. R. 4001–2(1)(i)(A) (2011).

[250] 596 F.2d 1092 (2d Cir. 1979).

[251] 963 F.2d 1490 (11th Cir. 1992).

the lender's prepetition unsecured claim by $2 million, from $24 million to $22 million, and to increase the secured claim from $10 million to $12 million.

Both courts of appeals struck down the cross-collateralization provision, but on somewhat different grounds. The historical progress between the two cases is intriguing. In *Texlon*, the Second Circuit, after condemning cross-collateralization on the merits in dictum as "a post-adjudication preference,"[252] rested its holding on procedural grounds, concluding that "a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an *ex parte* order."[253] Amazingly, post-*Texlon* cases read that decision as implicitly *authorizing* cross-collateralization as long as the procedural requisites of notice and a hearing were satisfied.[254] The leading case then announced a four-part test for approving cross-collateralization:[255]

1. The debtor's business would fail without the proposed financing;
2. The debtor cannot obtain alternative financing on acceptable terms;
3. The lender will not accede to less preferential terms; and
4. The financing is in the best interests of all creditors.

With this four-part test in place to guide bankruptcy judges weighing the merits of cross-collateralization orders, the action on cross-collateralization then shifted to the procedural issue of the mootness of an appeal of a financing order containing a cross-collateralization provision. Two circuit courts, the Sixth[256] and the Ninth,[257] held that § 364(e)[258] mooted the appeal of an unstayed cross-collateralization financing order.[259] Since bankruptcy judges invariably would refuse an appellant's request to stay a cross-collateralization order, which by definition would only be entered if the debtor's need for immediate financing was compelling, this mootness view effectively made cross-collateralization orders unreviewable.

The entire legal scene regarding cross-collateralization orders shifted dramatically in 1992 with the Eleventh Circuit's decision in *Saybrook*.[260] The court first held that the appeal was *not* moot under § 364(e).[261] As the *Saybrook* court explained, § 364(e) by its terms only applies to protect liens and priorities that are "authorized under this section," i.e., authorized under § 364. The decisive question, then, is whether cross-collateralization is "authorized under § 364." To conclude as the Sixth and Ninth

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[252] 596 F.2d at 1097.

[253] Id. at 1098.

[254] This development is discussed in Tabb, supra note 208, Critical Reappraisal, 60 S. Cal. L. Rev.at 116–19. See also In re Monach Circuit Indus., Inc., 41 B.R. 859, 861–62 (Bankr. E.D. Pa. 1984) (noting that "[s]everal bankruptcy courts have construed [*Texlon*] as providing that 'cross-collateralization provisions may not be approved *ex parte*, but only after notice and a hearing'" (collecting cases)).

[255] In re Vanguard Diversified, Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983).

[256] Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. (In re Ellingsen MacLean Oil Co.), 834 F.2d 599 (6th Cir. 1987), cert. denied, 488 U.S. 817 (1988).

[257] Burchinal v. Cent. Washington Bank (In re Adams Apple, Inc.), 829 F.2d 1484 (9th Cir. 1987).

[258] See § 11.10.d.

[259] These decisions were criticized in Tabb, supra note 208, Lender Preference Clauses, 50 Ohio St. L.J.at 116–35.

[260] 963 F.2d 1490 (11th Cir. 1992). For a detailed discussion of this case, see Tabb, supra note 247, Requiem, 2 J. Bankr. L. & Prac. 109, and Gebbia & Oscar, supra note 247, 2 J. Bankr. L. & Prac. 163.

[261] 963 F.2d at 1492–93.

Circuits did that the appeal is moot with regard to *all* provisions in a financing order, whether or not those provisions are authorized, would "put the cart before the horse," according to the Eleventh Circuit.[262]

That does not mean, however, that the entire financing order is open to appellate revision. Only those portions that are not authorized under § 364 would be vulnerable. Significantly, that limitation protects a lender's *post*-petition advances in full, because § 364 does expressly authorize granting liens and priorities to assure the repayment of postpetition advances.

The *Saybrook* court then turned to the merits of cross-collateralization clauses, and held that cross-collateralization was *per se* illegal.[263] According to the Eleventh Circuit:

> "We conclude that cross-collateralization is inconsistent with bankruptcy law for two reasons. First, cross-collateralization is not authorized as a method of post-petition financing under section 364. Second, cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code."[264]

Saybrook thus unequivocally rejected the arguments that had been made to support cross-collateralization. The primary supporting arguments were that (1) the court has the inherent equitable power under § 105(a) to approve cross-collateralization, because doing so might enhance the chances of a successful reorganization; (2) cross-collateralization might benefit all creditors, even those not preferred, by facilitating a reorganization; and (3) a cross-collateralization provision is just part of the price of the postpetition financing.

As the critical quoted passage above from *Saybrook* reveals, the Eleventh Circuit concluded that the court lacks the *power* to enter a cross-collateralization order. The equitable powers of the bankruptcy court cannot contradict the Code itself, and the direct effect of a cross-collateralization order is to alter the Code's priority scheme, by elevating the lender's prepetition unsecured claim ahead of all other unsecured claims.[265] Although the *Saybrook* court agreed that "rehabilitation is certainly the primary purpose of chapter 11," it went on to emphasize that "[t]his end, however, does not justify the use of any means."[266] Thus, if a postpetition lender wishes to extract a high price in exchange for its postpetition loan, it must do so directly, through permissible means, not by rearranging the Code's priorities.

The rationale of the *Saybrook* decision could draw into question the legality of the whole gamut of "emergency preferential orders."[267] Cross-prioritization clauses, in

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[262] Id. at 1493.

[263] Id. at 1494–96. In so holding, the court relied on Tabb, supra note 208, Critical Reappraisal, 60 S. Cal. L. 109.

[264] 963 F.2d at 1494–95.

[265] Id. at 1496.

[266] Id. See also In re Kaib, 448 B.R. 373, 376 n.2 (Bankr. W.D. Pa. 2011) ("Cross collateralizing is generally disallowed in a bankruptcy context" (citing *Saybrook*)).

[267] For a detailed discussion of these orders, see Tabb, Emergency Preferential Orders, supra note 247, 65 Am. Bankr. L.J. 75.

which a lender is granted priority for a prepetition claim in exchange for postpetition financing, rather than collateral, would clearly be proscribed under the *Saybrook* doctrine. "Roll-ups"—in which the lender's prepetition debt is "rolled up" into and paid off by the post-petition loan—likewise would be dubious in cases where the prepetition loan was not fully secured. So too does the decision cast doubt on the legitimacy of the practice of paying the prepetition claims of employees and trade creditors at the outset of a reorganization case under the supposed authority of the "necessity of payment" rule, a practice that today parades under the name of "critical vendor" orders.[268]

§ 11.12 The Necessity of Payment Rule and Critical Vendor Orders

Congress prescribed a very specific scheme of priority for the payment of claims in bankruptcy cases.[269] Secured claims are paid the value of their collateral.[270] Unsecured claims are paid out of the residue of the estate, after secured claims are satisfied. The universe of unsecured claims is divided into *priority* and *nonpriority* claims. The complete and exclusive listing of priority claims is contained in § 507.[271] In a chapter 7 case, priority claims must be paid in full before nonpriority claims are paid. § 726(a)(1). Nonpriority unsecured claims then share equally on a pro rata basis out of any remaining estate funds.[272] § 726(a)(2), (b).

In a chapter 11 case, § 1129(a)(9) requires that plans provide for the full payment of all priority claims under § 507 before being confirmed, but the Code contains no such mandate for nonpriority unsecured claims. For nonpriority unsecured claims, in order to be confirmed, a plan must only provide for payment equal to what they would receive in a liquidation.[273] § 1129(a)(7). While a plan may classify unsecured claims separately, and treat those classes differently if all affected classes consent, if a class votes against the plan, confirmation is possible only if the plan "does not discriminate unfairly, and is fair and equitable."[274] § 1129(b).

Most significantly, the Code contains *no express authority* for a bankruptcy court to create new priorities or otherwise alter the priority scheme, apart from the power to equitably *subordinate* claims in § 510(c).[275] Nor does any provision in the Code authorize the court to order the early payment of some unsecured claims in preference to other claims of the same class.

Notwithstanding the absence of any statutory authority in the Code to rearrange the priority scheme or to pay some unsecured claims in preference to others, many bankruptcy courts have invoked their residual "equitable" powers under § 105(a) to order the payment of certain unsecured claims in the early days of a chapter 11

[268] See § 11.12.

[269] See Chapter 7 of this treatise for a detailed discussion of the payment of claims.

[270] See § 7.27.

[271] See § 7.7.

[272] See § 7.25.

[273] See §§ 7.26, 11.26, 11.29.

[274] See §§ 11.17, 11.33.

[275] See § 7.23. In railroad reorganizations only, priority rules recognized in equity receiverships are incorporated into the Code. See § 1171(b).

reorganization.[276] Often included as part of a package of "first day orders," these orders typically direct the payment of the prepetition claims of employees of the debtor and key trade creditors. The rationale behind the payments is that these crucial claims need to be paid in order to preserve the debtor's chances of reorganizing, and that the paramount end of reorganization justifies any means. If employees and critical suppliers are not paid for their pre-bankruptcy claims, the reasoning goes, they might cease working for or doing business with the debtor, crippling the debtor's chances for business survival. This is true, supposedly, *even if* such creditors are paid in full for current services rendered or goods sold during the reorganization case. In short, these claimants are perceived to have leverage over the debtor that enables them to "extort" (a strong word, but it seems to describe the phenomenon) payment of their pre-bankruptcy claims in preference to other creditors and in contravention of the Code's priority scheme. The practice of paying these sorts of "necessary" claims has been called the "*necessity of payment rule*" or the "*doctrine of necessity*,"[277] and today is often discussed under the rubric of "*critical vendor orders*." As Judge Easterbook explained when writing for the majority in the Seventh Circuit's decision in *In re Kmart Corporation*, the " 'doctrine of necessity' is just a fancy name for a power to depart from the Code."[278]

The necessity of payment rule originated in federal equity receiverships for railroad reorganizations in the late nineteenth century.[279] These decisions relied heavily on the *public interest* in keeping the railroads running to justify the inequality in treatment of creditors.[280] The Necessity of Payment Rule was not a rule of priority, but a rule of payment, in which the equity courts bowed to the necessity of paying creditors who were able to apply economic sanctions to coerce payment.[281] By contrast, the "Six Months Rule" was a rule of priority that also developed in railroad cases.[282] The Six Months Rule permits the payment of necessary current operating expenses incurred in the ordinary course of business in the six months before the filing of the petition. That rule is based on principles of equitable restitution, on the theory that the current assets of the debtor are attributable in part to the credit extended in the six months preceding the filing. The Six Months Rule is incorporated into the Code in

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[276] See, e.g., In re Berry Good, LLC, 400 B.R. 741, 746 (Bankr. D. Ariz. 2008); In re Just for Feet, Inc., 242 B.R. 821 (D. Del. 1999); In re Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987); In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989). See also In re CoServ, LLC, 273 B.R. 487, 501–502 (Bankr. N.D. Tex. 2002) (holding that payment of prepetition debts "other than pursuant to a plan" might be allowed, but only under "extraordinary circumstances").

[277] See *Ionosphere Clubs*, 98 B.R. at 176. For an article explaining and justifying the doctrine, see Russell A. Eisenberg & Frances F. Gecker, The Doctrine of Necessity and Its Parameters, 73 Marquette L. Rev. 1 (1989). For criticism of the doctrine, see Tabb, supra note 247, Emergency Preferential Orders, 65 Am. Bankr. L.J. 75. See also In re Jeans.com, Inc., 502 B.R. 250 (Bankr. D.P.R. 2013) (applying the critical vendor doctrine).

[278] 359 F.3d 866, 871 (7th Cir. 2004).

[279] See Miltenberger v. Logansport, C. & S.W. Ry. Co., 106 U.S. (16 Otto) 286 (1882).

[280] See id. at 312. See also Thomas Finletter, The Law of Bankruptcy Reorganization 379 (1939).

[281] See In re B & W Enters., Inc., 713 F.2d 534, 537 (9th Cir. 1983).

[282] See Fosdick v. Schall, 99 U.S. (9 Otto) 235 (1878). For more recent applications, see In re Boston & Maine Corp., 634 F.2d 1359 (1st Cir. 1980), cert. denied, 450 U.S. 982 (1981); In re Penn Cent. Transp. Co., 458 F. Supp. 1234, 1319 (E.D. Pa. 1978), aff'd in part & remanded, 596 F.2d 1102 (3d Cir. 1979), supp. op., 596 F.2d 1127 (3d Cir. 1979), cert. denied, 444 U.S. 834 (1979); In re New York, New Haven & Hartford R.R. Co., 278 F. Supp. 592 (D. Conn. 1967), aff'd, 405 F.2d 50 (2d Cir. 1968), cert. denied, 394 U.S. 999 (1969).

railroad reorganization cases only. § 1171(b). Nothing in the Code, however, incorporates the Necessity of Payment Rule. Until the 2004 *Kmart* decision,[283] discussed below, it was universally assumed that the only possible source of authority for ordering "necessary" payments was the court's general equitable powers under § 105(a).

As noted above, a number of bankruptcy courts have determined that they do possess such a general power under § 105(a), in order to foster the debtor's chances of reorganizing.[284] Until the Seventh Circuit's decision in *Kmart*, every court of appeals to consider the issue had held that the courts have *no power* to interfere with the Code's priority scheme by ordering the early payment of selected prepetition unsecured claims.[285] These courts followed the Supreme Court's reasoning that whatever equitable powers the bankruptcy courts possess may only be exercised in a manner consistent with the express provisions of the Code.[286] Importantly, determining the relative payment rights of creditors in bankruptcy is a core *legislative* function, not amenable to equitable redetermination by the courts, other than "under principles of equitable subordination," pursuant to § 510(c). The Supreme Court has emphasized that "[d]ecisions about the treatment . . . of claims in bankruptcy proceedings . . . are not dictated or illuminated by principles of equity,"[287] and that "reordering of priorities . . . takes place at the legislative level of consideration [and] is beyond the scope of judicial authority[.]"[288] Thus, given the Code's comprehensive priority provisions, the payment of some nonpriority unsecured claims in preference to other claims transgresses the fundamental limitations on the scope of the court's equitable powers. Under this view, the Necessity of Payment Rule (or the "Doctrine of Necessity") is an illegal expansion of the bankruptcy court's powers, with no justifiable place in reorganization practice today. In short, critical vendor orders simply lie outside the scope of the bankruptcy court's powers.

The Seventh Circuit in *Kmart* agreed that the bankruptcy court could not invoke its general equitable powers under § 105(a) to rewrite the statutory priority scheme.[289] However, it then went on to speculate in dicta that possible authority for "critical

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[283] 359 F.3d 866 (7th Cir. 2004).

[284] See cases in supra note 276.

[285] The decision most squarely on point is *B & W Enterprises, Inc. v. Goodman Oil Co. (In re B & W Enterprises, Inc.)*, 713 F.2d 534 (9th Cir. 1983), in which the Ninth Circuit flatly rejected the argument that postpetition payments to suppliers could be justified by the Necessity of Payment Rule, concluding that the "Rule" did not apply outside of railroad cases (if even there) and that the bankruptcy court had no power to approve such a payment.

For other decisions in which a court of appeals held or observed that bankruptcy courts have no power to order payments to some prepetition creditors, see In re Oxford Mgmt., Inc., 4 F.3d 1329 (5th Cir. 1993); Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987), cert. denied, 485 U.S. 962 (1988); Southern Ry. v. Johnson Bronze Co. (In re Johnson Bronze Co.), 758 F.2d 137 (3d Cir. 1985); In re Crowe & Assocs., Inc., 713 F.2d 211 (6th Cir. 1983). In addition, the Eleventh Circuit's rationale for rejecting cross-collateralization in *In re Saybrook Manufacturing. Co.*, 963 F.2d 1490 (11th Cir. 1992), that the bankruptcy court does not have the equitable power to alter the Code's priority scheme, would apply with equal force to the Necessity of Payment Rule. See § 11.11.

[286] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988).

[287] United States v. Noland, 517 U.S. 535, 541 (1996) (quoting *Burden v. United States*, 917 F. 2d 115, 122 (3d Cir. 1990)).

[288] United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213, 229 (1996).

[289] 359 F.3d at 871.

vendor orders" might lie in § 363(b)(1),[290] which authorizes the trustee to use, sell, or lease property of the estate other than in the ordinary course of business. The *Kmart* court held, however, that even if in principle it was conceivable that § 363(b)(1) might support critical vendor orders, on the record before the court, insufficient proof had been made: "We need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1)."[291] Nevertheless, the court's further musings on what *might* constitute sufficient proof under § 363 has set the agenda by which bankruptcy courts—anxious to find any hook on which to hang their hat in order to enter orders they believe in their infinite wisdom to be necessary and prudent—may assess whether to approve critical vendor orders. The proof demanded for approval of a critical vendor order under § 363(b) is little, if any, different from that required under § 105(a) (for those courts, especially in Delaware and New York, which still find authorization under § 105(a)). In the final analysis, *Kmart* may have done little more than call a halt to the abusive practice of granting the debtor carte blanche to pay whomever it wished, just because it said so, without having to suffer the inconvenience of presenting actual proof. That the Seventh Circuit expressly stated that it was *not* deciding whether § 363 did or did not authorize critical vendor orders has to some extent been conveniently ignored.

The facts in *Kmart* are typical of what has become the practice in large reorganization cases, and demonstrate the stark disconnect between what the law *says* and what courts actually *do*. Here, the bankruptcy judge entered an extremely open-ended "critical vendor order" on the first day of the case, without notifying any disfavored creditors, without taking any pertinent evidence, and without making any findings as to the impact on the disfavored creditors. The order gave the debtor the unilateral discretion to pay in full the pre-bankruptcy claims of *any* of its suppliers that it deemed "critical," in exchange for an agreement to ship on "customary trade terms" for the next two years. Kmart exercised this remarkable power to pay a total of $300 million in satisfaction of the *pre-petition debts* of 2,330 suppliers (that is a *lot* of "critical" vendors!). Another 2,000 suppliers, however, did not get designated as "critical," a tough break indeed, since along with 43,000 other unsecured creditors, they eventually received only a dime on the dollar for their pre-bankruptcy claims.[292] One of the disfavored creditors appealed, wondering how it could be that some (thousands of) similarly situated creditors could get paid in full while it got paid a measly 10%, even though the Code's priority scheme appears to require equal payment, unless the unequal treatment is approved in a confirmed reorganization plan either by consent of all classes, or through the exercise of the rigorous "cram down" rules, none of which happened.

The district court reversed and held that the critical vendor order was illegal, following the unbroken line of circuit court authority[293] that has found no statutory or equitable power to order the payment of "critical" vendors, stating "we cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of 'equity'. . . . [T]hese payments . . . simply are not authorized by the Bankruptcy Code. Congress has not

[290] Id. at 872.

[291] Id. (emphasis in original).

[292] Id. at 869–70.

[293] See cases cited supra note 285.

elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims."[294] The Seventh Circuit then affirmed, but created much mischief with its unwarranted and unprecedented speculations that § 363(b)(1) may provide authority for critical vendor orders "if the record shows the prospect of benefit to the other creditors."[295]

Before turning to § 363, Judge Easterbrook for the Seventh Circuit quickly concluded that § 105(a) provides no authority for critical vendor orders, stating that "[a] 'doctrine of necessity' is just a fancy name for a power to depart from the Code," and that the court's equitable power under § 105(a) "is one to implement rather than override."[296] In order to override the Code's clear priority scheme, then, the Seventh Circuit insisted that some specific statutory authority be invoked. After rejecting suggestions that § 364 or § 503 might do the job, the *Kmart* court turned to § 363(b), and found it "more promising," reasoning that "satisfaction of a pre-petition debt in order to keep 'critical' supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy."[297]

This suggestion is grievously wrong. Section 363(b) has *nothing* to do with the priority of distributions. Yet the *Kmart* court's suggestion that it does turns § 363(b) into the debtor's ultimate priority trump card. Any court-approved "use" of property to pay pre-bankruptcy claims is *ipso facto* valid, even if doing so completely contradicts the express, specific statutory priority scheme spelled out in the Code. Normal statutory interpretation principles would dictate that the more specific provisions must control.[298] Under Judge Easterbrook's theory, however, a bankruptcy court has total authority and discretion to rewrite the Code's carefully conceived priority ordering as it sees fit, happily relying on the simple all-powerful justification that doing so is nothing more than a "use" of property under § 363. Even more mischievous is the fact that invoking a specific statutory provision as the basis for this supposed über-authority to rewrite priorities lends a false impression of legitimacy to the decision. At least when courts invoked § 105(a) they (and everyone else) knew that was a "Code" signal for the fact that they were skating on thin ice and basically making stuff up, but it was really important so everyone complicitly agreed to look the other way. It is deeply ironic that the *Kmart* court purported to denigrate the legitimacy of invoking a court's equitable powers to reorder the statutory priority scheme, but then turned around and did far worse by misreading § 363. Courts should not follow the *Kmart* lead; section 363(b) is *not* a legitimate source of authority to enter critical vendor orders. But they will follow it, because it gives them what they want.[299]

Having opened Pandora's box, the Seventh Circuit then at least partially closed the lid, stating that "it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy

[294] Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003).

[295] 359 F.3d at 874.

[296] Id. at 871.

[297] Id. at 872.

[298] E.g., RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S.Ct. 2065 (2012); Morales v. Trans World Airlines, Inc., 504 U.S. 374 (1992).

[299] See, e.g., In re News Publ'g Co., 488 B.R. 241 (Bankr. N.D. Ga. 2013); In re Orion Ref. Corp., 372 B.R. 688 (Bankr. D. Del. 2007); In re Tropical Sportswear Int'l Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005).

Code."[300] The court then effected this damage control by imposing several minimum evidentiary requirements that must be *proven* (and not just alleged) before a critical vendor order can be approved, even under the dubious authority of § 363(b):

1. "the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered;"[301]
2. "the supposedly critical vendors would have ceased deliveries if old debts were left unpaid;"[302] and
3. "discrimination among unsecured creditors was the only way to facilitate a reorganization."[303]

The overarching requirement that the court cited in summation is that "preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors."[304]

The *Kmart* court's list of proofs required to approve a critical vendor order bears a very close resemblance to the judicial test that came to be used to approve cross-collateralization orders: (1) that the debtor's business would fail without the financing (thus mirroring the third *Kmart* element); (2) the debtor cannot get alternative financing on acceptable terms (implicit in the second and third *Kmart* elements); (3) the lender will not agree to less preferential terms (thus mirroring the second *Kmart* element); and (4) the financing is in the best interests of all creditors (thus mirroring the first *Kmart* element).[305]

Just as with the cross-collateralization test, the *Kmart* tests collapse upon closer examination.[306] Judge Easterbrook himself noted some of the flaws. For one, he observed that to say that suppliers would not be willing to furnish *new* goods and services—which is the only thing that could possibly be relevant to the debtor's prospects for reorganization—*even if guaranteed payment for the new deliveries*, unless paid for *old* deliveries, would be economically irrational.[307] Yes it would—but not if the court is willing to cave in to the extortionate demands of the critical supplier that old debts be paid as well as being guaranteed payment for the new deliveries. By opening up even the prospect of approving a critical vendor order, the critical vendor's economic decision to insist on payment of both new *and* old debts is quite rational. Importantly, it is virtually impossible to test the credibility of a vendor's assertion that element #2 is satisfied, *viz.*, that it will not ship—even for cash!—unless old debts are paid. Since it is in the vendor's obvious economic interest to say that, how can a court tell who is

[300] *Kmart*, 359 F.3d at 872.

[301] Id. at 874. The court earlier described this element in a slightly different fashion, "the disfavored creditors *will* be as well off with reorganization as with liquidation[.]" Id. at 873 (emphasis in original). The difference in the two formulations is that the one in the footnote implicitly assumes that failure to enter the critical vendor order will lead to liquidation, whereas the one in the text does not.

[302] Id. at 873.

[303] Id. at 874.

[304] Id.

[305] See In re Vanguard Diversified, Inc., 31 B.R. 364 (Bankr. E.D.N.Y. 1983). See also § 11.11.

[306] See Tabb, supra note 208, Critical Reappraisal, 60 S. Cal. L. Rev. 109; Tabb, supra note 208, Lender Preference Clauses, 50 Ohio St. L.J. 109; Tabb, supra note 247, Emergency Preferential Orders, 65 Am. Bankr. L.J. 75.

[307] *Kmart*, 359 F.3d at 873.

bluffing? And, if the vendor truly is "critical" to the debtor's survival, then neither the debtor nor the bankruptcy court will be willing to call that bluff. In short, it will be an extremely difficult task as a practical matter for the courts to figure out when payment really is "necessary."

Furthermore, overlooked in this analysis is the fact that a pre-petition creditor's threat to cut off deliveries unless paid in full for its pre-bankruptcy claims appears to be a blatant violation of the automatic stay's proscription against "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case." § 362(a)(6).

Nor will it be an easy matter to determine which vendors are "critical." The truncated process by which the issue is resolved gives great power to the debtor to make the call, and makes it difficult for the court to second-guess the debtor's determination.[308] Relevant issues include how easily the debtor can acquire alternative products or services elsewhere, how essential this particular vendor's products or services are to the debtor's operations, and the extent to which the debtor can resist the vendor's demand for payment of its prepetition claims. The most extreme case would be one where the "critical" vendor is the only source for a good or service without which the debtor's business cannot operate. For example, if unpaid, the vendors would refuse to deal with the debtor, and as a result, the debtor would be unable to continue in business.[309] Likely, then, very few vendors would ever be considered "critical" to such a degree—certainly not 2,330 of them! Nor is it likely that other unsecured creditors would object to the payment of such a vendor. Indeed, one could fairly wonder why the debtor had not *already* paid a vendor who was that essential to survival.

Thus, the strong likelihood is that most supposedly "critical" vendors whom the debtor seeks to pay may be *important* to the debtor's business, but in fact would not satisfy a "reorganization failure" test. If a court were to take the third *Kmart* test seriously, few would pass muster. It is among this overwhelmingly preponderant intermediate mass of the debtors' vendors that the relative leniency or stringency of the "necessity" standard will determine how many vendors are considered "critical." How effective the demands of these "sort-of-critical" vendors for payment will be

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[308] One court, in considering the impact of Kmart, developed a three-prong test to determine critical vendor status: (1) the vendor must be necessary for the successful reorganization of the debtor; (2) the transaction must be in the "sound business judgment" of the debtor; and (3) the favorable treatment of the critical vendor must not prejudice other unsecured creditors. In re United Am., Inc., 327 B.R. 776, 782 (Bankr. E.D. Va. 2005). Note that the third prong of this test conflicts with *Kmart*'s third, minimum evidentiary requirement that: "discrimination among unsecured creditors was the only way to facilitate a reorganization." *Kmart,* 359 F.3d at 874. Thus, this might signal that in the wake of *Kmart,* courts continue to perform damage control by means of narrowing the circumstances of when critical vendor orders will be approved, while still acknowledging there might exist a time and place when appropriate. Indeed, *United American,* immediately prior to announcing the three-prong test, stated: "The Doctrine of Necessity can be easily abused. *Kmart Corp.* reflects the extent to which a narrowly constructed remedy became over time a routine appeasement of creditors. If there is to be a Doctrine of Necessity, it must be narrowly construed and sparingly applied." 327 B.R. at 782.

See also In re Corner Home Care, Inc., 438 B.R. 122 (Bankr. W.D. Ky. 2010) (applying *United*'s test); In re Ionosphere Clubs, Inc., 98 B.R. 174, 175–77 (Bankr. S.D.N.Y. 1989) (articulating the same factors, pre-*Kmart,* when discussing the doctrine of necessity).

[309] See, e.g., In re News Publ'g Co., 488 B.R. 241, 244 (Bankr. N.D. Ga. 2013) ("The foundation of a critical vendors order is that unpaid vendors will refuse to deal with the debtor, and as a result, the debtor will not be able to continue in business.").

depends in large part on how much resistance they can expect from the debtor—which in turn depends on the legal permissibility of paying prepetition claims. The easier it is to obtain authorization to pay prepetition claims pursuant to a critical vendor order, the more leverage more vendors will have to demand and receive such payment. Thus, an inherent problem for courts assessing critical vendor order requests is that their assessment is in substantial part circular and self-determining.

The first element of the *Kmart* test is problematic as well. To say that the disfavored creditors are as well off with the order as not paternalistically substitutes the *court's* determination of what is good for the disfavored creditors for the decision of those creditors themselves. Obviously those creditors who objected did not think that the order was in their interest. Why does the court know better? The *Kmart* court stated that "If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as 'critical.' "[310] The problem with that statement is that it is demonstrably false—all creditors do *not* favor payment.

Nor is this a determination that can be made pursuant to a defensible *process*. One of the most disturbing aspects of critical vendor orders is that they are entered on the first day of the case, with virtually no notice to adversely affected parties, little or no chance to object, no meaningful opportunity to be heard, and certainly no opportunity to vote. The court decides for them, and does so very much "under the gun" of urgency. It is significant that the Code's scheme *does* allow for differential treatment between unsecured creditors in a chapter 11 plan—*if* all of the confirmation safeguards are met, including both procedural and substantive protections. Creditors get a disclosure statement and they get to vote on a plan, and if a class votes against a plan, then confirmation is possible only if the rigorous cram down rules are satisfied. But *none* of those protections exists in the context of entry of a first-day critical vendor order.

Thus, Judge Easterbrook goes astray when he opines that a critical vendor order might be allowed pursuant to "a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization."[311] First, as just explained, *none* of the critical *procedural* protections built into the chapter 11 plan confirmation (and cram down) process are preserved. This fact alone casts grievous doubts on the legitimacy of critical vendor orders, and undermines Easterbrook's cram down analogy.

Second, the *Kmart* court gets the substantive cram down test wrong. What Judge Easterbrook cites as the cram down test—that the impaired class does as well as it would in a liquidation—is in fact the *best interests* test of § 1129(a)(7), and is a right that is enjoyed by and can be asserted by an *individual* unsecured creditor, even if that creditor's class votes in favor of the plan.[312] It is not a "class" protection at all, but a protection for minority class members, and must be satisfied in *all* cases (unless waived by every single creditor), not just in cram down cases. Cram down, by contrast,

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[310] *Kmart*, 359 F.3d at 872.

[311] Id. at 872–73.

[312] See § 11.26.

occurs when an entire class votes against a plan, and necessitates showings both that the plan (1) does not "discriminate unfairly" and (2) is "fair and equitable"—meaning that the absolute priority rule must be satisfied.[313] In the context of critical vendor orders, it is quite doubtful whether either the "no unfair discrimination" test or the absolute priority rule would be satisfied.

An intriguing postscript to *Kmart* concerns the impact of the 2005 Amendments. While nothing in those amendments directly deals with critical vendor orders or the Necessity of Payment Rule, two important amendments do address the underlying problem that partially motivated the impetus for critical vendor orders, by enhancing the likelihood that prepetition vendors will get paid for their pre-bankruptcy claims. First, the *reclamation* rights of a supplier of goods under § 546(c) were greatly expanded.[314] Second, the *administrative expense* priority entitlement for such suppliers was enhanced under § 503(b)(9).[315]

Under amended § 546(c), assuming that the debtor was insolvent at the time of delivery, an unpaid seller may be able to "reclaim" the actual goods delivered to the debtor in the ordinary course of business for 45 days prior to bankruptcy—and thus receive in effect full "payment" on its claim. A debtor who wished to keep the goods would be forced to pay off the creditor's reclamation claim in full, essentially mirroring the "critical vendor" payment. Note, though, that § 546(c) law imposes no "criticality" test; rather, *all* unpaid suppliers are entitled to reclamation if they meet the tests of ordinary course, delivery while insolvent, and timing.[316]

The second powerful new payment right given to trade suppliers in 2005 was an enhanced administrative expense priority for *all* unpaid sellers of goods for the value of goods (1) sold to the debtor in the ordinary course of business and (2) received by the debtor within 20 days of bankruptcy. § 503(b)(9). This administrative priority does not even require proof that the debtor received the goods while insolvent, and, like the reclamation provision, does not require proof that the vendor was "critical." Also, a creditor who meets the requirements for reclamation but who failed to give the required notice still is entitled to the administrative priority. § 546(c)(2). Now, a debtor can effectively pay vendors who qualify for the priority early in the reorganization case, without running afoul of the equality principle, since Congress has afforded statutory priority to such creditors. Courts routinely allow early payment of administrative claims during the pendency of a reorganization case, differing only on what to do if the estate later proves administratively insolvent.

The interesting question in the wake of the 2005 Amendments is whether these new statutory rules designed to protect unpaid vendors should be interpreted as *replacing* critical vendor orders entered under the dubious authority of § 363(b). The argument can be made that Congress now has directly addressed the core "unpaid vendor" problem, and that it would be even more indefensible than it currently is to

[313] See § 11.33.

[314] See § 7.37.

[315] See id.

[316] Though note, if the debtor enters into a DIP financing order proposing to use goods subject to the reclamation right at collateral for the postpetition financing, if the party with such reclamation right fails to object, its interest may be distinguished. See In re Circuit City Stores, Inc., 441 B.R. 496 (Bankr. E.D. Va. 2010).

give § 363(b) an expansive interpretation to go beyond what Congress has expressly permitted. The only factual situations in which critical vendor orders now might operate that are not already covered by the 2005 rules would be if one of the requirements for reclamation or the administrative priority was not met. These scenarios would include cases where the goods were delivered to the debtor (1) out of the ordinary course of business; (2) more than 45 days before bankruptcy; or (3) or more than 20 days before bankruptcy, while the debtor was solvent. One could fairly wonder whether a supposedly "critical vendor" payment *should* be ordered in such cases; doing so would substantially minimize the importance and relevance of those specific limitations that Congress enacted in 2005.

As a final note, another "extraordinary" chapter 11 practice, that of offering substantial retention packages to designated "key employees," was curtailed sharply in the 2005 Amendments.[317] Under new § 503(c), strict regulations now govern such "KERP" agreements with insiders. For retention agreements, the court must find (1) that the transfer or obligation is essential to retention because the person has a bona fide job offer from another business at the same pay or more; (2) the services provided are essential to the business's survival; and (3) the pay cannot exceed specified caps on amount. Severance payments are not permitted unless part of a general program for all employees and the amount is capped at ten times the mean severance pay to non-management employees. Indisputably, after 2005 a bankruptcy court would not have the authority to approve a key employee retention plan that did not comply with § 503(c) under either its equitable powers, § 105(a), or under § 363(b).

§ 11.13 Use, Sale or Lease of Property of the Estate

In chapter 11, continued operation of the debtor's business is the norm. § 1108. In fact, a party seeking to restrict business operations has the burden of obtaining a limiting order from the bankruptcy court. The debtor normally continues as debtor in possession (DIP), § 1101(1), and as DIP, retains control and management of its business and possession of property of the estate. The DIP is vested with the rights, powers, and duties of a trustee.[318] § 1107(a). For cause, a trustee may replace the debtor as DIP,[319] § 1104(a), and then will take possession of estate property and assume responsibility for operating the debtor's business. During the reorganization process, the estate representative (either trustee or DIP) not only will operate the business, but also might restructure that business. Both in operating and in restructuring the debtor's business, the estate representative of necessity will have to be able to deal with estate property. Section 363 governs the use, sale, or lease of property of the estate by the DIP or trustee.[320]

The statutory authorization for the debtor to use, sell, or lease estate property is found in subsections (b) and (c) of § 363. The principal difference in these subsections is whether the debtor must obtain court approval of the proposed use, sale, or lease of property, after notice and a hearing. The answer turns on whether the proposed transaction is in the *ordinary course of business*. If it is not in the ordinary course, then

[317] See § 7.13.

[318] See § 11.4.

[319] See § 11.6.

[320] See §§ 5.16–5.18.

the debtor must obtain court approval. § 363(b)(1). The debtor does not need to send notice or obtain court approval of ordinary course transactions, however. § 363(c)(1). The general authorization in § 1108 for the debtor to operate the debtor's business necessarily carries with it the authorization to engage in all transactions and activities necessary and essential to that business operation, including the use, sale, or lease of property of the estate. The only exception is for "cash collateral," which the DIP or trustee may use only if the lienholder consents, or after court approval. § 363(c)(2)–(4).[321]

Whether a particular transaction is in the ordinary course of the debtor's business depends on whether the transaction is one as to which creditors presumably would want prior notice and the opportunity to be heard. Courts have framed two tests for judging the ordinary course inquiry: first, whether the transaction is ordinary as compared to the debtor's own prepetition operations (the "vertical dimension" test); and second, whether that transaction is ordinary compared to other businesses in the industry (the "horizontal dimension" test).[322] Each test focuses in a different way on the reasonable expectations of the debtor's creditors. If a DIP or trustee makes a transfer outside of the ordinary course of business, then a party may challenge the transaction as an unauthorized postpetition transfer. § 549. Additionally, if a court finds that a DIP made an unauthorized transfer under § 549, then an order replacing said DIP may not be too far behind.[323] § 1104.

Even for transactions that are not in the ordinary course, an actual court hearing will not always be required. The phrase "after notice and a hearing" means "such notice as is appropriate in the particular circumstances and such opportunity for a hearing as is appropriate in the particular circumstances," § 102(1)(A), and recognizes that an act may be taken without a hearing if notice is given, and either no party in interest timely requests a hearing or an emergency dictates dispensing with a prior hearing. § 102(1)(B). The Bankruptcy Rules implement this "negative notice" approach, dispensing with the hearing if no objection to a proposed use, sale, or lease is filed and served after notice is given. Rule 6004.

The most basic constraint on the debtor's authority to use, sell, or lease estate property is found in § 363(e), which provides that an entity with an interest in property that the debtor proposes to use, sell, or lease is entitled to *adequate protection* of its interest. The court will prohibit or condition the use, sale, or lease of estate property as is necessary to provide adequate protection. What constitutes adequate protection is dealt with by § 361.[324] The adequate protection issue usually arises with respect to secured parties, who are entitled to maintain and preserve the value of their collateral during the bankruptcy case. The debtor has the burden of proving adequate protection. § 363(p)(1).

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321 See § 5.18.

322 See, e.g., Braunstein v. McCabe, 571 F.3d 108, 124–26 (1st Cir. 2009); In re Lavigne, 114 F.3d 379 (2d Cir. 1997); In re Roth Am., Inc., 975 F.2d 949 (3d Cir. 1992); In re Straightline Invs., Inc., 525 F.3d 870 (9th Cir. 2008).

323 See § 11.6.

324 See §§ 3.18–3.20 for a discussion of adequate protection.

The debtor may want to sell some (or all) property of the estate. Many sales are in the ordinary course of business, and will not need court approval. § 363(c)(1). For example, a retail debtor obviously may continue to sell its inventory. The debtor also may want to sell property out of the ordinary course of business.[325] For example, the debtor's business restructuring plan might call for selling some unprofitable stores. Court approval is needed for such sales. Under the conditions specified in § 363(f), property may be sold free and clear of the interests of others. Sales of property also may be effected through the plan itself. § 1123(a)(5)(D), (b)(4).

As mentioned above, the Code's general rules in § 363 allowing a debtor to use, sell, or lease estate property are subject to special limitations for "cash collateral." § 363(c)(2)–(4). For cash collateral, the interest of the non-debtor party in the property is given significant protection because of the risk that the cash collateral will be dissipated by the debtor. The debtor must segregate and account for any cash collateral in its possession, custody, or control. § 363(c)(4). Furthermore, the debtor is barred from using, selling, or leasing the cash collateral unless *prior permission* is obtained from either the secured creditor or the court. § 363(c)(2). The dispositive issue at a cash collateral hearing before the court usually is whether the secured creditor's interest in the cash collateral is being adequately protected. See §§ 363(e), 361.

In many chapter 11 cases, the debtor's need for cash collateral at the outset of the case is compelling. Section 363(c)(3) provides a specialized hearing procedure that enables the debtor to obtain emergency relief, and yet also safeguards the critical interests of the secured creditor. A cash collateral hearing often is the first significant contested matter in a chapter 11 case.

A question that has arisen is the extent to which § 363 can be used to sell *all or substantially all* of the property of the estate, instead of selling the property pursuant to a confirmed plan. This question was discussed in great detail in an earlier chapter, and I will not repeat that extended discussion here, but it is of course relevant.[326] The reality is that "the new 'chapter 3' reorganization"[327] is here to stay, although commentators differ as to whether we should applaud or decry that development.[328] The most notorious (in all senses of the word) § 363 sale cases have been the sale/reorganizations of General Motors[329] and Chrysler[330] in 2009.[331] In addition to the

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[325] See § 5.17.

[326] See id.

[327] Charles J. Tabb & Ralph Brubaker, Bankruptcy Law: Principles, Policies, and Practice 777 (4th ed. 2015).

[328] See, e.g., Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. 1375. See also Adler, supra note 8, 18 Am. Bankr. Inst. L. Rev. 305; Baird & Rasmussen, supra note 8, 55 Stan. L. Rev. 751; Todd L. Friedman, The Unjustified Business Justification Rule: A Reexamination of the *Lionel* Canon in Light of the Bankruptcies of *Lehman*, *Chrysler*, and *General Motors*, 11 U.C. Davis Bus. L.J. 181 (2010); Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: Allocating the Price of Proces in Chapter 11 Bankruptcy, 123 Yale L.J. 862 (2014); Lubben, supra note 8, No Big Deal, 83 Am. Bankr. L.J. 531; Lubben, supra note 8, New and Improved, 93 Ky. L.J. 839; Roe & Skeel, supra note 8, 108 Mich. L. Rev. 727; Skeel, supra note 8, 152 U. Pa. L. Rev. 917. Professor Westbrook examines the actual extent of secured-creditor controlled bankruptcy sales. Jay Lawrence Westbrook, Secured Creditor Control and Bankruptcy Sales: An Empirical View, 2015 U. Ill. L. Rev. 831 (2015).

[329] In re Gen. Motors Corp. 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

[330] In re Chrysler LLC, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009), aff'd, 576 F.3d 108, 123–26 (2d Cir. 2009), vacated as moot sub. nom. Ind. State Police Pension Trust v. Chrysler LLC, 558 U.S. 1087 (2009).

two auto cases, the largest § 363 sale in history occurred in the fall of 2008, when less than a week after filing chapter 11, Lehman Brothers sold its investment banking and trading businesses to Barclays for over a billion dollars.

Two related concerns arise when a debtor sells all or substantially all of its assets through a § 363 sale, one procedural and one substantive. The procedural concern is that the debtor is attempting to dispose of its assets and fix the payment to creditors without a formal disclosure statement, plan, ballot, or meaningful opportunity for creditors to participate in the bankruptcy process, other than by appearing at a court hearing and complaining. In short, debtors might use a § 363 sale to circumvent the more stringent and time-consuming procedural requirements of the chapter 11 plan confirmation process. On the substantive side, the worries are first, that this may not be the best deployment of the debtor's assets, and second, that the "sale" will subvert distributional entitlements. The first concern (deployment) is less problematic than the second (distribution), and might well be manageable in a sale setting. However, even if a prompt sale is the most efficient and value-enhancing way of deploying the debtor's assets, and even if the judge can make that determination wisely at a sale hearing, that deployment choice should not be allowed to bleed over into the "who gets what" question—but it often does. How to make the pie the biggest and who gets how big a slice are critically different questions. Regardless of how a company disposes of its property—whether by plan or sale—courts should keep their primary focus on the need to preserve distributional norms and the entitlements of stakeholders.[332] It bears noting, of course, that the procedural and substantive concerns are linked: if the more protective plan confirmation procedures are not followed, but instead the § 363 path is taken, it may be more difficult for the bankruptcy court to make a wise decision on the deployment and distributional questions.

Courts agree that a preplan sale of all estate assets is permitted under some circumstances, but disagree on what those circumstances are. Under the largely abandoned restrictive view, a § 363 sale of all assets is allowed only if there is an emergency that would prevent the debtor from complying with the time-consuming chapter 11 confirmation procedures.[333] The much more permissive and now overwhelming majority approach rejects the "emergency-only" view, and permits a proposed preplan sale of all or substantially all of the estate assets if the sale proponent offers a "*good business reason*" for the sale.[334] While courts talk in such flowery and catchy terms as "melting ice cubes," in truth the bar is not terribly high. Perhaps "stale bread" or "lukewarm coffee" would be more apt. A "good business reason" is a modest hurdle indeed.

The two gigantic auto cases have resolved this dispute (to the extent there even still was one) in favor of allowing free and clear sales of substantially all the debtor's

[331] For discussion of these cases, see Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. 1375; see also Adler, supra note 8, 18 Am. Bankr. Inst. L. Rev. 305; Douglas G. Baird, Lessons from the Automobile Reorganizations, 4 J. Legal Analysis 271 (2012); Lubben, supra note 8, No Big Deal, 83 Am. Bankr. L.J. 531; Roe & Skeel, supra note 8, 108 Mich. L. Rev. 727; A. Joseph Warburton, Understanding the Bankruptcies of Chrysler and General Motors: A Primer, 60 Syracuse L. Rev. 531 (2010).

[332] Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. at 1379.

[333] See, e.g., In re White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981).

[334] See In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983). The *Lionel* test was reaffirmed in the auto cases.

property, pursuant to the generous "good business reason" test,[335] as long as the supposed sale is not really a "*sub rosa*" plan.[336] It is difficult indeed formally to distinguish between reorganization by plan and reorganization by sale—any reorganization lawyer worth her salt can make a plan look like a sale, and vice versa[337]—which means that seeking to ferret out and condemn "*sub rosa*" sale-plans, as courts are wont to do, is both a fools' errand and a red herring. The real threat is to distributional entitlements. As the discussion in chapter 5 explains, what is the most troubling about *Chrysler* and *GM* is that they conflate the deployment and distributional questions—and in *GM*, distributional entitlements were undermined.[338] Union workers got a much bigger share than did other unsecured creditors, which *could* be allowed in a plan cram down if sufficient justification for the discrimination in treatment were shown, but because the court believed the canard that "the allocation of ownership interests in the new enterprise is irrelevant to the estates' economic interests,"[339] the justification question was never even asked.[340] Yet, a bedrock principle of reorganization law, dating back to the origins of the "fair and equitable" test and the absolute priority rule, in venerable foundational cases such as *Northern Pacific Railway Co. v. Boyd*,[341] is that the value doled out in the reorganized new enterprise must respect the distributional entitlements to the debtor's estate; the two are obviously and necessarily equivalent.[342]

D. THE PLAN

§ 11.14 What a Plan Is and Why Confirmation Matters

The ultimate goal of a chapter 11 case is to confirm a plan of reorganization. While the debtor's business normally will operate in the interim while the terms of plan are worked out, § 1108, Congress did not intend for the debtor to remain in chapter 11 in perpetuity.[343] At some point either a plan must be confirmed, with the debtor or a successor then emerging from chapter 11, or the case should be dismissed or converted to a liquidation under chapter 7. If a plan is confirmed, the terms of the plan will serve as the blueprint for the debtor's financial obligations from that point forward. Upon confirmation, all prior claims and interests against the debtor are replaced by the provisions of the plan.[344] § 1141.

A confirmed plan of reorganization is a combination of (1) a *contract* between the debtor, creditors, and equity; (2) an *investment* in the reorganized debtor by creditors

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[335] In re Chrysler LLC, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009), aff'd, 576 F.3d 108, 123–26 (2d Cir. 2009), vacated as moot sub. nom. Ind. State Police Pension Trust v. Chrysler LLC, 558 U.S. 1087 (2009); In re Gen. Motors Corp. 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

[336] In re Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983).

[337] See Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. at 1379.

[338] See id. at 1406–07.

[339] In re Motors Liquidation Co., 430 B.R. 65, 86 (S.D.N.Y. 2010) (quoting *In re Chrysler LLC*, 405 B.R. 84, 99 (Bankr. S.D.N.Y. 2009)). See Brubaker & Tabb, supra note 8, at 1402–03.

[340] See Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. at 1403–04.

[341] 228 U.S. 482 (1913). See § 11.33.

[342] See Brubaker & Tabb, supra note 8, 2010 U. Ill. L. Rev. at 1402–03.

[343] Ideally, a chapter 11 reorganization proceeding will not be pending for seven years. See Grp. of Inst. Investors v. Chicago, M., St. P. & P.R. Co., 318 U.S. 523 (1943).

[344] See § 11.35.