RECENT DEVELOPMENTS IN BANKRUPTCY LAW

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I. INTRODUCTION

This article notes developments in bankruptcy law since the sixteenth annual educational conference of the American Agricultural Law Association held November 3-4, 1995.

II. SOVEREIGN IMMUNITY

One of the most significant developments in bankruptcy law came in an Indian Gaming Law case, *Seminole Tribe of Florida v. Florida.*[1] The Supreme Court held that the Eleventh Amendment precludes Congress from statutorily authorizing suits by Indian tribes against the states under the Indian Commerce Clause.[2] Congress could not use its powers to legislate under Article I of the Constitution to abrogate the sovereign immunity which the Eleventh Amendment creates.[3]

Seminole creates a likelihood that a state which has not filed a claim in a given bankruptcy will be immune from suits in the bankruptcy proceeding. This immunity is likely to extend to suits alleging violations of the automatic stay in 11

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1. Seminole Tribe of Florida v. Florida, 116 S. Ct. 1114 (1996).
2. *See id.* at 1122.
3. *See id.* at 1131.

U.S.C. § 362. For example, immunity might be extended to actions by trustees and debtors-in-possession to recover preferences, actions to determine state tax liabilities and actions to enforce the terms of confirmed plans of reorganization. Whether the rights established by the Bankruptcy Code can be vindicated in a state court action against the state is a question that *Seminole* does not answer, and may be answered differently from state to state. In addition, only future litigation will determine the extent to which a state waives sovereign immunity by filing a bankruptcy claim. For bankruptcy practitioners, *Seminole* creates great doubt that the "unitary forum" principle of bankruptcy law will remain intact in cases where states hold significant claims.

III. DISCHARGEABILITY

In *Dalton v. Internal Revenue Service*, federal taxes were assessed against Dalton for 1976-78, 1981, and 1983-85.[4] The total amount of taxes assessed was $13,668,866.[5] Debtor's bankruptcy schedules listed $3,250 in assets.[6] The Internal Revenue Service did not object to discharge, but attempted collection after the bankruptcy case closed.[7] Debtor sought a determination of discharge, claiming he had not concealed assets, he had merely failed to pay.[8] The bankruptcy court had found that the debtor's conduct in titling a condominium in his fiancé's name, making her the sole stockholder of a corporation he organized, and attempting to transfer the condominium in violation of a court order, constituted something more than mere failure to pay, and indeed constituted a willful attempt to evade taxation.[9] The court of appeals upheld that finding, and the denial of discharge.[10]

> **Practice Issue:** Income tax liabilities become dischargeable, generally, three years after the tax return showing the liability is last due. What advice can lawyers give to debtors for managing their finances during that time, without endangering the prospective discharge?

In re Straub involved a divorce, followed by the husband's bankruptcy.[11] Vernon and Cecilia Straub divorced in 1984.[12] Vernon was to pay Cecilia $20,000

4. Dalton v. Internal Revenue Serv., 77 F.3d 1297, 1299 (10th Cir. 1996).
5. *See id.*
6. *See id.*
7. *See id.*
8. *See id.*
9. *See id.*
10. *See id.* at 1304.
11. Straub v. Straub (*In re* Straub), 192 B.R. 522, 522 (Bankr. D.N.D. 1996).
12. *See id.* at 523.

by ten equal installments of $2,000.[13] In 1985 Vernon quit-claimed 480 acres to his parents, despite having substantial equity in the land.[14] In 1986 the divorce court granted Cecilia a security interest in Vernon's remaining 160 acres and personal property to protect her right to the annual payments.[15] Subsequently, Vernon transferred the land and the personal property to his father, but continued to farm as before.[16] He paid no rent to his father for the land.[17] Cecilia obtained a judgment for $38,000.[18] Vernon filed a Chapter 12 proceeding.[19] His plan proposed a dividend of fifteen percent to holders of unsecured claims.[20]

Cecilia objected to the discharge because the one-year statute of limitations on fraudulent transfers had expired.[21] She also relied on 11 U.S.C. § 523(a)(6) instead, claiming that Vernon failed to satisfactorily explain the deficiency in his assets and had maliciously injured her property.[22] The court denied discharge on the basis of § 523(a)(6) and (15).[23]

Field v. Mans is a Supreme Court case involving a Chapter 11 proceeding.[24] Mr. and Mrs. Field claimed that Mans' letters to them fraudulently induced the Fields to extend credit to Mans' corporation, and therefore his debt to the Fields arising under his guarantee of the corporation's obligations should not be discharged.[25] The three lower courts concurred in holding that while the representations were false, the Fields' reliance was not reasonable.[26]

The Fields argued to the Supreme Court that reliance in fact is sufficient, and that the creditor need not show reliance that is reasonable under the circumstances.[27] The creditor and the Solicitor General argued that the omission of the word "reasonable" or any similar adjective from 11 U.S.C. § 523(a)(2)(A) and its inclusion in § 523(a)(2)(B), indicated that Congress did not intend to require that creditor reliance be reasonable.[28] The Supreme Court held that the use of the term "fraud" in § 523(a)(2)(A) carried with it the common law elements of fraud, and thus made the

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13. *See id.*
14. *See id.* at 524.
15. *See id.* at 523.
16. *See id.* at 524.
17. *See id.* at 525.
18. *See id.*
19. *See id.*
20. *See id.*
21. *See id.* at 525-26.
22. *See id.* at 526.
23. *See id.* at 526-29.
24. Field v. Mans, 116 S. Ct. 437 (1995).
25. *See id.* at 439-40.
26. *See id.* at 440.
27. *See id.* at 442.
28. *See id.*

wisdom of reliance an issue.[29] The Court held, however, that the standard is neither reliance in fact nor reasonable reliance, but "justifiable" reliance; justifiable reliance is to be a middle standard, not as high as reasonable reliance, but higher than reliance in fact.[30] A creditor relies justifiably if the falsity of the representation would not be patent upon a cursory examination.[31]

Justice Souter's majority opinion states that reasonableness is not "wholly irrelevant" because the reasonableness of reliance sheds light on the likelihood that the creditor actually relied on the representation.[32] Justices Breyer and Scalia dissented in a well-stated objection to excessive reliance on hyper-technical terminology to the exclusion of the practicalities of day-to-day commercial life.[33]

IV. TAXATION

The Internal Revenue Service established new regulations for creditor reporting of discharges of debt; the discharges became effective December 22, 1996.[34] Internal Revenue Code § 6050J requires any person who makes secured loans in connection with that person's trade or business and who either acquires an interest in the property in exchange for satisfaction for all or part of the debt, or who learns that such property has been abandoned, must make an informational return with respect to that property.[35] The return is required to disclose the name and address of the borrowers, a general description of the nature of the property and the debt, and as to lender acquisitions, must show the amount of the debt at the time of acquisition and the amount of indebtedness satisfied by the acquisition.[36]

In re Gleason featured a married debtor filing bankruptcy without his spouse, who sought relief under Chapter 7 in February 1995.[37] The debtor filed a 1994 income tax return in April of 1995, showing a $2,631 refund due.[38] The debtor, who had paid $8,000 in estimated taxes attributable to his law practice and other earnings, claimed that half of the refund belonged to his non-debtor spouse.[39] The non-debtor spouse's economic activities had led to 1994 business losses of $16,657.[40] The debtor argued that while he had made the tax payments, it was his

29. *See id.*
30. *See id.* at 443-47.
31. *See id.* at 444.
32. *See id.* at 446.
33. *See id.* at 447-50.
34. *See* Treas. Reg. § 1.6050(p)-1 (1996).
35. *See* 26 U.S.C. § 6050J(a).
36. *See id.* § 6050J(c).
37. *In re* Gleason, 193 B.R. 387 (Bankr. D.N.H. 1996).
38. *See id.* at 388.
39. *See id.*
40. *See id.*

wife's losses that created the right to a refund.[41] Absent her losses, he would have owed an additional $2,031.[42]

The court rejected the debtor's argument.[43] It traced the refund to the debtor's individual income, by comparing the income of each spouse to the amount of estimated or withheld taxes each spouse had paid.[44] The spouse had not paid any estimated taxes or had any taxes withheld, so the court determined that the total refund was included in the bankruptcy estate.[45] The court buttressed this conclusion by declaring that the non-debtor spouse would have been entitled to no refund at all had she filed separately.[46] Interestingly, the court never discussed the fact that the debtor, filing separately, would not have received a refund either.

In *In re Perlman*, a trustee liquidating a partnership interest sold two parcels of real estate and received the proceeds of those sales, which were approximately $47,000.[47] Unfortunately, the sale compelled the trustee to recognize more than $600,000 in taxable gain.[48] Hastily reversing field, the trustee attempted to abandon the debtor's interest in the real estate retroactively, or to have abandonment of the proceeds treated as the equivalent of abandoning the asset without sale.[49] The court was unable to find any statutory authorization for retroactive abandonment or for the proposition that realized income could effectively be "disclaimed" for tax purposes, and further declined to exercise any equitable powers under Section 105 to accomplish that end.[50]

The court noted the result in *Erickson v. United States* (*In re Bentley*), in which a trustee was permitted to abandon the proceeds of an ill-advised sale of corn.[51] The Eighth Circuit held that while the proceeds had been abandoned, the abandonment made no difference to the bankruptcy estate's liability for the income realized on the sale.[52]

United States v. Noland involved tax liabilities incurred by First Truck Lines while operating as a debtor-in-possession under Chapter 11 of the Bankruptcy Code.[53] The Internal Revenue Service filed claims in the debtor's subsequent Chapter 7 proceeding.[54] The bankruptcy court granted first priority to the claims and

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41. *See id.*
42. *See id.*
43. *See id.*
44. *See id.*
45. *See id.*
46. *See id.*
47. *In re* Perlman, 188 B.R. 704, 706 (Bankr. S.D. Fla. 1995).
48. *See id.*
49. *See id.*
50. *See id.* at 709.
51. Erickson v. United States (*In re* Bentley), 916 F.2d 431, 431-32 (8th Cir. 1990).
52. *See id.* at 432-33.
53. United States v. Noland, 116 S. Ct. 1524, 1524-25 (1996).
54. *See id.* at 1525.

interest, but subordinated the penalty claims, basing its action on 11 U.S.C. § 510(c), which the court interpreted as giving it authority to adjust the statutory priority of a category of claims.[55] The subordination was affirmed by the district court and the Sixth Circuit, which concluded that post-petition nonpecuniary loss tax penalty claims are susceptible to subordination.[56] The Supreme Court held that such a subordination violates the legislatively established scheme of priorities, and is not within the power of the court.[57]

V. AUTOMATIC STAY

Under Chapter 12, the debtors demanded that the U.S. Department of Agriculture (USDA) compensate them for attorneys' fees incurred in opposing the USDA's willful violation of the automatic stay under 11 U.S.C. § 362.[58] Before the bankruptcy, the USDA denied the debtors certain disaster payments on the 1988 rice crop.[59] The Department denied disaster payments on the ground that the debtors had failed to follow normal husbandry practices.[60] The debtors filed a Chapter 12 proceeding and the USDA setoff the advance disaster payment against disaster payments owed for wheat crops.[61] The debtors objected to the setoff on the ground that the automatic stay precluded the setoff. The Court agreed with the debtors, and the district court and court of appeals affirmed that decision.[62]

In re Winchester concerned an action to recover attorneys' fees.[63] The Bankruptcy Court found § 106 of the 1994 Bankruptcy Reform Act authorized recovery of actual attorneys fees from the United States.[64] The court determined the United States had greatly aggravated the costs of the proceeding, but was also concerned that the debtors' counsel had billed $41,000 in pursuing a claim for $6,449.[65] The court awarded the debtors attorneys' fees and costs of $13,949.[66]

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55. *See id.* at 1525-26
56. *See id.* at 1526.
57. *See id.* at 1527.
58. *In re* Winchester, 191 B.R. 93, 94 (Bankr. N.D. Miss. 1995).
59. *See id.* at 95.
60. *See id.*
61. *See id.*
62. *See id.* at 99.
63. *See id.* at 94.
64. *See id.* (citing 11 U.S.C. § 106 (1994)).
65. *See id.* at 99.
66. *See id.*

VI. TRUSTEE'S FEES

A number of 1996 cases involve efforts by debtors to reduce the Chapter 12 trustee's compensation by paying claims outside the plan of reorganization, thereby escaping the trustee's ten percent fee:

(1) *In re Jennings*: concerned a debtors' Chapter 12 plan that attempted to pay impaired claims directly to creditors.[67] The trustee argued the direct payment reduced the trustee's compensation unduly.[68] The court permitted the direct payments relying on *In re Wagner*.[69]

(2) *In re Cross* concerned a plan in which impaired secured claims were paid directly, without compensation to the Standing Trustee.[70] The trustee objected, appealed, and lost.[71] As drafted, the Plan left the trustee with a possibility of receiving no payments at all.[72] The trustee sought compensation under 11 U.S.C. § 105.[73] The bankruptcy court ruled that the specific provisions of 11 U.S.C. § 326(b) preclude entry of an order for compensation under § 105.[74]

(3) *In re Michel v. Beard* concerned a plan under which the secured portion of an under secured claim would be paid directly to the trustee, with no trustee's fees to be paid on those amounts.[75] The Sixth Circuit agreed with the debtor and permitted the payment to be made without additional trustee's fees.[76]

VII. EXEMPTION PLANNING

In re Carletta concerned a case in which debtors converted cash into life insurance policies prior to filing a Chapter 7 proceeding.[77] A creditor objected to discharge on the ground that the conversion was made with the intent to defraud creditors.[78] The debtors testified that they bought the insurance policies to cut down on the total of the non-exempt assets.[79] The court held that such a conversion was

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67. *In re* Jennings, 190 B.R. 863 (Bankr. W.D. Mo. 1995).

68. *See id.*

69. *See id.* at 864-65 (citing Wagner v. Armstrong (*In re* Wagner), 36 F.3d 723 (8th Cir. 1994)).

70. *In re* Cross, 195 B.R. 440 (Bankr. D. Neb. 1996).

71. *See id.* at 443.

72. *See id.* at 441.

73. *See id.*

74. *See id.* at 441-42.

75. *In re* Michel v. Beard, 45 F.3d 113 (6th Cir. 1995).

76. *See id.* at 120.

77. *In re* Carletta, 189 B.R. 258 (Bankr. N.D.N.Y. 1995).

78. *See id.*

79. *See id.* at 261.

inadequate to deny discharge without further evidence of wrongful conduct by the debtors.[80]

In *AgriBank v. Green*, a creditor attempted to justify the late filing of a claim on the ground that the bankruptcy proceeding had stayed its foreclosure sale.[81] The amount of its unsecured claim could not be determined until the foreclosure sale was completed and the deficiency determined.[82] The creditor proceeded with the sale after obtaining relief from the automatic stay and filed its claim one month after the claims' bar date.[83] Although the Bankruptcy Court permitted the late filing, the district court reversed, holding that Rule 3003 could not be used to allow a late filing and that the creditor's attempt to rely on Rule 9006 would fail because it could not meet the excusable neglect standard.[84]

In *Winthrop Old Farm Nurseries, Inc. v. New Bedford Institute for Savings*, a Chapter 11 proceeding, the debtor proposed to transfer its real property to a new entity controlled by the debtors' principals and to pay the second mortgage for the liquidation value of the property.[85] The debtors' principals controlled the new entity.[86] The court held that under these circumstance the property would be valued at fair market value.[87] The court declared that fair market value is the appropriate standard for valuing collateral which a Chapter 11 debtor proposes to retain.[88] The creation of the new entity, because it was controlled by the debtor's principals, was not permitted to sway the court's application of the going concern value rather than the liquidation value.[89]

VIII. Lien Stripping

Lomas Mortgage, Inc. v. Louis held that debtors owning and occupying one dwelling in a multiple family residence can strip the mortgage down to the value of the collateral.[90] The debtors lived in one unit of a three-unit home in which they owed approximately double its value.[91] Debtors proposed to value the creditor's secured claim at the appraised value of the residence and treat the balance of the debt

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80. *See id.* at 263-64.
81. Agribank v. Green, 188 B.R. 982, 990 (C.D. Ill. 1995).
82. *See id.* at 990.
83. *See id.* at 985.
84. *See id.* at 991 n.5.
85. Winthrop Old Farm Nurseries, Inc. v. New Bedford Institute for Sav., 50 F.3d 72, 73 (1st Cir. 1995).
86. *See id.*
87. *See id.* at 76.
88. *See id.*
89. *See id.* at 74.
90. Lomas Mortgage, Inc. v. Louis, 82 F.3d 1, 7 (1st Cir. 1996).
91. *See id.* at 2.

as an unsecured claim.[92] The debtors argued that the mortgage was not secured solely by their homestead, because the income producing portions of the property were subject to the mortgage and did not constitute the debtors' homestead.[93] The court traced the congressional approach to similar cases in Chapter 11 and noted that in the course of its deliberations, Congress considered the decision of *In re Ramirez* controlling.[94]

IX. CONCLUSION

The large number of lien-stripping cases probably culminated in the *Lomas* decision, with little more to be said by courts of appeal until Congress revisits the issue.[95] Next year's crop of significant cases is likely to concern the import of the Seminole Doctrine for bankruptcy proceedings.

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92. *See id.*
93. *See id.* at 3.
94. *In re* Ramirez, 62 B.R. 668 (Bankr. S.D. Cal. 1986).
95. *See* Lomas Mortgage, Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996).