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## 9th Biennial Judge Joe Lee Bankruptcy Institute

Office of Continuing Legal Education at the University of Kentucky College of Law

David G. Epstein  
*University of Alabama School of Law*

Kenneth N. Klee  
*Klee, Tuchin & Bogdanoff, LLP*

Paul H. Asofsky  
*Weil, Gotshal & Manges LLP*

Beverly M. Burden  
*Chapter 13 Trustee*

*See next page for additional authors*

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**Authors**

Office of Continuing Legal Education at the University of Kentucky College of Law, David G. Epstein, Kenneth N. Klee, Paul H. Asofsky, Beverly M. Burden, Lawrence P. King, Charles P. Normandin, John J. Jerome, Taft A. McKinstry, Joan Lloyd Cooper, G. Ray Warner, and Gerald K. Smith

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**9<sup>th</sup> Biennial  
Judge Joe Lee  
BANKRUPTCY  
INSTITUTE**

**December 1999**

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Suite 260 Law Building  
Lexington, Kentucky 40506-0048  
(606) 257-2921 or  
(606) 257-CLE1  
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— 9th Biennial —  
JUDGE JOE LEE  
BANKRUPTCY INSTITUTE

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**PREFERENTIAL  
AND  
FRAUDULENT CONVEYANCES**

**David G. Epstein  
University of Alabama School of Law  
Tuscaloosa, Alabama**

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**SECTION A**



# PREFERENTIAL AND FRAUDULENT CONVEYANCES

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# BANKRUPTCY AVOIDANCE - 1999

David G. Epstein  
Professor of Law, University of Alabama Law School  
November 1999

## PART 1 - SIX CURRENT QUESTIONS

### I. WHO CAN AVOID TRANSFERS?

Avoidance does not occur by operation of law. Rather, a person whom the Code empower to avoid transfers must bring an action or proceeding to so 1 David G. Epstein, Steve H. Nickles, & James J. White, Bankruptcy section 6-2 (1992).

#### A. Chapter 13

A Chapter 13 trustee has the same powers to avoid a transfer as a Chapter 7 trustee. Section 1303 gives the Chapter 13 debtor some of the trustee's powers. The trustee's powers expressly given to a Chapter 13 debtor do not include the trustee's avoiding powers. Yet, statements can be found in the legislative history that the purpose of section 1303 was simply to set out "rights and powers that the debtor has exclusive of the trustee" without implying that the "debtor does not also possess other powers concurrently with the trustee." 124 Cong. Rec. 32,409 (1978)(Rep. Edwards)(emphasis added).

Most of the early reported cases held that a Chapter 13 debtor is free to exercise the various avoiding powers for the benefit of the estate. E.g., In re *Pinkstaff*, 121 B.R.596, 597 (Bankr. Ore. 1990); *Matter of Ware*, 99 B.R. 103,105 (Bankr. M.D. Fla. 1989).

According to Judge Sigmund,

These early Code cases took a pragmatic view of the debtors standing, Recognizing that the Chapter 13 trustee was unlikely to exercise the avoiding powers for the debtor's benefit, the courts found the debtor's right, implicit in the Code, notwithstanding the express grant of such powers only to trustees (and the debtor-in-possession which is given the rights of a trustee by section 1107). This liberal reading of the statute is unlikely to prevail under more recent pronouncements by the United States Supreme Court.

*In re Compton*, 1998 WL 372659, n. 5 (Bankr. E.D. Pa. 1998). In *Compton*, the Chapter 13 debtors avoidance powers were limited to section 522(h) and involuntary transfers of exempt property. See also, e.g., *In re Smoot*, 237 B.R. 675 (Bankr. Md. 1999); *In re Reddift*, 146 B.R. 693, 697 (Bankr. S.D. Miss. 1992).

Is section 1107 helpful to understanding section 1303? Is it important that there is either a debtor-in-possession or a trustee in a Chapter 11 case but both a debtor and a trustee in a Chapter 13 case? Is important that section 1303 but not section 1107 uses the term "exclusive"? See generally Morgan King & Jonathan Moss, *Avoiding Tax Liens on Personal Property in Bankruptcy: A Look at the Interplay Between the Bona Fide Purchaser Provisions of the Tax and Bankruptcy Codes*, 31 Calif West. L. Rev. 1, 34 seq (1994).

## **B. Chapter 11**

### **(1) Preconfirmation**

There is express statutory authorization for a Chapter 11 trustee or debtor in possession to bring an avoidance action, sections 1106, 1107. There is no express statutory authorization for a creditors' committee to pursue an avoidance action. There is, however, ample case authority: most reported cases have held that the authority exists (i) on a case by case basis, (ii) when specifically approved by the court, and (iii) on a showing of good cause. E.g., *In re*

Daley, 224 B.R. 307 (Bankr. S.D.N.Y. 1998); *In re Jones*, 37 B.R. 969 (Bankr. N.D. Tex. 1984).

Neither the Chapter 11 trustee nor the Chapter 11 debtor in possession is statutorily authorized to transfer avoidance actions. *In North Atlantic Milwork Corp.* 155 B.R. 271 (Bankr. Mass. 1993), the court approved a section 363 sale of a chapter 11 debtors assets including avoidance actions. The asset purchase agreement expressly authorized the buyer to commence the avoidance actions for itself. When the purchaser brought avoidance actions, one of the defendants successfully challenged its authority. After acknowledging that the sale order approved the assignments, the court ruled that there was no statutory authority for assigning avoidance actions other than section 11 23(b)(3)(B) which do not here apply. See also *In re S & D Foods, Inc.*, 110 B. R. 34, 36 (Bankr. Colo. 1990).

## (2) Postconfirmation

According to section 11 23(b)(3)(B), the plan may provide for "retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose of any ... claim or interest." (emphasis added) Courts have construed this language as permitting a transfer of the avoiding powers to the person named in the plan. See generally C. Wesley Vines & Vernon O, Teofan, *The Preservation and Prosecution of Avoidance Actions Post-Confirmation*, 12 Bankr. Dev.J. 735 (1996); see also Note, *Recovering Avoidable Transfers Under Section 550 of the Bankruptcy Code: Defining For the "Benefit of the Estate"*, 72 Chi-Kent L. Rev. 591 (1996).

In applying section 1123(b)(3)(B), courts require a high level of plan specificity. *Matter of Huntsville Small Engines, Inc.*, 228 B.R. 9 (Bankr. N.D. Ala. 1998) seems to

require that the plan "specifically and unequivocally" provide that the assignee of the claims is a representative of the estate for the purpose of pursuing the claims. A "confirmation order that merely approved the assignment by the debtor to South Trust of any avoidance claims that the debtor held against Husqvarna" did not satisfy section 1123(b)(3)(B). But, cf. In re P.R.T.C., 177 F3d 774 (9th Cir. 1999), (holding that a Chapter 7 trustee could assigne avoidance actions to largest creditor who agreed to pay 50% of any recovery to the estate). It is helpful to look not only at section 11 23(a)(3) and the reported cases under that section but also to other statutory provisions: section 1141 (b)("except as otherwise provided in the plan or in the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor") and section 550 ("the trustee may recover for the benefit of the estate the property transferred") and section 541 (a)(3)("any interest in property that the trustee recovers under section ... 550"). In *In re Burlington Motor Holdings, Inc.*, 231 B.R. 874 (Bankr. Del. 1999), the court held that the requirements of section 550 were not satisfied by an assignment of the claims where there was no requirement that all or even a part of the recovery be paid to the estate. But, cf. Blonder v. Cumberland Engineering, 84 Cal. Rptr.3d 216 (Cal. Ct. App. 4 1999) (dictum that section 550 requirement of "benefit of the estate" inapplicable to assignee's avoidance of security interests because section 547 operates independently of section 550 in avoidance of liens).

## II. CAN THE VARIOUS AVOIDANCE PROVISIONS OPERATE INDEPENDENT OF SECTION 550?

Sections 544, 545, 547 548, 549, and 553 expressly empower the trustee to "avoid."

None of these provisions use the word "recover." Section 550 uses the word "recover" and expressly refers to section 544, 545, 547, 548, 549, and 553. Obviously, the avoidance powers are linked to section 550. What is less obvious is whether the avoidance powers can operate independent of section 550.

This question can be of practical importance if: (1) A fully solvent Chapter 11 debtor seeks to avoid a security interest or mortgage. The avoidance will not meet the section 550 requirement of benefit to the estate, or (2) An noninsider creditor receives a mortgage or security interest on a guaranteed loan more than ninety days but less than a year before the primary obligor files for bankruptcy. The 1994 *Deprizio* fix, section 550(c) simply provides that the "the trustee may not recover under subsection (a)[of section 550] from a transferee that is not an insider."

The relatively few reported cases that have considered the general question are divided. Compare *In re Williams*, 234 B.R. 801 (Bankr. Ore. 1999)(independent) with *Weaver v. Aquila Energy Marketing Corp.*, 196 B.R. 945, 954-55 (S.D. Tex. 1996)(dependent); see generally 2 David G. Epstein, Steve H. Nickles, & James J. White, *Bankruptcy* section 6-79 (1992); John Clemency & John A. Harris, *Recognizing the Separation Between Avoidance of Interests Under Section 544(a) and Recovery Under Section 550*, 16 *American Bankruptcy Institute Law Journal* 20 (Nov. 1997); Margaret Howard, *Avoiding Powers and the 1994 Amendments to the Bankruptcy Code*, 69 *Am. Bankr. L.J.* 259, 267 (1995).

### **III. CAN A PREPETITION SECURITY INTEREST REACH AVOIDANCE RECOVERIES?**

There are reported cases allowing creditors with a blanket security interest to claim a

lien upon whatever the estate recovered in an avoidance action. *In re Enserv Co.*, 64 B.R. 519 (9th Cir. B.A.P. 1986) (levy by unsecured creditor was avoidable as a preference under section 547; proceeds were encumbered by bank's sweeping security interest), *affd*, 813 F.2d 1230 (9th Cir. 1987); *In re Ellingsen MacLean Oil Co.*, 98 B.R. 284 (Bankr. W.D. Mich. 1989) (where fully secured creditor was the only party prejudiced by preferential transfer, that creditor would receive all proceeds of preference avoidance). *See, generally, Note Avoidance Recoveries in Bankruptcy For the Benefit of the Estate of the Secured Creditor?*, 90 Colum. L. Rev. 1376 (1990).

#### A. Arguments Against

Under section 552(a), a prepetition floating security interest or lien does not extend to property acquired by the debtor or by the estate after the commencement of the case. A prepetition security interest cannot attach to a preference or fraudulent transfer action as such because the right to bring such an action only arises postpetition. *In re Vogel Van & Storage, Inc.*, 210 B.R. 27 (N.D.N.Y. 1997), *affd* 142 F.3d 571 (2d Cir. 1998); *In re Tek-Aids Indus., Inc.*, 145 B.R. 253 (Bankr. N.D. Ill. 1992). From this principle, some courts have concluded that the proceeds of a preference action cannot be subject to a prepetition security interest because they flow from a postpetition chose in action and amount to property acquired by the estate postpetition. *In re Overland Park Merchandise Mart Partnership, L.P.*, 167 B.R. 647 (Bankr. D. Kan. 1994); *In re Lease-A-Fleet, Inc.*, 152 B.R. 431 (Bankr. E.D. Pa. 1993); *see* Elliot D. Levin & Phyllis McGurk, *Who Gets the Goodies: What Happens to the Enhancement of the Secured Parties; Collateral Post-Petition?*, 102 Com. L.J. 55 (1997).

Second, some courts have suggested that, under sections 550 and 551, the benefits of an avoidance action must go to the estate-i.e., to general creditors-rather than to a secured creditor. See *In re Integrated Testing Products Corp.*, 69 B.R. 901 (D.N.J. 1987); *Overland Park Merchandise Mart Partnership*, 167 B.R. at 647; see also *In re Double LL Invs., Inc.*, No. 90-03877-H5-7, 1995 WL 736463, 1995 Bankr. LEXIS 1773 (Bankr. S.D. Tex. 1995)(court chastised Chapter 7 trustee for bringing an avoidance action that benefitted only a secured creditor).

#### **B. Counter Arguments**

First, there is a difference between the right of recovery (Le., the estate's avoidance chose in action) and the property that is actually recovered. It is entirely possible for a secured creditor to have no rights in a cause of action as such and yet to have every right to assert a security interest in what the estate receives. See *In re Figearo*, 79 B.R. 914 (Bankr. D. Nev. 1987).

For example, U.C.C. § 9-104(k) excludes tort claims from the scope of Article 9. Nonetheless, if a tortfeasor has damaged or destroyed the collateral, and if the debtor recovers from the wrongdoer, then the security interest attaches to whatever the tortfeasor must pay. The tort recovery is proceeds of the collateral under U.C.C. § 9-306; *In re Phoenix Marine Corp.*, 20 B.R. 424 (Bankr. E.D. Va. 1982).

Whether a prepetition security interest attaches to the estate's avoidance action as such is simply irrelevant. The prepetition security interest will attach to the recovery made under the avoidance action if what is recovered may be identified as the prepetition collateral or the proceeds of the collateral, just as a security interest will attach to tort recovery or insurance



payments, provided that these are identifiable as payments made to replace the collateral. See *In re Antinarelli Enters, Inc.*, 107 B.R. 410 (D. Mass. 1989); Figaero, 79 B.R. at 914.

Second, the fact that sections 550 and 551 demand that any recovery must be for the benefit of the estate in no way prevents a prepetition security interest from attaching to the recovery. Expanding the secured creditor's collateral reduces the total amount of unsecured claims. Moreover, recovery for the benefit of the estate encompasses recovery for secured as well as unsecured creditors. E.g., *In re Nowicki*, 202 B.R. 729 (Bankr. N.D. Ill. 1996); *In re North Atlantic Millwork Corp.*, 155 B.R. 271 (Bankr. D. Mass. 1993).

### C. Resolution

A prepetition lien or security interest should attach to an avoidance recovery if, but only if, what is recovered is clearly identifiable as the collateral itself or as the proceeds of prepetition collateral, and if the creditor's security interest would be enforceable against the transferee outside of bankruptcy. If what is recovered is not the collateral itself, look to section 9-306(4)(d) to see whether the recovery constitutes the identifiable proceeds of prepetition collateral. If so, then, under the mandate of section 552(b), the recovery will be subject to the security interest

## IV. CAN THE AVOIDANCE POWER AVOID THE AVOIDANCE OF BEQUESTS?

### A. Prepetition Disclaimers

Two circuits have held that a prepetition disclaimer is not subject to attack as a fraudulent transfer (or, presumably, as a voidable preference) in the disclaimant's later bankruptcy. . *Matter of Simpson*, 36 F.3d 450 (5th Cir. 1994) (*per curiam*) (debtor executed valid disclaimer one day before filing bankruptcy petition; disclaimer was not subject to attack

as fraudulent transfer because, under Texas law, debtor would be deemed never to have held any interest in the property); *In re Atchison*, 925 F.2d 209 (7th Cir.) (same result applying Illinois law), *cert. denied*, 502 U.S. 860 (1991); accord *Hoecker v. United Bank of Boulder*, 476 F.2d 838 (10th Cir. 1973) (same result under the Bankruptcy Act applying Colorado law); see Charles W. Wiley, *Use of Disclaimers in Gift Tax, Generation-Skipping Tax and Income Tax Post-Mortem Planning*, 2 DRAKE J. AGRIC. L. 23 (1997). These courts have reasoned that (i) under state law, the creditors of the debtor/disclaimant would have had no right to reach the property or interest that was disclaimed, and (2) nothing in the Bankruptcy Code gives creditors of the estate any greater rights than the debtor/disclaimant has.

At least two lower courts have reached a contrary conclusion, reasoning that the debtor must have had an interest in the property to transfer when she executed her disclaimer; otherwise, there would have been nothing to disclaim. *In re Brajkovik*, 151 B.R. 402 (Bankr. W.D. Tex. 1993) (applying Missouri law), *rejected by Matter of Simpson*, 26 F.3d 450 (5th Cir. 1994); *In re Peery*, 40 B.R. 811 (Bankr. M.D. Tenn. 1984).

#### **B. Postpetition Disclaimer by Debtor**

These prepetition disclaimer cases should be distinguished from attempts by a debtor to disclaim a bequest, devise or inheritance postpetition. Under section 541 (a)(5)(A), a bequest, devise or inheritance in which the debtor acquires an interest within 180 days of the filing of the petition becomes the property of the estate. This statute overrides any state law right to disclaim, and a postpetition disclaimer is subject to avoidance under section 549. See *in re Cornell*, 95 B.R. 219 (Bankr. W.D. Okla. 1989); *Matter of Lewis*, 45 B.R. 27 (Bankr. W.D.

Mo. 1984); see also *In re Detlefsen*, 610 F.2d 512 (8th Cir. 1979) (holding that, under the Bankruptcy Act, debtor could validly disclaim a bequest both prepetition and postpetition, and, under state law relation back doctrine, debtor would be retreated as having never had any interest in the property, but nothing that the result would be different for postpetition disclaimers under section 541 (a)(5). Property that the debtor receives within 180 days of the date of the petition as the result of a third party's death is clearly estate property. See *In re Doyle*, 209 B.R. 897 (Bankr. N.D. 111. 1997) (where debtor's wife died postpetition, life insurance proceeds became part of the bankruptcy estate).

### C. Postpetition Action by Testator

Although the debtor may not disclaim postpetition, there is nothing to prevent a testator or testatrix from changing his or her will postpetition so as to effectively disinherit the debtor. In *In re McGuire*, 209 B.R. 580 (Bankr. D. Mass. 1997), the debtor's mother had altered her will after the bankruptcy petition had been filed as to exclude the debtor-and hence the debtors creditors-from any distribution of her property. The mother died shortly thereafter. The court rejected arguments that the change in the will was invalid because of an overriding federal bankruptcy policy, and that the mother's property designated for the debtor under the previous will should pass to the bankruptcy estate under section 541 (a)(5). All that the debtor had when the petition was filed was an unmatured expectancy under the previous will, and whatever remote property interest this may have given the debtor, that interest was subordinate to the mothers absolute state law right to leave her property to whomever she pleased.

### V. CAN A TRUSTEE AVOID A PREPETITION LEASE TERMINATION?

Cases and commentators are divided as to whether a prepetition noncollusive

termination of a commercial lease because of the debtor's default can be a transfer of an interest of the debtor in property. Nancy C. Connery, *Current Issues: Impact of Bankruptcy on Commercial Leases*, 427 PLI/REAL 417 (1998); Marvin Garfinkel, *Lease Terminations, Assignments, and Subleases as Fraudulent Conveyances*, SA 81 ALIABA 425 (1996).

#### **A. Transfer**

The initial issue is whether a lease termination is a "transfer" for purposes of section 547 or section 548. . Some reported decisions have held that such noncollusive termination is a "transfer," and hence the termination is subject to analysis as a constructively fraudulent transfer (or, conceivably, a preference). *In re Edward Harvey Co.*, 68 B.R. 851 (Bankr. D. Mass 1987); *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985); see Robert E. Goodman, Jr., *Avoidance of Lease Termination as Fraudulent Transfers*, 54 Bus. I-Aw 897 (1988). Other courts have held that a noncollusive termination of a lease is not a "transfer" at all in the relevant sense, and hence such a transaction cannot be a preference or a fraudulent transfer. *In re Egyptian Bros. Donut, Inc.*, 190 B.R. 26 (Bankr. D.N.J. 1995); *In re Haines*, 178 B.R. 471 (Bankr. W.D. Mo. 1995); see *Matter of Jermoo's, Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984).

#### **B. Interest of the Debtor in Property**

Other courts have focused on the phrase "interest of the debtor in property" and have concluded that lawful lease terminations are not subject to avoidance as preferences or fraudulent transfers, even though these transactions are "transfers" in a strict sense. *In re Durso Supermarkets, Inc.*, 193 B.R. 682 (Bankr. S.D. N.Y. 1996); *In re Metro Water &*

*Coffee Servs., Inc.*, 157 B.R. 742 (Bankr. W.D. N.Y. 1993). While the loss of a leasehold estate means parting with an interest in property held by the prepetition debtor, such property would not be available to creditors of the estate. Under section 365(c)(3), the bankruptcy estate may not assume any executory contract or nonresidential lease that has been legitimately terminated prepetition. In effect, the estate would never have had any interest in the lease. If an "interest of the debtor in property" is synonymous with "property of the estate," then noncollusive prepetition lease terminations cannot be preferential or fraudulent, not because they are not "transfers," but rather because they do not involve a property interest of the debtor (i.e., the bankruptcy estate).

#### VI. IS SECTION 546 JURISDICTIONAL?

One court of appeals has held that section 546(a) is jurisdictional, so that, if an avoidance claim is not brought within the time specified, a federal court lacks subject matter jurisdiction to entertain the action. *In re Butcher*, 829 F.2d 596 (6th Cir. 1987), *cert. denied*, 484 U.S. 1078 (1988). Some lower court decisions support this view. *In re Gardner*, 218 B.R. 338 (Bankr. E. D. Pa. 1998); *Matter of Railway Reorganization Estate, Inc.*, 133 B.R. 578 (Bankr. D. Del. 1991); *In re Frascatore*, 98 B.R. 710 (Bankr. E.D. Pa. 1989); *In re Oro import Co.*, 52 B.R. 357 (Bankr. S.D. Fla. 1985), *revd on other grounds*, 69 B.R. 6 (S.D. Fla. 1986). This position has important consequences. If section 546(a) goes to subject matter jurisdiction, then defects under that statute simply cannot be waived, and they may be raised for the first time on appeal.

More courts, however, hold that section 546(a) is in the nature of statute of limitations, and that it has nothing whatsoever to do with subject matter jurisdiction. *In re Compuadd*

*Corp.*, 137 F.3d 880 (5th Cir. 1998) (concluding that the 1994 amendment was intended to clarify the original intent behind the statute); *Matter of Texas Gen. Petroleum Corp.*, 52 F.3d 1330 (5th Cir. 1995); *In re M&L Bus. Machs., Inc.*, 153 B.R. 308(D. Colo. 1993); *In re Shape, Inc.*, 138 B.R. 334 (Bankr. D. Me. 1992); *see also Smith v. Mark Twain Natl Bank*, 805 F.2d 278 (8th Cir. 1986) (construing section 549(d), which is very similar to section 546(a), as having "nothing to do with the jurisdiction of the United States federal courts."); *In re Day*, 82 B.R. 365 (Bankr. E.D. Pa. 1988) (criticizing Sixth Circuit's holding in *Butcher*), *affd*, 102 B.R. 414 (E.D. Pa. 1989). Again, if section 546(a) is not jurisdictional, then its provisions may be waived. *See In re Klayman*, 1999 WIL 21446 (Bankr. M.D. Fla. 1998).

The Bankruptcy Reform Act of 1994 did not specifically address whether Section 546(a) is jurisdictional or merely a statute of limitations. Nonetheless, the Eleventh Circuit, in examining the 1994 legislative history, concluded that, at least implicitly, Congress meant to confirm that section 546(a) is a waivable statute of limitations and not a jurisdictional statute of repose. *In re Pugh*, 158 F.3d 530 (11th Cir. 1998).

## **PART 2 - SIX OTHER RECENT CIRCUIT COURT DECISIONS**

- 1     *In re Dak Industries, Inc.*, 170 F.3d 1197 (9th Cir. 1999)(preference/insolvency)
2.     *In re Thompson Boat Co.*, 173 F.3d 430 (6th Cir. 1999)(547(c)(2))(unpublished opinion)
- 3     *Matter of Micro Innovations Corp.*, 185 F.3d 329 (5th Cir. 1999)(547(c)(4))
4.     *Nelson v. Scala*, 192 F.3d 32 (9th Cir. 1999)(522(f))
5.     *Matter of Gasmark Ltd.*, 1999 WL 824574 (5th Cir. 1999)
6.     *In re Larbar*, 177 F.3d 439 (6th Cir. 1999)(setoff/mutuality)

### PART 3 - SIX OTHER LAW REVIEW ARTICLES

1. Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713 (1985)
2. Thomas Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725 (1984)
3. Shalom Kohn, *Recoupment Re-Examined*, 73 American Bankruptcy Law Journal 353 (1999)
4. Douglas Michael, *The Past and Future of Kentucky's Fraudulent Transfer and Preference Law*, 86 Ky. L.J. 937 (1997-98)
5. Lawrence Ponoroff, *Exemption Impairing Liens Under Bankruptcy Code Section 522(f): One Step Forward and One Step Back*, 70 U.Colo.L. Rev. 1 (1999)
6. Barry Zaretsky, *Fraudulent Transfer Law As the Arbiter of Unreasonable Risk*, 46 S. Carolina L. Rev. 1165 (1995)





**SOVEREIGN IMMUNITY**

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**STATE DEFIANCE OF BANKRUPTCY LAW**

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**Kenneth N. Klee**  
Acting Professor, University of California at Los Angeles School of Law  
*and*  
**Klee, Tuchin & Bogdanoff, LLP**  
Los Angeles, California

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# State Defiance of Bankruptcy Law

Kenneth N. Klee  
James O. Johnston  
Eric Winston

## I. INTRODUCTION

Bankruptcy is the principal device by which failing businesses and financially-troubled families get one last chance to reorganize their affairs back to financial health. It is also the graveyard for business failures, the place where we bury dead corporations and divide their remaining assets among their surviving creditors.

In the last decade, the bankruptcy system has given seven million middle-class families a way to start over—an opportunity to save their homes from foreclosure, rid themselves of overwhelming debts, and reintegrate themselves into the workforce as productive citizens. It has also been the way that 10,000 corporations have restructured their way from failure to health, avoiding the disruptive costs of dissolution and liquidation and instead preserving jobs, stabilizing community tax bases, and fueling the longest period of economic expansion in United States history. Another 100,000 less fortunate corporations have had their funerals in bankruptcy, as their creditors have divided their assets and facilitated the redistribution of capital and labor resources that must accompany liquidation.

Bankruptcy is the safety valve in America's capitalist system: technical and arcane, but so important. For the last 100 years, bankruptcy has functioned efficiently, providing a vital lubricant at the rough edges of the American economy. We do not expect individuals to live life without hope and force them into the underground economy to avoid a mountain of debt. Nor do we discourage entrepreneurs from starting new ventures by holding them personally liable if that corporate venture fails. Instead, we give each individual and business person a fair chance to start over. This second chance breeds innovation and risk taking that puts the United States at the cutting edge of technological and scientific development.

When our corporations experience liquidity problems, we do not allow lenders to shut them down and break them up. Rather, we permit sick businesses to file under chapter 11 to provide a breathing spell to rehabilitate themselves; if rehabilitation cannot be accomplished, we provide a forum for liquidation of the businesses for the collective good of all creditors.

At a time when the economies of Europe and Asia are moving toward an American-style bankruptcy system, an ironic twist has taken place in the United States. In cases concerning gambling rights on Indian territory, the Fair Labor Standards Act, and trademarks and the value of patents, the United States Supreme Court inadvertently has thrown the bankruptcy system into upheaval. As the shock wave of the cases reverberates, the bankruptcy system threatens to shake apart at its core, at least in those cases in which a state is involved.<sup>1</sup>

The premise behind bankruptcy is that efficiency can be accomplished with aggressively enforced collective action. All of a debtor's problems are dealt with in a single case in a single court. The rules of the court are clear, and unless creditors agree otherwise, they will have rights determined according to a strict priority scheme—secured creditors ahead of unsecured creditors, employees ahead of taxing authorities, and trustees ahead of creditors. If there is any chance to save the business, all creditors will be forced to hold off in their collection actions, while they have predetermined rights to shape (or even stop) the company's efforts to reorganize.<sup>2</sup> Although unsecured

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\* Kenneth N. Klee is Acting Professor of Law, UCLA Law School and a partner at Klee, Tuchin & Bogdanoff, LLP; James O. Johnston is a partner at Hennigan, Mercer & Bennett; Eric Winston is an associate at Stutman, Treister & Glatt, PC. The authors gratefully acknowledge the comments and criticisms on previous drafts of Michael Asimow, Daniel Bussel, Evan Caminker, Karen Cordry, Jerry Kang, William Klein, Lynn LoPucki, Daniel Lowenstein, William Rubenstein, Kirk Stark, Richard Steinberg, Elizabeth Warren, Stephen Yeazell, and Jonathan Zasloff, the excellent research assistance of John Schafer of the 1999 Class of UCLA Law School, and the clerical assistance provided by Therese A. Barron, Tal Grietzer, and Michele Leibovitz. Generous funding was provided by the UCLA Dean's Fund and UCLA Academic Senate.

1. The severity of this threat has not been the subject of an empirical study. However, the few reported decisions hint at the magnitude of state abuse that occurs in numerous other cases. See, e.g., *infra* notes 147-55.

2. In a chapter 11 reorganization case, the automatic stay enjoins most creditors from commencing or continuing litigation or other debt collection activities against the debtor or its property. See 11 U.S.C. § 362 (1994). Creditors may shape the reorganization case by negotiating their treatment under a plan of reorganization. If a plan impairs creditors' rights, the affected creditors have the right to vote to accept or reject the plan. See *id.* §§ 1124, 1129(a)(8). In order for a class of claims to accept the plan, 2/3 in dollar

creditors often must be satisfied with only pennies on the dollar for what they are owed, they can draw comfort from one fact: every other general unsecured creditor of the debtor is in exactly the same boat.

In 1996, the Supreme Court decided a case that ended that certainty as it applies to states and the involvement of states in bankruptcy cases. Three years later, it is apparent that although some states are complying with traditionally held notions of bankruptcy law, other states are defying bankruptcy law by seizing money or property of a bankrupt business or individual. When bankrupt debtors try to sue states in bankruptcy court to remedy this defiance, states rely on newly-minted Supreme Court jurisprudence to assert the Eleventh Amendment as a defense to federal jurisdiction, rendering the federal bankruptcy courts powerless to act.<sup>3</sup>

Not only does self-help allow the states to get more than their fair share by jumping ahead of other creditors without regard to statutory priorities, it also enables states to seize essential equipment or assets that can cripple the ability of a business to reorganize. As one court noted:

Our national bankruptcy system, in which Congress intended debtors to retain the opportunity to reorganize and to obtain a fresh start, may be in grave danger if the states cannot be bound by orders issued by the federal courts under bankruptcy law.<sup>4</sup>

This dire pronouncement, made by Bankruptcy Judge Tice of the Eastern District of Virginia, relates to the Supreme Court's 1996 decision in *Seminole Tribe v. Florida*, in which the Court stated that Congress has no authority to abrogate a state's immunity under the Eleventh Amendment by enacting legislation pursuant to an exercise of the powers enumerated in Article I of the Constitution.<sup>5</sup> Although the *Seminole Tribe* holding itself did not involve bankruptcy law, the Court, in dictum,<sup>6</sup> and nearly every court and commentator that subsequently have addressed the issue,<sup>7</sup> interpreted the decision to render unconstitutional section 106(a) of the Bankruptcy Code,<sup>8</sup> by which Congress has attempted to abrogate Eleventh Amendment immunity in the context of bankruptcy cases. Abrogation enables a bankruptcy court to hold states accountable under the Supremacy Clause for compliance with the Bankruptcy Code, including violation of the automatic stay or receipt of preferential or fraudulent transfers.<sup>9</sup> In many cases, states are creditors based on regulatory claims, such as permit and license fees and fines, tax claims, student loans, unpaid alimony claims, small-business loans, and the like.<sup>10</sup> The importance of the states' claims (and thus the importance of abrogation) can vary from case to case, but in a particular case, states now may elect to act aggressively to seize money or property postpetition in violation of the automatic stay or a discharge injunction. This wrongful activity can advantage states with respect to other creditors, can imperil the viability of a business as a going concern, and can undermine the discharge and the debtor's fresh start.

As a result of *Seminole Tribe*, some states have felt free to violate the myriad protections afforded to debtors and creditors by the Bankruptcy Code and thereafter to assert the Eleventh Amendment to avoid the enforcement of the federal statute by a bankruptcy court or, indeed, by any federal court at all. In so doing, such states have fulfilled a prophecy made by the Court of Appeals for the Seventh Circuit more than a decade ago:

[If] the federal courts were not able to order a state to turn over assets to a bankruptcy estate, then any state owed money by a debtor having financial problems would have a strong incentive to collect whatever funds it believed to be due as rapidly as possible—even if this pushed the debtor into insolvency—rather than risking the possibility of recovering only a portion of their debt in any subsequent bankruptcy proceedings. In effect, we would be holding that the Constitution makes a state a preferred creditor in every bankruptcy. The very existence of this power would doubtless encourage other creditors to accelerate their collections. The end re-

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amount and a majority in number of those voting must vote to accept the plan. See *id.* § 1126(c). The plan may be confirmed consensually if it is accepted by all impaired classes. See *id.* § 1129(a)(8). If an impaired class does not vote to accept the plan, contested confirmation is possible but difficult to achieve. See *id.* § 1129(b). Creditors who oppose the plan or are antagonistic toward the debtor may seek to dismiss the bankruptcy case or convert it to a liquidation case under chapter 7 of the Bankruptcy Code. See *id.* § 1112(b). Creditors also might seek to limit or condition the operation of the business or seek the appointment of a trustee or examiner to exert control over the reorganization case. See *id.* §§ 1104, 1108.

3. Nor, apparently, may a debtor now sue states in state courts without their consent. See *Alden v. Maine*, 119 S. Ct. 2240, 2246 (1999).

4. *In re NVR, L.P.*, 206 B.R. 831, 843 (Bankr. E.D. Va. 1997).

5. See *Seminole Tribe v. Florida*, 517 U.S. 44, 71-72 (1996) (invalidating congressional legislation promulgated under the Indian Commerce Clause, U.S. CONST. art. I, § 8, cl. 3).

6. See *id.* at 72 n.16; see also *id.* at 77 (Stevens, J., dissenting).

7. See *infra* notes 102-11 and accompanying text.

8. 11 U.S.C. § 106(a) (1994). Thus far, the cases have addressed the unconstitutionality of section 106(a) to the extent it abrogates sovereign immunity to subject states to suits in federal courts. See *infra* notes 102-11.

9. See, e.g., *Merchants Grain, Inc. v. Mahern*, 59 F.3d 630 (7th Cir. 1995), *vacated*, *Ohio Agric. Commodity Depositors Fund v. Mahern*, 517 U.S. 1130, 1130 (1996); *In re Shealy*, 90 B.R. 176 (Bankr. W.D.N.C. 1988); *In re Ellis*, 66 B.R. 821 (N.D. Ill. 1986).

10. "States play an important role in the bankruptcy process, appearing in many bankruptcy cases in a myriad of roles— as priority tax creditor, secured creditor, unsecured creditor, police and regulatory authority, environmental creditor, landlord, guarantor, bondholder, leaseholder, and equity interest holder." NATIONAL BANKRUPTCY REVIEW COMM'N BANKRUPTCY: THE NEXT 20 YEARS 900 (1997).

sult would be an increase in bankruptcies and a distortion of the system of preferences that Congress has carefully crafted.<sup>11</sup>

Indeed, one bankruptcy court has concluded that, without the abrogation of the Eleventh Amendment provided by section 106(a), "[t]he Bankruptcy Code would soon unravel and the Bankruptcy Clause [of Article I of the Constitution] would be rendered meaningless."<sup>12</sup>

But the Supreme Court has not rested with *Seminole Tribe*. Earlier this year, in three cases the Court dramatically disrupted the balance of power between the states and the federal government.<sup>13</sup> In one, *Alden v. Maine*, the Court held that the Constitution provided states with the right to assert common law sovereign immunity in state court as a defense to suits brought to enforce rights conferred by Article I of the United States Constitution.<sup>14</sup> In a second case, *Florida Prepaid Postsecondary Education Expense Board v. College Savings Bank*, the Court held that congressional legislation that authorized suits against states for patent infringement was unconstitutional.<sup>15</sup> Last, the Court's decision in *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board* overturned the doctrine of "implied" or constructive waiver of sovereign immunity.<sup>16</sup> Each of these cases concerns separate issues, but together they represent a great shift in favor of states' rights. And with this shift comes a very real apprehension of state abuse of federal rights in the bankruptcy context.

Although these fears might be exaggerated,<sup>17</sup> congressional inability to abrogate the states' Eleventh Amendment and common law sovereign immunity can lead to and has resulted in troubling situations that are antithetical to some of the core purposes of the Bankruptcy Code. Consider the case of the Tri-City Turf Club, a horse racing facility in Kentucky.<sup>18</sup> After Tri-City filed a voluntary petition for reorganization under chapter 11 of the Bankruptcy Code, the state unilaterally revoked Tri-City's license to conduct live horse racing and intertrack wagering.<sup>19</sup> In doing so, the state violated the automatic stay of section 362(a) of the Bankruptcy Code,<sup>20</sup> which Congress has deemed to be "one of the fundamental debtor protections provided by the bankruptcy laws,"<sup>21</sup> and deprived Tri-City of the ability to reorganize its business operations. Tri-City thereafter commenced an adversary proceeding in bankruptcy court against the state to enjoin the state from violating the automatic stay.<sup>22</sup> The bankruptcy court dismissed the adversary proceeding, believing that "[t]he inescapable conclusion . . . is that the holding of *Seminole Tribe* clearly undermines the jurisdictional basis of this action against the defendant, Kentucky Racing Commission, and the members of the Commission. The court simply lacks jurisdiction to entertain this adversary proceeding."<sup>23</sup> Tri-City therefore was unable to enforce one of the Bankruptcy Code's "most fundamental debtor protections" in the forum in which its bankruptcy case was pending.

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11. *McVey Trucking, Inc. v. Secretary of State (In re McVey Trucking, Inc.)*, 812 F.2d 311, 328 (7th Cir. 1987); see *Hoffman v. Connecticut Dep't of Income Maintenance*, 492 U.S. 96, 109-11 (1989) (Marshall, Brennan, Blackmun & Stevens, JJ., dissenting) (agreeing with the analysis in *McVey*); *Employment Dev. Dep't v. Joseph (In re HPA Assocs.)*, 191 B.R. 167, 174 (B.A.P. 9th Cir. 1995) (same).

12. *Stern v. Massachusetts Alcohol Beverage Control Comm'n (In re J.F.D. Enters.)*, 183 B.R. 342, 354 (Bankr. D. Mass. 1995). Examples of the unraveling of the Bankruptcy Code are discussed *infra* notes 147-55.

13. See generally *Alden v. Maine*, 119 S. Ct. 2240 (1999); *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199 (1999); *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219 (1999).

14. See *Alden*, 119 S. Ct. at 2246.

15. See *Florida Prepaid*, 119 S. Ct. at 2202; see also *infra* notes 276-85 and accompanying text.

16. See *College Sav. Bank*, 119 S. Ct. at 2228; see also *infra* notes 176-81 and accompanying text.

17. Some states appear to have obeyed the bankruptcy laws despite the availability of Eleventh Amendment and sovereign immunity to shield improper conduct. Perhaps this is due to enlightened self-interest on the part of government officials in the executive branch who have reputational concerns and must be accountable for their actions to the electorate in a political arena. Some government officials might have concluded that the failure of a state to obey federal bankruptcy law would provoke preemptive actions by other creditors to encumber, attach, or seize the debtor's assets before bankruptcy. Indeed, if bankruptcy relief becomes ineffective for debtors, they can be expected to resort to asset-backed securitization and other forms of financing ex ante that will remove assets from the reach of the state. For example, a state has little recourse against a debtor that leases all assets or has all valuable assets located offshore. Full development of these second-order effects is beyond the scope of this Article.

18. *Tri-City Turf Club, Inc. v. Kentucky Racing Comm'n (In re Tri-City Turf Club)*, 203 B.R. 617 (Bankr. E.D. Ky. 1996).

19. See *id.* at 618.

20. 11 U.S.C. § 362(a) (1994); see generally James O. Johnston, Jr., *The Inequitable Machinations of Section 362(a)(3): Rethinking Bankruptcy's Automatic Stay Over Intangible Property Rights*, 66 S. CAL. L. REV. 659, 690-96 (1992) (analyzing decisions regarding governmental revocation of licenses and related rights). But see 11 U.S.C. § 362(b)(4) (1994), amended by Pub. L. No. 105-277, § 603, 112 Stat. 2681, 2886 (1998) (ambiguously exempting governmental police or regulatory power from section 362(a)(3)).

21. H.R. REP. NO. 95-595, at 340 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6296.

22. See *In re Tri-City Turf Club*, 203 B.R. at 618.

23. *Id.* at 620. To the extent the court thought it was powerless to grant prospective injunctive relief, the opinion appears to be erroneous. The court probably could have issued a prospective injunction against the responsible state official in accordance with *Ex parte Young*. See *infra* Part IV.D.



Consider also the case of Harry and June Mitchell, who filed chapter 7 bankruptcy cases and subsequently received a discharge of more than \$300,000 in back taxes owed to the State of California.<sup>24</sup> After the Bankruptcy Court entered its discharge order, the state commenced assessment proceedings with respect to the discharged taxes, and the Mitchells thereafter commenced an adversary proceeding in federal bankruptcy court to determine the dischargeability of their tax debt and to recover damages based on the state's violation of the Bankruptcy Court's discharge order.<sup>25</sup> The Bankruptcy Court, however, dismissed the Mitchells' complaint on the ground that the state's Eleventh Amendment immunity deprived the court of jurisdiction over the action, and the Bankruptcy Appellate Panel for the Ninth Circuit subsequently affirmed that determination.<sup>26</sup> As a consequence, the Mitchells were unable to receive the full benefit of the fundamental "fresh start" otherwise accorded to them by the Bankruptcy Code.<sup>27</sup>

This Article explores policy concerns and legislative solutions to determine whether there is any escape from the "inescapable conclusion" (in the words of the *Tri-City* court) seemingly demanded by *Seminole Tribe* and exacerbated by *Alden* and its companion decisions. For the reasons set forth below, the Eleventh Amendment, as construed in *Seminole Tribe*, and common law sovereign immunity, as construed in *Alden*, render unconstitutional section 106(a) of the Bankruptcy Code to the extent Congress has purported to abrogate state sovereign immunity and Eleventh Amendment immunity in the context of suits against states in bankruptcy courts. Moreover, *Alden* has the effect of denying the vindication of bankruptcy rights in state courts and federal courts alike. As a result, *Seminole Tribe* and *Alden* have the effect of undermining a key purpose of the federal bankruptcy laws by altering the priorities legislated by Congress to elevate states to preferred positions relative to other creditors.<sup>28</sup> The various mechanisms that courts and commentators have proposed to circumvent or limit the effect of these decisions, as discussed below, are of limited utility.<sup>29</sup> Congress should consider enacting legislation that ameliorates the effects of *Seminole Tribe* and *Alden* in order to level the playing field on which states and other creditors find themselves in bankruptcy cases.<sup>30</sup> Without change, the system is likely to crumble or, at a minimum, produce vastly different and inequitable results in cases in which states take an active role. One greedy governmental creditor can undo all the good for literally millions of debtors, creditors, employees, and communities. The case law now shows us that the only way to stop it is by congressional action—not by relying on clever arguments in court. Because we are dealing with a constitutional proscription, congressional options are limited, but they are not nonexistent. Below, we consider fundamental policy concerns and offer the best options available.

Part II of this Article briefly summarizes the history and nature of Eleventh Amendment immunity and the common-law doctrine of sovereign immunity and concludes with an examination of *Seminole Tribe*, *Alden*, and the states' newly enshrined constitutional sovereign immunity right. Part III examines the effect of constitutional sovereign immunity on section 106(a) of the Bankruptcy Code, and Part IV reviews the various arguments that courts have considered regarding limitation of sovereign immunity in the bankruptcy context. Finally, Part V considers and critiques legislation that Congress possibly could enact to neutralize constitutional sovereign immunity, which include (a) reenactment of an analog to section 106(a) under the guise of the Fourteenth Amendment; (b) creation of an automatic prospective injunction against state officials with respect to bankruptcy matters; (c) authorization of suits by the United States trustee or private rights of action by bankruptcy estates and their representatives on behalf of the United States; (d) disallowance of state claims unless the state waives immunity; and (e) encouragement of a waiver of Eleventh Amendment immunity through the conditional receipt of federal funds.

## II. THE ELEVENTH AMENDMENT AND SOVEREIGN IMMUNITY

### A. Common-Law Sovereign Immunity and Eleventh Amendment Immunity

The common law doctrine of sovereign immunity flows from the premise that the "King could do no wrong,"<sup>31</sup> and in its most basic form operates such that "the sovereign cannot be sued in [its] own courts without [its]

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24. See *Mitchell v. California Franchise Tax Bd.* (*In re Mitchell*), 222 B.R. 877, 878-79 (B.A.P. 9th Cir. 1998); see also 11 U.S.C. § 727 (setting forth the discharge provisions).

25. See *In re Mitchell*, 222 B.R. at 878-79. The Mitchells did not seek prospective injunctive relief against a named state official. See *id.* at 881 n.4.

26. See *id.* at 888.

27. Congress deemed the discharge to be "the heart of the fresh start provisions of the bankruptcy law." H.R. REP. NO. 95-595, at 384 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6340.

28. For the law regarding priorities in bankruptcy cases, see 11 U.S.C. § 507(a). For the numerous ways in which the federal bankruptcy laws apply to the states and other creditors, see, for example, *infra* notes 147-55 and accompanying text. Readers who are unfamiliar with bankruptcy law concepts like priorities are referred to GEORGE M. TREISTER ET AL., *FUNDAMENTALS OF BANKRUPTCY LAW* (4th ed. Supp. 1998).

29. See *infra* Part III.A-B.

30. See *infra* Part IV.A-E.

31. Vicki C. Jackson, *The Supreme Court, the Eleventh Amendment, and State Sovereign Immunity*, 98 YALE L.J. 1, 76 (1988); Louis L. Jaffe, *Suits Against Governments and Officers: Sovereign Immunity*, 77 HARV. L. REV. 1, 4 (1963).

consent."<sup>32</sup> Before *Alden*, however, such common law sovereign immunity was not thought to be constitutionally guaranteed.<sup>33</sup> As a result, until *Seminole Tribe* it appeared that the Supremacy Clause of the Constitution enabled Congress unilaterally to waive or abrogate common law sovereign immunity for several purposes, including enforcement of the Bankruptcy Code.<sup>34</sup> Although Congress has power to waive federal sovereign immunity,<sup>35</sup> it is less clear whether Congress has the power to abrogate state sovereign immunity to subject a state to suit without its consent in federal or state courts.<sup>36</sup>

Noting that the Constitution in its original form did not refer to or purport to preserve state sovereign immunity, the Supreme Court held in the 1793 decision of *Chisholm v. Georgia*<sup>37</sup> that the federal courts had jurisdiction under Article III of the Constitution to hear and determine actions by citizens of one state against another state as a sovereign entity.<sup>38</sup> The four judges who concurred in the *Chisholm* decision each wrote a separate opinion, but the common thread binding their judgments was the theory that Article III of the Constitution "evidenced the states' surrender of sovereign immunity as to those provisions extending jurisdiction over suits to which States were parties."<sup>39</sup> The *Chisholm* decision, however, apparently produced such a great "shock of surprise" that the Eleventh Amendment was proposed quickly and was ratified in about two years.<sup>40</sup>

The Eleventh Amendment provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another state, or by Citizens or Subjects of any Foreign State."<sup>41</sup> Under the Amendment, therefore, federal courts lack jurisdiction over suits against non-consenting states.<sup>42</sup>

By its plain language, the Eleventh Amendment does not extend to suits against a state by its own citizens<sup>43</sup> or, arguably, to suits based on federal-question jurisdiction (as opposed to diversity jurisdiction).<sup>44</sup> Indeed, perhaps because there was no general federal question jurisdiction in the district courts at the time,<sup>45</sup> the Supreme Court initially interpreted the Eleventh Amendment narrowly, holding that its protection applied solely to actions based on diversity jurisdiction.<sup>46</sup>

However, in the 1880s, the Court implied that under the Eleventh Amendment, a state could not be sued under federal question jurisdiction by a citizen of another state.<sup>47</sup> Then, in its 1890 decision of *Hans v. Louisiana*, the Court broadened the scope of the Eleventh Amendment by holding that its protections applied to cases based on federal question jurisdiction filed by a citizen against the citizen's own state.<sup>48</sup> In effect, *Hans* went beyond the language of the text and appeared to elevate the doctrine of common law sovereign immunity to constitutional status through the Eleventh Amendment.<sup>49</sup>

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32. *The Siren*, 74 U.S. (7 Wall.) 152, 153-54 (1868); Jaffe, *supra* note 34, at 1. The concept of sovereign immunity in American jurisprudence is taken from the law in England that the Crown could not be sued without consent in its own courts. *See Alden v. Maine*, 119 S. Ct. 2240, 2247 (1999). By comparison, a voluntary grant of immunity by one sovereign to another sovereign in the first sovereign's courts is considered a form of comity. *See Nevada v. Hall*, 440 U.S. 410, 416 (1979).

33. *See Patricia L. Barsalou, Defining the Limits of Federal Court Jurisdiction Over States in Bankruptcy Court*, 28 ST. MARY'S L.J. 575, 580-81 (1997).

34. *See, e.g., United States v. Nordic Village, Inc.*, 503 U.S. 30, 33-34 (1992) (dealing with congressional waiver of federal sovereign immunity).

35. *See id.*

36. *See infra* notes 41-52 and accompanying text.

37. *Chisholm v. Georgia*, 2 U.S. (2 Dall.) 419 (1793).

38. *See Michael P. Kenny, Sovereign Immunity and the Rule of Law: Aspiring to a Highest-Ranked View of the Eleventh Amendment*, 1 GEO. MASON INDEP. L. REV. 1, 8-9 (1992).

39. *Alden v. Maine*, 119 S. Ct. 2240, 2250 (1999). Two of the four *Chisholm* judges argued a more extreme position—that state sovereign immunity was inconsistent with the principle of popular sovereignty established by the Constitution. *See id.* at 2249-50 (citing *Chisholm*, 2 U.S. (2 Dall.) at 454-58, 470-72).

40. *See Monaco v. Mississippi*, 292 U.S. 313, 325 (1934).

41. U.S. CONST. amend. XI.

42. *See Atascadero State Hosp. v. Scanlon*, 473 U.S. 234, 238 (1985); *Pennhurst State Sch. & Hosp. v. Halderman*, 465 U.S. 89, 119-20 (1984); *McKay v. Boyd Constr. Co.*, 769 F.2d 1084, 1086 (5th Cir. 1985).

43. *See Seminole Tribe v. Florida*, 517 U.S. 44, 67-68 (1996).

44. *See id.* at 110-11 (Souter, J., dissenting) ("In precisely tracking the language in Article III providing for citizen-state diversity jurisdiction, the text of the Amendment does, after all, suggest to common sense that only the Diversity Clauses are being addressed.")

45. *See Act of Mar. 3, 1875, ch. 137, § 1, 18 Stat. 470* (adopting, for the first time, federal-question jurisdiction in 1875).

46. *See United States v. Peters*, 9 U.S. (5 Cranch) 115 (1809); John J. Gibbons, *The Eleventh Amendment and State Sovereign Immunity: A Reinterpretation*, 83 COLUM. L. REV. 1889, 1968 (1983) ("The Marshall and Taney Courts read the eleventh amendment in the narrowest possible way and in no instance applied it to cases other than those in which federal jurisdiction depended solely upon party status.")

47. *See In re Ayers*, 123 U.S. 443, 506-08 (1887); *Hagood v. Southern*, 117 U.S. 52, 69-71 (1886).

48. *Hans v. Louisiana*, 134 U.S. 1, 10-11 (1890). *See generally* Alan D. Cullison, *Interpretation of the Eleventh Amendment (A Case of the White Knight's Green Whiskers)*, 5 HOUS. L. REV. 1 (1967) (focusing on the importance of the source of the cause of action).

49. *See also Monaco v. Mississippi*, 292 U.S. 313, 322-23 (1934). The Court made clear its current view that the constitutional bar contained in the Eleventh Amendment is derived from common-law sovereign immunity:

Since *Hans*, the Supreme Court has reaffirmed its expansive view of the Eleventh Amendment, holding repeatedly that the Eleventh Amendment prohibits not only suits against a state by another state's citizen, but also suits against a state by its own citizens, even if the case involves only federal question jurisdiction.<sup>50</sup> The Court, however, occasionally has recognized various limitations on the scope of the Eleventh Amendment,<sup>51</sup> including, from 1989 until the *Seminole Tribe* decision, the authority of Congress to abrogate Eleventh Amendment immunity pursuant to an exercise of power enumerated in Article I of the Constitution.<sup>52</sup>

### B. The Seminole Tribe Decision

In *Seminole Tribe*, the Supreme Court held unconstitutional Congress's attempt to abrogate state Eleventh Amendment immunity under the Indian Gaming Regulatory Act,<sup>53</sup> which was enacted pursuant to the Indian Commerce Clause of Article I of the Constitution.<sup>54</sup> The Court, noting a "due concern for the Eleventh Amendment's role as an essential component of our constitutional structure,"<sup>55</sup> held that Congress, acting under either the Commerce Clause or the Indian Commerce Clause of Article I, could not abrogate Eleventh Amendment immunity and require states to submit to a federal court's order for mediation. Specifically, the Court reasoned that "[t]he Eleventh Amendment restricts the judicial power under Article III, and Article I cannot be used to circumvent the constitutional limitations placed upon federal jurisdiction."<sup>56</sup>

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[W]e cannot . . . assume that the letter of the Eleventh Amendment exhausts the restrictions upon suits against non-consenting States. Behind the words of the constitutional provisions are postulates which limit and control. . . . There is . . . the postulate that States of the Union, still possessing attributes of sovereignty, shall be immune from suits, without their consent, save where there has been a "surrender of this immunity in the plan of the convention."

*Id.* (citations omitted).

50. See, e.g., *Seminole Tribe v. Florida*, 517 U.S. 44, 72 (1996) ("[T]he background principle of state sovereign immunity embodied in the Eleventh Amendment is not so ephemeral as to dissipate when the subject of the suit is an area . . . that is under the exclusive control of the Federal Government."); *Welch v. Texas Dep't of Highways and Pub. Transp.*, 483 U.S. 468, 472 (1987) ("[T]he Court long ago held that the Eleventh Amendment bars a citizen from bringing suit against the citizen's own State in federal court, even though the express terms of the Amendment refer only to suits by citizens of another State.")

The Court's prevailing interpretation of the Eleventh Amendment is subject to much debate. Indeed, four current Justices appear to favor an interpretation that would prevent application of the Eleventh Amendment to cases based on federal-question jurisdiction and cases involving suits against a state by its own citizens. See *Seminole Tribe*, 517 U.S. at 76-101 (Stevens, J., dissenting); *id.* at 101-85 (Souter, Ginsburg, & Breyer, JJ., dissenting). Several recently departed Justices shared similar views, see *Welch*, 483 U.S. at 496-521 (Brennan, Marshall, Blackmun & Stevens, JJ., dissenting), as do numerous commentators, see 13 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 3524 n.186 (2d ed. Supp. 1995) (surveying commentary critical of the Court's current Eleventh Amendment jurisprudence). See also *Pennsylvania v. Union Gas Co.*, 491 U.S. 1, 31 (1989) (Scalia, J., dissenting) (acknowledging that modern sovereign immunity doctrine depends on "some other constitutional principle beyond the immediate text of the Eleventh Amendment").

51. See, e.g., *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco, Dep't of Bus. Regulation*, 496 U.S. 18, 27 (1990) (The Supreme Court has "repeatedly and without question accepted jurisdiction to review issues of federal law arising in suits brought against States in state court."); *Mt. Healthy City Sch. Dist. Bd. of Educ. v. Doyle*, 429 U.S. 274, 280 (1977) (Eleventh Amendment applies only to states and state agencies and not to local governmental entities); *Ex parte Young*, 209 U.S. 123, 144-45 (1908) (federal courts have jurisdiction over a suit against a state official for prospective injunctive relief); *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 376-77, 430 (1821) (rejecting argument that the Eleventh Amendment bars the Supreme Court's power on writ of error to review the judgment of a state court involving an issue of federal law); *infra* notes 102-93 and accompanying text; see generally Kurt E. Springmann, Comment & Legis. Rev., *The Impact of Seminole on Intellectual Property Infringement By State Actors: The Interaction of Article I, Article III, the Eleventh Amendment, and the Fourteenth Amendment*, 29 ARIZ. ST. L.J. 889, 892-94 (1997).

52. See *Pennsylvania v. Union Gas Co.*, 491 U.S. 1, 23 (1989) (holding that the Commerce Clause of Article I gives Congress the authority to render states "liable in money damages in federal court"). The *Union Gas* decision was the product of only a four-Justice plurality (Justices Brennan, Marshall, Blackmun, and Stevens), with Justice White concurring only in the result. Nevertheless, both before and after *Union Gas*, lower federal courts routinely held that Congress in fact could abrogate state sovereign immunity when legislating pursuant to its Article I authority. See, e.g., *Merchants Grain, Inc. v. Mahern*, 59 F.3d 630, 634-36 (7th Cir. 1995) ("[T]here was no constitutional basis for distinguishing between the plenary powers accorded Congress under the Fourteenth Amendment and those accorded under Article I.") *vacated*, *Ohio Agric. Commodity Depositors Fund v. Mahern*, 517 U.S. 1130 (1996) (mem.); *Employment Dev. Dep't v. Joseph (In re HPA Assocs.)*, 191 B.R. 167, 172-74 (B.A.P. 9th Cir. 1995) ("Congress' plenary powers under Article I did empower it to abrogate sovereign immunity pursuant to the Bankruptcy Clause mandate to establish uniform bankruptcy laws."); *McVey Trucking, Inc. v. Secretary of State (In re McVey Trucking, Inc.)*, 812 F.2d 311, 314-23 (7th Cir. 1987) (concluding that "Congress may abrogate state immunity to suit pursuant to any of its plenary powers," including the Bankruptcy Clause); *Mather v. Oklahoma Employment Sec. Comm'n (In re Southern Star Foods, Inc.)*, 190 B.R. 419, 425-26 (Bankr. E.D. Okla. 1995); *Florida Dep't of Revenue v. Sparkman (In re York-Hannover Devs., Inc.)*, 190 B.R. 62, 65-66 (E.D.N.C. 1995) ("[I]t is clear that the states have ceded their sovereign immunity in the field of bankruptcy law."); *Stern v. Massachusetts Alcohol Beverage Control Comm'n (In re J.F.D. Enters.)*, 183 B.R. 342, 354 (Bankr. D. Mass. 1995); *Murray v. Withrow (In re PM-II Assocs.)*, 100 B.R. 940, 942 (Bankr. S.D. Ohio 1989); *Wayne Manor, Inc. v. Department of Pub. Welfare (In re Wayne Manor, Inc.)*, 94 B.R. 240, 243-44 (Bankr. D. Mass. 1988).

53. Indian Gaming Regulatory Act ("IGRA"), 25 U.S.C. §§ 2701-2721 (1994).

54. U.S. CONST. art. I, § 8, cl. 3.

55. *Seminole Tribe v. Florida*, 517 U.S. 44, 56 (1996) (quoting *Dellmuth v. Muth*, 491 U.S. 223, 227-28 (1989)).

56. *Id.* at 72-73.

*Seminole Tribe* has been interpreted to stand for the proposition that no clause in Article I “bestows upon Congress the power to abrogate a state’s Eleventh Amendment immunity.”<sup>57</sup> *Seminole Tribe*, however, does not purport to render void, as a *per se* rule, any and all attempts by Congress to abrogate Eleventh Amendment immunity. Rather, under *Seminole Tribe*, a “simple but stringent” two-question test applies to determinations whether Congress may abrogate state immunity in a particular context: “first, whether Congress has ‘unequivocally expresse[d] its intent to abrogate the immunity;’ and second, whether Congress has acted ‘pursuant to a valid exercise of power,’ ”<sup>58</sup> (which, after *Seminole Tribe*, may not be found within the confines of Article I itself). Unless both prongs of the *Seminole Tribe* test are satisfied, the congressional enactment will be insufficient to abrogate the states’ Eleventh Amendment immunity.

### C. Alden v. Maine and the New Constitutional Sovereign Immunity Principle

Until 1999, the Supreme Court, despite its expansive interpretation of the Eleventh Amendment, did not elevate to constitutional status a state’s common law sovereign immunity to suits in state court. Thus, it was thought that Congress had the power to abrogate a state’s sovereign immunity to further legislation enacted under Article I.<sup>59</sup>

In *Alden v. Maine*, the Supreme Court created a new principle of constitutional sovereign immunity by holding that “the powers delegated to Congress under Article I of the United States Constitution do not include the power to subject nonconsenting states to private suits for damages in state courts.”<sup>60</sup> The plaintiffs in *Alden* were probation officers employed by the State of Maine. They initially brought suit in federal court alleging Maine had violated the overtime provisions of the Fair Labor Standards Act (“FLSA”), seeking compensation and liquidated damages.<sup>61</sup> The federal district court dismissed the suit pursuant to the Eleventh Amendment, reasoning that the *Seminole Tribe* decision deprived the federal court of jurisdiction to hear the suit. The plaintiffs then filed the same action in state court. The trial judge dismissed the action pursuant to Maine’s assertion of sovereign immunity, the Maine Supreme Judicial Court affirmed, and the United States Supreme Court granted certiorari to resolve the constitutional issue.<sup>62</sup>

In concluding that Maine’s state sovereign immunity barred the suit, the Supreme Court based its decision on three key concepts. First, the Constitution’s structure and history, coupled with the Court’s interpretation of the Eleventh Amendment, establishes that “the States’ immunity from suit is a fundamental aspect of the sovereignty which the States enjoyed before the ratification of the Constitution, and which they retain today . . . except as altered by the plan of the Convention or certain constitutional Amendments.”<sup>63</sup> The majority opinion, authored by Justice Kennedy, strived mightily to prove that at the time the Constitution was ratified, the states universally believed that immunity from suit was a key aspect of their continuing vitality in the new government.<sup>64</sup> From this concept Justice Kennedy was able to conclude “that sovereign immunity derives not from the Eleventh Amendment but from the structure of the original Constitution itself.”<sup>65</sup>

Second, the Court determined that neither the Supremacy Clause of the Constitution, nor the powers delegated to Congress under Article I authorizes Congress to abrogate the states’ sovereign immunity. The Court reasoned that when “a State asserts its immunity to suit, the question is not the primacy of federal law but the implementation of the law in a manner consistent with the constitutional sovereignty of the States.”<sup>66</sup>

Third, according to the *Alden* majority, principles of federalism favor constitutional sovereign immunity as a bar to federal legislation: “[i]n some ways, of course, a congressional power to authorize suits against nonconsenting

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57. *In re NVR, L.P.*, 206 B.R. 831, 837 (Bankr. E.D. Va. 1997); see *Seminole Tribe*, 517 U.S. at 72-73. The *Florida Prepaid* case removes any doubt that *Seminole Tribe* was limited to Commerce Clause legislation. “*Seminole Tribe* makes clear that Congress may not abrogate state sovereign immunity pursuant to its Article I powers. . . .” *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2205 (1999).

58. *Seminole Tribe*, 517 U.S. at 55 (quoting *Green v. Mansour*, 474 U.S. 64, 68 (1985)).

59. See *supra* notes 41-52 and accompanying text.

60. *Alden v. Maine*, 119 S. Ct. 2240, 2246 (1999).

61. See *id.*

62. See *id.*

63. *Id.* at 2246-47. Justice Kennedy, writing for the majority, focused on the purported acknowledgement by the Founders that states could not be sued without their consent. See *id.* at 2247.

64. See *id.* at 2247-49.

65. *Id.* at 2254. *Alden* makes clear that the principles of sovereign immunity that served as a backdrop to the Eleventh Amendment are not restricted to only cases involving the Eleventh Amendment. “While the constitutional principle of sovereign immunity does pose a bar to federal jurisdiction over suits against nonconsenting States . . . this is not the only structural basis of sovereign immunity in the constitutional design.” *Id.* at 2255.

66. *Id.* at 2255-56. The Court also rejected appeals to the Necessary and Proper Clause as “incidental authority to subject States to private suits as a means of achieving objectives otherwise within the scope of the enumerated powers.” *Id.* at 2256. Yet as explained below, the Court does not appear to extend this rule to the Spending Clause. See *infra* notes 354-56, and accompanying text.

States in their own courts would be even more offensive to state sovereignty than a power to authorize the suits in a federal forum."<sup>67</sup>

*Alden* is a flawed decision for at least four reasons.<sup>68</sup> First, the majority premises its decision on the existence of the states' constitutional right to sovereign immunity. The Constitution, except for the Supremacy Clause, which supports the primacy of federal power, and the Eleventh Amendment, which concerns federal court jurisdiction, contains no mention nor hints of the existence of a constitutional sovereign immunity.<sup>69</sup> The majority implicitly concedes that the Constitution does not expressly grant the right of sovereign immunity; instead, "[t]his separate and distinct structural principle is not directly related to the scope of the judicial power established by Article III, but inheres in the system of federalism established by the Constitution."<sup>70</sup> In essence, "Kennedy found a penumbra."<sup>71</sup>

Second, by finding a new constitutional right to sovereign immunity, the Supreme Court prospectively renders the Eleventh Amendment irrelevant. Constitutional sovereign immunity in *Alden* necessarily precludes suits both in federal and state courts. Justice Kennedy attempted to explain why the Eleventh Amendment's language is fairly limited: "Congress chose not to enact language codifying the traditional understanding of sovereign immunity but rather to address the specific provisions of the Constitution that had raised concerns during the ratification debates and formed the basis of the *Chisholm* decision."<sup>72</sup> But the majority made no concerted effort to analyze why the Eleventh Amendment is necessary if "sovereign immunity derives not from the Eleventh Amendment but from the structure of the original Constitution itself."<sup>73</sup> If the Constitution was always meant to guarantee a state's right to sovereign immunity to suits both in state and federal court, then surely *Chisholm* was wrongly decided and the Eleventh Amendment was surplus. Thus the Court violated the ancient rule of construction: "[i]t cannot be presumed that any clause in the constitution is intended to be without effect."<sup>74</sup>

Third, *Alden* creates unnecessary and substantial constitutional questions.<sup>75</sup> Under the Court's rationale, the *Alden* plaintiffs have a federal right under the FLSA against the State of Maine for money damages that cannot be enforced in any court. *Alden* therefore violates the "general and indisputable rule, that where there is a legal right, there is also a legal remedy, by suit or action at law, whenever that right is invaded."<sup>76</sup> The "right and remedy" principle, which has deep roots in English law,<sup>77</sup> is particularly well-settled in American law and as much inheres in the United States Constitution as does the purported penumbral right of sovereign immunity.<sup>78</sup>

Moreover, leaving parties with private rights no remedy to protect those rights opens the door for abuse by the states.<sup>79</sup> The majority attempts to rebut this argument by noting certain limitations on the exercise of sovereign immunity<sup>80</sup> and by further stating: "We are unwilling to assume the States will refuse to honor the Constitution or obey the binding laws of the United States."<sup>81</sup> But reliance on a state's "good faith" is an unsettling justification.<sup>82</sup> As the Court previously stated, "[i]f the Constitution provided no protection against unbridled authority, all property rights would exist only at the whim of the sovereign."<sup>83</sup>

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67. *Alden*, 119 S. Ct. at 2264.

68. We also note the majority's questionable account of the history of sovereign immunity at the time of the ratification of the Constitution and its conclusion that *Chisholm* was wrongly decided, but we leave that criticism for development by others. See *id.* at 2270-71 (Souter, J., dissenting).

69. See Erwin Chemerinsky, *High Court Wrongly Lets States Off the Hook*, L.A. TIMES, June 25, 1999, at B9.

70. *Alden*, 119 S. Ct. at 2255.

71. Molly Ivins, *Hey, Watch Out! Those Supremes Are at it Again*, FORT WORTH STAR-TELEGRAM, June 29, 1999, at 11; see also *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2219 (1999) (Stevens, J., dissenting) ("The full reach of [*Seminole Tribes*'] dramatic expansion of the judge-made doctrine of sovereign immunity is unpredictable; its dimensions are defined only by the present majority's perception of constitutional penumbras rather than constitutional text.").

72. *Alden*, 119 S. Ct. at 2251.

73. *Id.* at 2254.

74. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 174 (1803).

75. See *Florida Dep't of State v. Treasure Salvors, Inc.*, 458 U.S. 670, 697 (1982).

76. *Alden*, 119 S. Ct. at 2293 (Souter, J., dissenting) (quoting 3 WILLIAM BLACKSTONE, COMMENTARIES \*23).

77. See *Ashby v. White*, 87 Eng. Rep. 808, 815 (K.B. 1794).

78. Justice Souter noted in *Alden* that several of the states perceived the principle to be so crucial that it was enshrined in state constitutions. See *Alden*, 119 S. Ct. at 2293 n.42 (citing the Delaware, Maryland, Massachusetts, Kentucky and Tennessee, Constitutions); see also Charles Fried, *Supreme Court Folly*, N.Y. TIMES, July 6, 1999, at A21 (in criticizing *Alden*, *Florida Prepaid*, and *College Savings Bank*, Fried noted: "Patent and related protection is proclaimed in the Constitution itself, and the Court did not deny that patent and trademark laws bind the States. Its structural argument was just that the patent holders cannot sue states to protect their rights. What kind of structure is that?"). Moreover, the Court's conclusion may create a conflict with the Takings Clause of the Fifth Amendment. See *infra* notes 243-53 and accompanying text.

79. See Chemerinsky, *supra* note 69, at B9.

80. See *Alden*, 119 S. Ct. at 2266-68. We discuss these limitations in greater detail below. See *infra* Part III.

81. *Alden*, 119 S. Ct. at 2266.

82. "[I]t is implausible to claim that enforcement by a public authority without any incentive beyond its general enforcement power will ever afford the private right a traditionally adequate remedy." *Id.* at 2293 (Souter, J., dissenting); see also *id.* at 2294 n.43.

83. *Florida Dep't of State v. Treasure Salvors*, 458 U.S. 670, 697 (1982).

Fourth, *Alden* dramatically, and perhaps unknowingly in its full ramifications,<sup>84</sup> alters the balance of power to favor the states. Under *Alden*, legislation that authorizes private parties to sue states to enforce federal rights is unconstitutional. Yet the Supremacy Clause requires the states to accept and enforce lawful federal legislation.<sup>85</sup> One must ponder how lawful federal legislation, which the FLSA undoubtedly is, can ever be enforced adequately? The Court mentions the fact that the federal government itself can sue states in violation of federal law,<sup>86</sup> but as Justice Souter notes in dissent, that supposed check against state abuse is likely illusory as a practical matter.<sup>87</sup>

Moreover, the Court concedes the principle that the Supremacy Clause guarantees primacy of federal law but states that “[a]ppeal to the Supremacy Clause alone merely raises the question whether a law is a valid exercise of the national power.”<sup>88</sup> However, *Alden*’s view of the Supremacy Clause makes no sense when one considers the purpose of the *Ex parte Young* doctrine,<sup>89</sup> which *Alden* expressly reaffirms and which permits suit in federal court against state officials to enforce federal law.<sup>90</sup>

### III. SEMINOLE TRIBE, ALDEN, AND SECTION 106 OF THE BANKRUPTCY CODE

Section 106(a) of the Bankruptcy Code provides that, “[n]otwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to” various enumerated sections of the Bankruptcy Code.<sup>91</sup> Through section 106(a), Congress expressed an unequivocal intent to abrogate state immunity.<sup>92</sup> Thus, under the rubric of *Seminole Tribe* and *Alden*, the question is whether, in so legislating, Congress acted within a valid exercise of its power.

#### A. Section 106(a) Is Unconstitutional as Applied to the States

In 1989, the Supreme Court held that former section 106(c) of the Bankruptcy Code,<sup>93</sup> the predecessor to current section 106(a), did not express an unequivocal intent to abrogate state Eleventh Amendment immunity with respect to money judgments for bankruptcy-related causes of action.<sup>94</sup> As a result, Congress subsequently enacted the current version of section 106(a) to make clear its unequivocal intent to abrogate state immunity in bankruptcy matters. Indeed, the legislative intent of section 106(a) is unequivocal: “[t]his amendment expressly provides for a waiver of sovereign immunity by governmental units with respect to monetary recoveries as well as declaratory and injunctive relief.”<sup>95</sup> Courts considering the issue therefore have held that Congress unequivocally intended to abrogate state immunity through section 106(a),<sup>96</sup> and the statute accordingly satisfies the first prong of the *Seminole Tribe* analysis.

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84. The rule that the United States Supreme Court has jurisdiction to review state court decisions involving federal questions, enshrined in *Martin v. Hunter’s Lessee*, 14 U.S. (1 Wheat.) 304, 326 (1816), might fall in light of the recent Supreme Court decisions. Because the Court interprets constitutional sovereignty to allow states to assert immunity to suits against it in either state or federal court, it is not inconceivable for a state to waive immunity in state court on a federal cause of action, obtain a favorable ruling and then assert immunity in an appeal to the United States Supreme Court. *Martin v. Hunter’s Lessee* is premised on Article III’s grant of jurisdiction to the Supreme Court to review state court decisions involving federal questions. Yet *Seminole Tribe* and *Alden* make clear that the states did not surrender their sovereignty in Article III. See *Alden*, 119 S. Ct. at 2253. Unless there is some other constitutional principle of judicial review (which the majority may have to create) that trumps constitutional sovereign immunity, the bar that *Alden* and *Seminole Tribe* support theoretically would prevent the Court from reviewing state court decisions without state consent.

85. See *Alden*, 119 S. Ct. at 2288 (Souter, J., dissenting).

86. See *id.* at 2267.

87. See *id.* at 2293 (Souter, J., dissenting). “[T]he allusion to enforcement of private rights by the National Government is probably not much more than whimsy.” *Id.*

88. *Id.* at 2255. The Court’s authority for this statement is Alexander Hamilton’s analysis: “But it will not follow from [the Supremacy Clause] that acts of the larger society which are not pursuant to its constitutional powers, but which are invasions of the residuary authorities of the smaller societies, will become the supreme law of the land.” THE FEDERALIST NO. 33, at 204 (Alexander Hamilton) (Clinton Rossiter ed., 1961). But Hamilton was concerned with federal intrusion on areas of traditional state governing. In *Holeu*, Congress had acted pursuant to its lawful powers under Article I.

89. See *infra* Part IV.D.

90. See *Alden*, 119 S. Ct. at 2262-63.

91. 11 U.S.C. § 106(a) (1994). The Bankruptcy Code defines “governmental units” to include the states. *Id.* § 101(27).

92. See *infra* notes 95-96 and accompanying text.

93. Former section 106(c), the predecessor to section 106(a), provided that, “notwithstanding any assertion of sovereign immunity—(1) a provision of this title that contains ‘creditor,’ ‘entity,’ or ‘governmental unit’ applies to governmental units; and (2) a determination by the court of an issue under such a provision binds governmental units.” *Id.* § 106(c) (repealed 1994).

94. See *Hoffman v. Connecticut Dep’t of Income Maintenance*, 492 U.S. 96, 101-04 (1989).

95. 140 CONG. REC. H10766 (1994) (Judiciary Committee Chairman Jack Brooks describing § 113 of H.R. 5116). Congress confused its own power to abrogate state sovereign immunity with a state’s “waiver” of its own immunity, but congressional intent to overturn *Hoffman v. Connecticut* and abrogate state sovereign immunity is crystal clear.

96. See, e.g., *Department of Transp. & Dev. v. PNL Management Co.* (*In re Fernandez*), 123 F.3d 241, 243 (5th Cir. 1997); *Schlossberg v. Maryland* (*In re Creative Goldsmiths*), 119 F.3d 1140, 1145 (4th Cir. 1997), *cert. denied*, 118 S. Ct. 1517 (1998); *California Employment Dev. Dep’t v. Taxel* (*In re Del Mission Ltd.*), 98 F.3d 1147, 1152 n.6 (9th Cir. 1996); *Employment Dev. Dep’t v. Joseph* (*In re HPA Assocs.*), 191 B.R. 167, 171-72 (B.A.P. 9th Cir. 1995); *Wyoming Dep’t of Transp. v. Straight* (*In re Straight*), 209 B.R. 540, 549 (D. Wyo. 1997), *aff’d*, 143 F.3d 1387 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (1998); *In re NVR, Inc.*, 206 B.R. 831, 837 (Bankr. E.D.

Whether Congress actually had the power to so act, however, is a more difficult question. Congress clearly has the power to waive or abrogate federal, foreign, or local sovereign immunity.<sup>97</sup> Prior to *Seminole Tribe*, it also appeared that Congress had the power to abrogate state Eleventh Amendment immunity in the bankruptcy context because (a) the Supreme Court consistently had held that Congress could abrogate Eleventh Amendment immunity when enacting legislation pursuant to the "Enforcement Clause" of the Fourteenth Amendment;<sup>98</sup> and (b) in *Pennsylvania v. Union Gas Co.*, a plurality of the Court had held that Congress similarly could do so when enacting legislation pursuant to its plenary powers under the Commerce Clause of Article I.<sup>99</sup> Indeed, following the *Union Gas* decision and prior to *Seminole Tribe*, every lower court to consider the issue had held that Congress had the power to abrogate state immunity when enacting legislation pursuant to its plenary powers under the Bankruptcy Clause of Article I of the Constitution,<sup>100</sup> and several courts had reached the same conclusion prior to the issuance of the *Union Gas* opinion.<sup>101</sup>

In *Seminole Tribe*, however, the Supreme Court held that Congress had no authority under the Commerce Clause or the Indian Commerce Clause of Article I to abrogate Eleventh Amendment immunity. As a result, since *Seminole Tribe* a significant majority of courts, including all of the Courts of Appeals to consider the issue,<sup>102</sup> have held that Congress may *not* abrogate state Eleventh Amendment immunity pursuant to the Bankruptcy Clause of Article I of the Constitution.<sup>103</sup> Such courts have reasoned that congressional power to enact legislation pursuant to the Bankruptcy Clause is analogous to and coextensive with its authority to enact legislation pursuant to the Commerce Clause and the Indian Commerce Clause and that, as a result, there is "no basis for treating its powers under the Bankruptcy Clause any differently"<sup>104</sup> from the explicated powers under the Commerce Clause.<sup>105</sup>

Unfortunately, these courts are correct because there are no logical bases to distinguish the Indian Commerce Clause from the Bankruptcy Clause or other grants of Congressional power under Article I of the Constitution. Indeed, even the Constitution's Framers recognized that the Article I powers are "intimately connected"<sup>106</sup> and reflect the need to "escape the risks of economic balkanization."<sup>107</sup> Moreover, both the majority and the dissent in *Seminole Tribe* foreshadowed this conclusion. The dissent, for example, decried that application of the *Seminole Tribe* reasoning "prevents Congress from providing a federal forum for a broad range of actions against states, from those sounding in copyright and patent law, to those concerning *bankruptcy*, environmental law, and the

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Va. 1997); *Florida Dep't of Revenue v. Sparkman* (*In re York-Hannover Devs., Inc.*), 190 B.R. 62, 65 (E.D.N.C. 1995); *Mather v. Oklahoma Employment Sec. Comm'n* (*In re Southern Star Foods, Inc.*), 190 B.R. 419, 425-26 (Bankr. E.D. Okla. 1995); *Stern v. Massachusetts Alcohol Beverage Control Comm'n* (*In re J.F.D. Enters.*), 183 B.R. 342, 354 (Bankr. D. Mass. 1995).

97. See 28 U.S.C. §§ 1604-05 (1994); *Argentine Republic v. Amerasia Shipping Corp.*, 488 U.S. 428 (1989); *United States v. Mississippi*, 380 U.S. 128, 140-41 (1965).

98. The Enforcement Clause provides that "[t]he Congress shall have power to enforce, by appropriate legislation, the provisions of [the Fourteenth Amendment]." U.S. CONST. amend. XIV, § 5; see, e.g., *Fitzpatrick v. Bitzer*, 427 U.S. 445, 452-56 (1976).

99. *Pennsylvania v. Union Gas Co.*, 491 U.S. 1, 13-23 (1989) (Brennan, Marshall, Blackmun, & Stevens, JJ.); see also *id.* at 45 (White, J., concurring without explanation in the plurality's conclusion, but not concurring in its reasoning). The Commerce Clause provides that "Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several states, and with the Indian Tribes." U.S. CONST. art. I, § 8, cl. 3.

100. See, e.g., *Merchants Grain, Inc. v. Mahern*, 59 F.3d 630, 634-36 (7th Cir. 1995), *vacated*, Ohio Agric. Commodity Depositors Fund v. Mahern, 517 U.S. 1130 (1996) (mem.) ("[T]here was no constitutional basis for distinguishing between the plenary powers accorded Congress under the Fourteenth Amendment and those accorded under Article I."); *In re HPA Assocs.*, 191 B.R. at 172-74 ("Congress' plenary powers under Article I did empower it to abrogate sovereign immunity pursuant to the Bankruptcy Clause mandate to establish uniform bankruptcy laws."); *In re York-Hannover Devs., Inc.*, 190 B.R. at 64-65 ("[I]t is clear that the states have ceded their sovereign immunity in the field of bankruptcy law."); *In re Southern Star Foods*, 190 B.R. at 425-26; *In re J.F.D. Enters.*, 183 B.R. at 354.

101. See, e.g., *McVey Trucking v. Secretary of State* (*In re McVey Trucking, Inc.*), 812 F.2d 311, 314-23 (7th Cir. 1987) (concluding that "Congress may abrogate state immunity to suit pursuant to any of its plenary powers," including the Bankruptcy Clause); *Murray v. Withrow* (*In re PM-II Assocs.*), 100 B.R. 940, 942 (Bankr. S.D. Ohio 1989); *Wayne Manor, Inc. v. Department of Pub. Welfare* (*In re Wayne Manor, Inc.*), 94 B.R. 240, 243-44 (Bankr. D. Mass. 1988); cf. *WJM, Inc. v. Massachusetts Dep't of Pub. Welfare*, 840 F.2d 996, 1002 (1st Cir. 1988) (declining to consider whether Congress has the power to abrogate state sovereign immunity under the Bankruptcy Clause because of "the uncertainty that permeates the subject of abrogation").

102. See *Sacred Heart Hosp. v. Pennsylvania* (*In re Sacred Heart Hosp.*), 133 F.3d 237, 243-44 (3d Cir. 1998); *Department of Transp. and Dev. v. PNL Management Co.* (*In re Fernandez*), 123 F.3d 241, 244-45 (5th Cir. 1997), *amended by* 130 F.3d 1138, 1139 (5th Cir. 1997); *Schlossberg v. Maryland* (*In re Creative Goldsmiths*), 119 F.3d 1140, 1147 (4th Cir. 1997); *Aer-Aerotron, Inc. v. Texas Dep't of Transp.* (*In re Aer-Aerotron, Inc.*), 104 F.3d 677, 680-81 (4th Cir. 1997) ("[P]erhaps the handwriting is on the wall that the abrogation provisions of the Bankruptcy Reform Act will suffer the same fate as the statutes involved in *Seminole*."); *Light v. State Bar* (*In re Light*), 87 F.3d 1320 (9th Cir. 1996) (unpublished disposition); *In re NVR, L.P.*, 206 B.R. 831, 838 (Bankr. E.D. Va. 1997); *Sparkman v. Florida Dep't of Revenue* (*In re York-Hannover Devs., Inc.*), 201 B.R. 137, 141 (Bankr. E.D.N.C. 1996) (listing cases in which courts have so held).

103. The Bankruptcy Clause provides that "[t]he Congress shall have Power . . . [t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4.

104. *Hoffman v. Connecticut Dep't of Income Maintenance*, 492 U.S. 96, 105 (1989) (Scalia, J., concurring in judgment).

105. See *In re Sacred Heart Hosp.*, 133 F.3d at 243; *In re Fernandez*, 123 F.3d at 244; *In re Creative Goldsmiths*, 119 F.3d at 1145-46.

106. THE FEDERALIST NO. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961).

107. *In re Fernandez*, 123 F.3d at 244.



regulation of our vast national economy."<sup>108</sup> Rather than dispute that conclusion, the majority readily agreed, but nevertheless professed to be unconcerned:

[I]t has not been widely thought that the federal antitrust, *bankruptcy*, or copyright statutes abrogated the States' sovereign immunity. . . . Although the copyright and *bankruptcy* laws have existed practically since our nation's inception, . . . there is no established tradition in the lower federal courts of allowing enforcement of those federal statutes against the States.<sup>109</sup>

In fact, following the issuance of *Seminole Tribe*, the Supreme Court granted certiorari of the *Merchants Grain* decision, in which the Seventh Circuit had concluded that section 106(a) represented a valid exercise of power under the Bankruptcy Clause,<sup>110</sup> and the Court promptly vacated and remanded that decision "for further consideration in light of *Seminole Tribe*."<sup>111</sup>

In defense of *Seminole Tribe's* rendering unconstitutional Section 106(a), certain commentators opined that bankruptcy causes of action against states could be resolved in state courts and that as a result, *Seminole Tribe* would not have the catastrophic impact that many believed it would have. Before *Alden*, these commentators were correct that federal question causes of action could be brought against a state in state court without offending Eleventh Amendment immunity. States cannot rely on the Eleventh Amendment immunity to protect them against suits in their own court system.<sup>112</sup> Moreover, when states have waived sovereign immunity through statutes or conduct, they clearly can be sued in state courts.<sup>113</sup> Under the prevailing pre-*Alden* view,<sup>114</sup> Congress could abrogate common-law "sovereign immunity enjoyed by states in their own courts by legislating pursuant to its Article I powers,"<sup>115</sup> including, presumably, its powers under the Bankruptcy Clause. At least one lower court held that section 106(a) of the Bankruptcy Code validly abrogated common law sovereign immunity for actions against a state brought in state courts.<sup>116</sup>

Indeed, the Court had held that the Supremacy Clause not only provides state courts with jurisdiction over federal causes of action, it also *required* state courts of general jurisdiction to exercise such jurisdiction absent some

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108. *Seminole Tribe v. Florida*, 517 U.S. 44, 77 (1996) (Stevens, J., dissenting) (emphasis added).

109. *Id.* at 72 n.16 (emphasis added). Several bankruptcy courts have taken issue with the Court's statement that there is no tradition of allowing enforcement of federal bankruptcy laws against the states. See, e.g., *O'Brien v. Vermont (In re O'Brien)*, 216 B.R. 731, 736 (Bankr. D. Vt. 1998) ("We, like every bankruptcy judge we know, regularly and routinely enforced applicable bankruptcy law against the States prior to *Seminole*."); *Schulman v. California Water State Resources Control Bd. (In re Lazar)*, 200 B.R. 358, 376 (Bankr. C.D. Cal. 1996).

110. *Merchants Grain, Inc. v. Mahern*, 59 F.3d 630, 634-37 (7th Cir. 1995), *vacated*, *Ohio Agric. Commodity Depositors Fund v. Mahern*, 517 U.S. 1130 (1996) (mem.).

111. See *Ohio Agric. Commodity Depositors Fund v. Mahern*, 517 U.S. 1130, 1130 (1996).

112. See *Hilton v. South Carolina Public Rys. Comm'n*, 502 U.S. 197, 204-05 (1991) ("[A]s we have stated on many occasions, the Eleventh Amendment does not apply in state courts.").

113. Many states have elected to waive sovereign immunity with respect to proprietary, as opposed to governmental, functions. For example, New York State has done so in section 8 of its Court of Claims Act. See *Miller v. New York*, 467 N.E.2d 493, 496 (N.Y. 1984). If a debtor were owed money by the State of New York based on a proprietary function, the debtor could sue the state. See also 705 ILL. COMP. STAT. 505/8 (West Supp. 1998) ("The court [of claims] shall have exclusive jurisdiction to hear . . . [a]ll claims against the state for damages in cases sounding in tort . . ."). In all, it appears that thirty-four states have enacted statutes waiving sovereign immunity in state courts, to some extent. See ALASKA STAT. 09.50.250 (Michie Supp. 1997); ARIZ. REV. STAT. ANN. § 12-821 (1995); ARK. CODE ANN. § 19-10-201 to -210 (Michie 1998); CONN. GEN. STAT. ANN. § 4-61(a) (West Supp. 1998); GA. CODE ANN. § 50-21-1 (Michie 1998); HAW. REV. STAT. § 661-1 (1993); 705 ILL. COMP. STAT. § 505/8 (West Supp. 1998); KAN. STAT. ANN. § 46-913 (1994); KY. REV. STAT. ANN. § 45A.245 (Michie 1997); LA. REV. STAT. ANN. § 38:2181 (West 1999); ME. REV. STAT. ANN. tit. 5, § 1510-A (West 1989 & Supp. 1997); MD. CODE ANN., STATE GOV'T § 12-201(a) (Supp. 1997); MICH. COMP. LAWS ANN. § 600.6419 (West 1995); MINN. STAT. § 3.751 (1997); MISS. CODE ANN. § 11-45-1 (1993); MONT. CODE ANN. § 18-1-404 (1994); NEB. REV. STAT. § 81-8,301 (1994); NEV. REV. STAT. § 41.031 (Supp. 1997); N.H. REV. STAT. ANN. § 491:8 (1997); N.J. STAT. ANN. § 59:13-3 (West 1995); N.M. STAT. ANN. § 37-1-23 (Michie 1990); N.Y. Ct. Cl. Act § 8 (McKinney Supp. 1998); N.D. CENT. CODE § 32-12-02 (1996); OHIO REV. CODE ANN. § 2743.02(A)(1) (Anderson Supp. 1997); OR. REV. STAT. § 30.320 (Supp. 1996); 72 PA. CONS. STAT. ANN. § 4651-1 (1998); R.I. GEN. LAWS § 37-13.1-1 (1997); S.D. CODIFIED LAWS §§ 21-32-2, 21-32-10 (Michie 1987); TENN. CODE ANN. § 9-8-307(a)(1)(L) (Supp. 1997); UTAH CODE ANN. § 63-30-5 (1997); VA. CODE ANN. § 11-69,11-70 (Michie 1995); WASH. REV. CODE ANN. § 4.92.010 (West 1988); W. VA. CODE § 14-2-4, 14-2-13 (1995); WYO. STAT. ANN. § 1-39-104 (Michie 1997).

114. See Daniel J. Meltzer, *The Seminole Decision and State Sovereign Immunity*, 1996 SUP. CT. REV. 1, 58 & n.273; Henry Paul Monaghan, Comment, *The Sovereign Immunity "Exception"*, 110 HARV. L. REV. 102, 122-25 (1996). This view is "better" precisely because the original doctrine of sovereign immunity was not so much about "whether the Crown or its agents could be sued, but how." PAUL M. BATOR ET AL., HART & WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 1002 (4th ed. 1996). Adoption of the contrary position, as in *Alden*, will immunize states and their agents from retrospective suits in any forum and would encourage state defiance of federal laws without accountability to any court.

115. *In re NVR, L.P.*, 206 B.R. 831, 843 (Bankr. E.D. Va. 1997). See *Howlett v. Rose*, 496 U.S. 356, 374-78 (1990). Only if the state court invokes a neutral rule of judicial administration may it refuse to exercise its general jurisdiction against the state on a federal cause of action. See *id.* To the extent state law of sovereign immunity reflects a substantive disagreement with the extent to which governmental entities should be held liable for their constitutional violations, that disagreement cannot override the dictates of federal law. The *Howlett* Court was careful to note that it left open the question "whether Congress can require the States to create a forum with the capacity to enforce federal statutory rights or to authorize service of process on parties who would not otherwise be subject to the court's jurisdiction." *Id.* at 378.

116. See *O'Brien v. Vermont (In re O'Brien)*, 216 B.R. 731, 736-38 (Bankr. D. Vt. 1998).



other available federal forum.<sup>117</sup> But to say that a state court has subject matter jurisdiction<sup>118</sup> to resolve federal causes of action is not to resolve whether Congress can abrogate a state's immunity in its own courts with respect to those actions.<sup>119</sup> *Seminole* ducked the issue but noted in passing that "this Court is empowered to review a question of federal law arising from a state-court decision where a State has consented to suit."<sup>120</sup>

As a conceptual matter, where the state had not consented to suit, Congress should be able to abrogate state sovereign immunity to require vindication of federal causes of action in state courts.<sup>121</sup> Otherwise no forum would be available to vindicate state violations of federal law, federal legislative power would be impotent to bind the states, and the Supremacy Clause would be undercut severely.<sup>122</sup>

Despite these obvious concerns, the Supreme Court's decision in *Alden* squarely decides the issue in favor of the states. Under *Alden*, states may assert sovereign immunity to suit in their courts to any cause of action arising under Article I. Congress's abrogation of sovereign immunity in section 106(a), like its attempted abrogation in the Fair Labor Standards Act, is unconstitutional as applied to a state without its consent. Thus, while causes of action for money damages granted under the Bankruptcy Code against a state are, in theory, available, there is currently no forum in which to bring such bankruptcy causes of action.

### B. Section 5 of the Fourteenth Amendment

In *Seminole Tribe*, the Supreme Court reaffirmed<sup>123</sup> that Congress constitutionally may abrogate state Eleventh Amendment immunity when legislating pursuant to the Fourteenth Amendment. The Court reasoned that, since the Fourteenth Amendment was ratified by the states after the Eleventh Amendment was ratified, federal legislation enacted pursuant to the Fourteenth Amendment constitutionally could "intrude upon the province of the Eleventh Amendment."<sup>124</sup>

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117. See *Hilton v. South Carolina Pub. Rys. Comm'n*, 502 U.S. 197, 207 (1991) ("[When] a federal statute does impose liability upon the States, the Supremacy Clause makes that statute the law in every State, fully enforceable in state court.") (quoting *Howlett*, 496 U.S. at 367-68); *Testa v. Katt*, 330 U.S. 386 (1947); see also *In re O'Brien*, 216 B.R. at 736 ("[S]tates are bound by federal law; they must comply with federal law; and federal law can ensure that they do."); *In re NVR, L.P.*, 206 B.R. at 843. Section 1334(b) of title 28, United States Code, the primary bankruptcy jurisdiction statute, supports this point by providing that the federal courts "shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334(b) (1994) (emphasis added). Nevertheless, some commentators have suggested that only states may determine whether to provide jurisdiction in state courts of federal causes of action. See Karen Cordry, *State Governments in the Bankruptcy Courts After Seminole: Are They the New 800-Pound Gorillas*, 28 BANKR. CT. DECISIONS WKLY. NEWS & COMMENT 23, at A10 (May 14, 1996). Moreover, it is doubtful that a state court would have jurisdiction over disputes relating to property of the estate or other matters over which Congress has granted exclusive jurisdiction to federal courts, such as in 28 U.S.C. § 1334(e), which grants the federal district court exclusive jurisdiction over property of the estate. See Scott P. Glauber, *Citizen Suits Against States: The Exclusive Jurisdiction Dilemma*, 45 J. COPYRIGHT SOC'Y U.S.A. 63, 99-100 (1997); Roberta Rosenthal Kwall, *Governmental Use of Copyrighted Property: The Sovereign's Prerogative*, 67 TEX. L. REV. 685, 765 (1989); Monaghan, *supra* note 114, at 132. Thus, Congress should consider amending section 1334(e) to grant state courts concurrent jurisdiction over property of the estate solely for actions that cannot be brought in federal court without the state's consent.

118. Some courts have held that the Eleventh Amendment bars a court's subject matter jurisdiction over the suit. See, e.g., *Demery v. Kupperman*, 735 F.2d 1139, 1149 n.8 (9th Cir. 1984). The better view is that although sovereign immunity is jurisdictional, it is "not of the same character as subject matter jurisdiction." *In re Prairie Island Dakota Sioux*, 21 F.3d 302, 304 (8th Cir. 1994); see *infra* note 182. When a state waives sovereign immunity, it confers personal jurisdiction rather than subject matter jurisdiction on the court. See *PEAKSolutions Corp. v. State Dep't of Transp.* (*In re PEAKSolutions Corp.*), 168 B.R. 918, 922 & n.10 (Bankr. D. Minn. 1994).

119. See *Meltzer*, *supra* note 114, at 57-60. Where a state deprives a person of property in violation of federal law, the state court must provide relief, notwithstanding "the sovereign immunity States traditionally enjoy in their own courts." *Reich v. Collins*, 513 U.S. 106, 110 (1994) (tax refund case).

120. *Seminole Tribe v. Florida*, 517 U.S. 44, 71 n.14 (1996)

121. See Nicole A. Gordon & Douglas Gross, *Judicialability of Federal Claims in State Court*, 59 NOTRE DAME L. REV. 1145, 1171-77 (1984); *Meltzer*, *supra* note 114, at 58; Louis E. Wolcher, *Sovereign Immunity and the Supremacy Clause: Damages Against States in Their Own Courts for Constitutional Violations*, 69 CAL. L. REV. 189 (1981).

122. See *Hilton v. South Carolina Pub. Rys. Comm'n*, 502 U.S. 197, 211 (1991) ("If a suit against state officers is precluded in the national courts by the Eleventh Amendment to the Constitution, and may be forbidden by a state to its courts . . . an easy way is open to prevent the enforcement of many provisions of the Constitution . . ."). Indeed one might speculate whether state prosecutors and other officials will misbehave if they are immune from federal review and liability. Prospective injunctive relief under *Ex parte Young* might not be sufficient to remedy actions taken by state officials before injunctive relief is granted. Conceivably, second order reputational and political pressures will operate to keep state officials obedient to federal law. See *supra* note 17. Resorting to state courts to resolve complex bankruptcy issues is inconsistent with concepts of federalism.

123. See *Seminole Tribe*, 514 U.S. at 59; *Fitzpatrick v. Bitzer*, 427 U.S. 445, 456 (1976) (recognizing congressional power to abrogate Eleventh Amendment immunity under the Fourteenth Amendment). Recently the Court renewed this reaffirmation in *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2206-07 (remedial legislation waiving state sovereign immunity under section 5 of the Fourteenth Amendment is limited to cases where Congress identifies a pattern of state deprivation of constitutional rights).

124. *Seminole Tribe*, 517 U.S. at 59. Another basis to distinguish the Fourteenth Amendment from Article I is that the Fourteenth Amendment is of limited scope and was intended specifically to alter the relationship between states and the federal government. See *Fitzpatrick*, 427 U.S. at 454-55.

At least four bankruptcy courts and one district court have seized upon this "exception" to the Eleventh Amendment to hold that section 106(a) in fact is constitutional.<sup>125</sup> The first such case was *Southern Star Foods, Inc.*,<sup>126</sup> in which a chapter 7 trustee brought an adversary proceeding against a state agency to recover an unauthorized postpetition transfer<sup>127</sup> of property of the estate and to equitably subordinate the agency's claim against the debtor in priority of distribution to claims of other creditors.<sup>128</sup> After the state argued that Congress lacked the power to abrogate Eleventh Amendment immunity and that section 106(a) was unconstitutional,<sup>129</sup> the bankruptcy court held that the Privileges and Immunities Clause of the Fourteenth Amendment<sup>130</sup> enabled the trustee's action to proceed. Specifically, the court held that the exercise of "national legislative powers under any of the provisions of Article I will usually (if not invariably) implicate" privileges and immunities within the scope of the Fourteenth Amendment and that, as a result, section 106(a) is a constitutional embodiment of Congress's powers under the Fourteenth Amendment.<sup>131</sup> The court reasoned that the Bankruptcy Code provides citizens with at least the following "privileges and immunities" within the scope of the Fourteenth Amendment:

[The] efficient liquidation or other use and ratable distribution of a debtor's assets, or (to put it another way) with immunity from the inefficient liquidation or use and inequitable distribution of a debtor's assets which may occur under State laws; the privilege of discharge, or . . . with immunity from oppressive debt collection which may obtain under State laws; liberty from economic bondage, and protection against undue loss of value of property in exigent financial circumstances; and fair and efficient determination of all of the above, according to the process due in a national court of equitable jurisdiction, without regard to persons or to any special privileges save those considered by Congress to be justified as a matter of policy.<sup>132</sup>

Courts that have followed *Southern Star* have adopted similar reasoning.<sup>133</sup>

Courts of Appeals addressing the issue, however, unanimously have rejected the Fourteenth Amendment as a means of "rescuing" the viability of section 106(a).<sup>134</sup> In so doing, the appellate courts have focused on the legislative history of the statute<sup>135</sup> where, not surprisingly, "there is simply no evidence suggesting that section 106(a) was enacted pursuant to any constitutional provision other than Congress's Bankruptcy Clause authority."<sup>136</sup> The

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125. See Wyoming Dep't of Transp. v. Straight (*In re Straight*), 209 B.R. 540, 555 (D. Wyo. 1997), *aff'd*, 143 F.3d 1387 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (1998); Headrick v. Georgia (*In re Headrick*), 203 B.R. 805, 808 (Bankr. S.D. Ga. 1996); Mather v. Employment Sec. Comm'n (*In re Southern Star Foods, Inc.*), 190 B.R. 419, 426 (Bankr. E.D. Okla. 1995); Burke v. Georgia (*In re Burke*), 203 B.R. 493, 497 (Bankr. S.D. Ga. 1996), *aff'd on other grounds*, 146 F.3d 1313, 1317 (11th Cir. 1998), *cert. denied*, 119 S. Ct. 2410 (1999).

126. *In re Southern Star Foods, Inc.*, 190 B.R. at 426. Although *Southern Star* actually predates *Seminole Tribe*, its reasoning has been followed by every court that has held section 106(a) to be constitutional since *Seminole Tribe* was published.

127. *Id.* at 422. See 11 U.S.C. §§ 549(a), 550(a) (1994) (permitting the trustee to avoid an unauthorized postpetition transfer of property of the estate and to recover the transferred property or its value from the transferee).

128. *In re Southern Star Foods, Inc.*, 190 B.R. at 422. See 11 U.S.C. § 510(c) (permitting the trustee to bring an action to equitably subordinate the priority in distribution granted to the claim of one creditor to the claims of other creditors).

129. See *In re Southern Star Foods, Inc.*, 190 B.R. at 422.

130. See *id.* at 426. The Privileges and Immunities Clause provides that "[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States." U.S. CONST. amend. XIV, § 1. The Fourteenth Amendment thus forbids states from abridging the "privileges and immunities that flow from national citizenship." *Storer v. French* (*In re Storer*), 58 F.3d 1125, 1128 (6th Cir. 1995).

131. *In re Southern Star Foods, Inc.*, 190 B.R. at 426.

132. *Id.*

133. See Wyoming Dep't of Transp. v. Straight (*In re Straight*), 209 B.R. 540, 555 (D. Wyo. 1997), *aff'd*, 143 F.3d 1387 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (1998); Headrick v. Georgia (*In re Headrick*), 203 B.R. 805, 808 (Bankr. S.D. Ga. 1996); Burke v. Georgia (*In re Burke*), 203 B.R. 493, 497 (Bankr. S.D. Ga. 1996). Courts addressing the issue also could note that bankruptcy is not a right of citizenship and that entities that are not individual human beings, residents of the United States, or citizens may be debtors under the Bankruptcy Code. See 11 U.S.C. §§ 101(9), (27), (40), (41), 109(a) (1994).

134. See, e.g., *Sacred Heart Hosp. v. Pennsylvania* (*In re Sacred Heart Hosp.*), 133 F.3d 237, 244 (3d Cir. 1998); Department of Transp. & Dev. v. PNL Management Co. (*In re Fernandez*), 123 F.3d 241, 245 (5th Cir. 1997), *amended by* 130 F.3d 1138, 1139 (5th Cir. 1997); Schlossberg v. Maryland (*In re Creative Goldsmiths*), 119 F.3d 1140, 1146 (4th Cir. 1997); *cf.* Velasquez v. Frapwell, 160 F.3d 389, 391 (7th Cir. 1998) ("[I]f section 5 is not to be distended beyond all reasonable bounds, it cannot be used to authorize legislation so remote from the policies and objectives of the equal protection clause as [the Uniformed Services Employment and Reemployment Rights Act] is."); *Elias v. United States* (*In re Elias*), 218 B.R. 80, 84-86 (B.A.P. 9th Cir. 1998).

135. See *In re Sacred Heart Hosp.*, 133 F.3d at 244; *In re Fernandez*, 123 F.3d at 245; *In re Creative Goldsmiths*, 119 F.3d at 1146; see also *Bakst v. New Jersey* (*In re Ross*), 234 B.R. 199, 202 (Bankr. S.D. Fla. 1999); *In re NVR, L.P.*, 206 B.R. 831, 842 (Bankr. E.D. Va. 1997); *Schulman v. California Water State Resources Control Bd.* (*In re Lazar*), 200 B.R. 358, 382 (Bankr. C.D. Cal. 1996); *In re Lush Lawns*, 203 B.R. 418, 421 (Bankr. N.D. Ohio 1996); *Tri-City Turf Club, Inc. v. Kentucky Racing Comm'n* (*In re Tri-City Turf Club*), 203 B.R. 617, 620 (Bankr. E.D. Ky. 1996) ("The court can find no hint that Congress had in its collective mind Fourteenth Amendment concerns when it enacted Section 106(a) of the Bankruptcy Code.")

136. [T]he conclusion seems logically inescapable that in passing the 1994 [Bankruptcy] Act Congress exercised the same specifically enumerated Article I bankruptcy power that it has traditionally relied on in enacting prior incarnations of the bankruptcy law dating back to 1800—68 years before the passage of the Fourteenth Amendment. We will not presume that Congress intended to enact a law under a general Fourteenth Amendment power to remedy an unspecified violation of rights when a specific, substantive Article I power clearly enabled the law.

better reasoned result, therefore, is that *Seminole Tribe* sounded the death knell for section 106(a) and that, as a result, states' Eleventh Amendment immunity currently remains intact with respect to most, if not all, bankruptcy causes of action brought against a state in federal bankruptcy court.

One very limited exception might lead a court to conclude that section 106(a) effectively abrogates Eleventh Amendment immunity with respect to actions to remedy discriminatory practices brought against a state in bankruptcy court pursuant to section 525 of the Bankruptcy Code.<sup>137</sup> Although there is no legislative history indicating that Congress promulgated Section 525 under the Fourteenth Amendment,<sup>138</sup> the prohibition against discriminatory treatment goes to the heart of the Equal Protection Clause of the Fourteenth Amendment. A section 525 cause of action is analogous to a cause of action brought under section 1983 of title 42 of the United States Code.<sup>139</sup> Although the Court has held Congress did not explicitly abrogate a state's Eleventh Amendment immunity with respect to section 1983 of title 42,<sup>140</sup> this precedent should not apply by analogy to preclude abrogation with respect to section 525 of the Bankruptcy Code in light of the explicit reference to section 525 in section 106(a).<sup>141</sup> Courts holding that they are without jurisdiction to order a state to reinstate a debtor's driver's license have simply overlooked the possibility that section 525 was promulgated under section 5 of the Fourteenth Amendment.<sup>142</sup>

The potential flaw in relying on the Equal Protection Clause to uphold abrogation with respect to section 525 is that bankruptcy debtors are not members of suspect classifications. Some courts have held that using the Equal Protection Clause and section 5 of the Fourteenth Amendment to overcome sovereign immunity should be limited to discrimination based upon suspect classifications.<sup>143</sup> The Supreme Court may resolve this issue during the October 1999 term.<sup>144</sup>

#### IV. LIMITATIONS ON THE APPLICABILITY OF THE ELEVENTH AMENDMENT IN BANKRUPTCY CASES AFTER SEMINOLE TRIBE AND ALDEN

Because Congress cannot simply "overrule" the decisions (which, of course, are based on interpretations of the Constitution), *Seminole Tribe* and *Alden* have created a "potentially irreconcilable conflict" between the Bankruptcy Code, the Eleventh Amendment, and constitutional sovereign immunity.<sup>145</sup> Indeed, as noted at the outset of this Article,<sup>146</sup> constitutional sovereign immunity, as construed by *Seminole Tribe* and *Alden*, might substantially undermine the paramount bankruptcy policies of a debtor's discharge and "fresh start" and of the fair and equitable distribution of the estate's assets to creditors. For example, since the *Seminole Tribe* decision was published, courts have held that unless states consent to bankruptcy court jurisdiction, the Bankruptcy Code's provisions regarding

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*In re Creative Goldsmiths*, 119 F.3d at 1146 (citation omitted). See also *In re Sacred Heart Hosp.*, 133 F.3d at 244; *In re NVR, L.P.*, 206 B.R. at 840.

137. Section 106(a) expressly abrogates sovereign immunity with respect to section 525 of the Bankruptcy Code. Section 525 protects debtors, who are, or have been, seeking protection under the Bankruptcy Code from discriminatory treatment. See 11 U.S.C. § 525.

[Section 525] codifies the result in *Perez v. Campbell*, 402 U.S. 637 (1971), which held that a state would frustrate the congressional policy of a fresh start for a debtor if it were permitted to refuse to renew the debtor's driver's license because a tort judgment against the debtor resulting from an automobile accident had been unpaid as a result of a discharge in bankruptcy.

H.R. REP. NO. 95-595, at 366 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6321-22.

138. Congress is not required to state expressly that it enacts legislation pursuant to the Fourteenth Amendment. See *EEOC v. Wyoming*, 460 U.S. 226, 243 n.18 (1983).

139. See *Maya v. Philadelphia Gas Works (In re Maya)*, 8 B.R. 202 (Bankr. E.D. Pa. 1981). But see *Toth v. Michigan State Hous. Dev. Auth.*, 136 F.3d 477, 479 n.1 (6th Cir. 1997).

140. See *Quern v. Jordan*, 440 U.S. 332, 345 (1979).

141. Section 106(a) provides in pertinent part: "Notwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit . . . with respect to . . . [section] 525 . . . of this title." 11 U.S.C. § 106(a).

142. See, e.g., *In re Burkhardt*, 220 B.R. 837, 842 (Bankr. D.N.J. 1998); *In re Perez*, 220 B.R. 216, 224-25 (Bankr. D.N.J. 1998), *aff'd*, No. 98-2043, 1998 U.S. Dist. LEXIS 21513 (D.N.J. Aug. 10, 1998) (unpublished opinion) (holding in light of *Seminole Tribe* that "to the extent earlier cases have relied on . . . the 'anti-discrimination provision' set forth at Bankruptcy Code § 525, to restore a debtor's driver's license . . . such reliance . . . is no longer applicable").

143. See *Velasquez v. Frapwell*, 160 F.3d 389, 391 (7th Cir. 1998); see also *infra* note 261 and accompanying text. But see *Little Rock Sch. Dist. v. Mauney*, No. 98-1721, 1999 U.S. App. LEXIS 13166, at \*7 (8th Cir. June 14, 1999). The Court of Appeals for the Eighth Circuit held that Congress validly abrogated state Eleventh Amendment immunity with respect to the Individuals with Disabilities Education Act. *Id.* The court rejected the state's argument that because disabled status is not a suspect classification Congress could not use the Fourteenth Amendment exception to the Eleventh Amendment. Citing the Eleventh Circuit's decision in *Kimel v. Florida Bd of Regents*, 139 F.3d 1429 (11th Cir. 1998), the court stated: "the mere fact of non-suspect status does not preclude Congress from legislating on a group's behalf." *Id.* at \*23. Moreover, the court explained why the IDEA satisfies the *Boerne* "proportionality" test. The Eighth Circuit reaffirmed its views on non-suspect status in *Alsbrook v. City of Maumelle*, No. 97-1825, 1999 U.S. App. LEXIS 16945, at \*23 (8th Cir. July 23, 1999).

144. See *Kimel v. Florida Bd. of Regents*, 139 F.3d 1426 (11th Cir. 1998), *cert. granted*, 119 S. Ct. 901 (1999). Even if the Equal Protection Argument fails, section 525 might survive as a provision protecting "property" rights secured by the Due Process Clause. See *infra* notes 276-85 and accompanying text.

145. See *In re NVR, L.P.*, 206 B.R. 831, 843 n.25 (Bankr. E.D. Va. 1997).

146. See *supra* notes 4-12 and accompanying text.

discharge,<sup>147</sup> avoidance of preferences,<sup>148</sup> avoidance of fraudulent conveyances,<sup>149</sup> avoidance of unauthorized postpetition transfers,<sup>150</sup> turnover of property of the estate,<sup>151</sup> protection against discriminatory treatment,<sup>152</sup> the automatic stay,<sup>153</sup> and determination of tax liability of the bankruptcy estate<sup>154</sup> cannot be enforced against states in federal bankruptcy courts.<sup>155</sup>

Application of *Seminole Tribe*, *Alden*, and principles of constitutional sovereign immunity to bankruptcy cases, however, will not result in a blanket immunity from bankruptcy-related matters for all governmental units. Rather, the scope of sovereign immunity is limited by several established doctrines, which are summarized below and have been explored and defined in a veritable torrent of opinions published after the *Seminole Tribe* decision.

#### A. Only States and Agents Are Protected

One significant and well-established limitation on the scope of Eleventh Amendment immunity is that only a state and its agents may invoke the amendment's protection. Other governmental units, including local jurisdictions such as counties and municipalities, cannot avail themselves of the Eleventh Amendment and its protections.<sup>156</sup>

Because many tax and licensing issues involve local governments, the benefit to a bankruptcy estate and its creditors of such a limitation is clear.<sup>157</sup> However, because state law determines the status of a particular governmental unit, a local governmental unit that is regarded as autonomous in one state may be regarded as a mere agent in another state for Eleventh Amendment purposes.<sup>158</sup> Moreover, the same kinds of governmental functions may be exercised by an arm of the state in one state but by a local agency in another state.<sup>159</sup> As a result, the "local government" exception to the Eleventh Amendment has varying and inconsistent application.<sup>160</sup>

147. 11 U.S.C. § 727 (1994); see, e.g., *Franchise Tax Bd. v. Lapin* (*In re Lapin*), 226 B.R. 637, 641 (B.A.P. 9th Cir. 1998); *Mitchell v. California Franchise Tax Bd.* (*In re Mitchell*), 222 B.R. 877, 883-84 (B.A.P. 9th Cir. 1998); *Elias v. United States* (*In re Elias*), 218 B.R. 80, 83-84 (B.A.P. 9th Cir. 1998); *Morrell v. Franchise Tax Bd.* (*In re Morrell*), 218 B.R. 87, 90 (Bankr. C.D. Cal. 1998); *Kish v. Verniero* (*In re Kish*), 221 B.R. 118, 124 (D.N.J. 1997); *Ranstrom v. IRS* (*In re Ranstrom*), 215 B.R. 454, 455-56 (Bankr. N.D. Cal. 1997); *Rose v. United States Dep't of Educ.* (*In re Rose*), 214 B.R. 372, 375 (Bankr. W.D. Mo. 1997); *Koehler v. Iowa College Student Aid Comm'n* (*In re Koehler*), 204 B.R. 210, 216-17 (Bankr. D. Minn. 1997). But see *Department of Transp. and Dev. v. PNL Management Co.* (*In re Fernandez*), 123 F.3d 241, 243-44 (5th Cir. 1997).

148. 11 U.S.C. § 547; see, e.g., *Brewer v. New York State Dep't of Correctional Servs.* (*In re Value-Added Communications, Inc.*), 224 B.R. 354, 359 (N.D. Tex. 1998); see also *Ted Janger, Strategies For Preserving the Bankruptcy Trustee's Avoidance Power Against States After Seminole Tribe*, 23 OHIO N.U. L. REV. 1431, 1435 (1997).

149. 11 U.S.C. § 548; see, e.g., *Sparkman v. Florida Dep't of Revenue* (*In re York-Hannover Devs., Inc.*), 201 B.R. 137, 138, 142 (Bankr. E.D.N.C. 1996) (holding fraudulent conveyance action brought by trustee against state was barred by Eleventh Amendment).

150. 11 U.S.C. § 549; see also *Janger, supra* note 148, at 1435. In *Southern Star Foods*, the court held that the Eleventh Amendment defense was not available to a state because laws enacted pursuant to Article I are enforceable through the Fourteenth Amendment. See *Mather v. Oklahoma Employment Sec. Comm'n* (*In re Southern Star Foods, Inc.*) 190 B.R. 419, 426 (Bankr. E.D. Okla. 1995). Because the Fourteenth Amendment exception cannot withstand analysis as applied to a postpetition transfer in the bankruptcy context, the court should have held that the Eleventh Amendment barred the exercise of bankruptcy court jurisdiction against the state in an adversary proceeding under section 549 of the Bankruptcy Code.

151. 11 U.S.C. § 542; see, e.g., *Guiding Light Corp. v. Louisiana* (*In re Guiding Light Corp.*), 213 B.R. 489, 491 (Bankr. E.D. La. 1997); *Horwitz v. Zywczyński* (*In re Zywczyński*), 210 B.R. 924, 925-26 (Bankr. W.D.N.Y. 1997).

152. 11 U.S.C. § 525; see *In re Perez*, 220 B.R. 216, 224-25 (Bankr. D.N.J. 1995), *aff'd*, No. 98-2043, 1998 U.S. Dist. LEXIS 21513 (D.N.J. Aug. 10, 1998) (unpublished opinion).

153. 11 U.S.C. § 362; see, e.g., *In re Burkhardt*, 220 B.R. 837, 843-44 (Bankr. D.N.J. 1998); *Louis; Harris v. Barall* (*In re Louis; Harris*), 213 B.R. 796, 798 (Bankr. D. Conn. 1997); *Tri-City Turf Club, Inc. v. Kentucky Racing Comm'n* (*In re Tri-City Turf Club*), 203 B.R. 617, 618 (Bankr. E.D. Ky. 1996); *In re Martinez*, 196 B.R. 225 (D.P.R. 1996).

154. 11 U.S.C. § 505; see *Bakst v. New Jersey* (*In re Ross*), 234 B.R. 199, 202-03 (Bankr. S.D. Fla. 1999); *Mueller v. Idaho* (*In re Mueller*), 211 B.R. 737, 739-40 (Bankr. D. Mont. 1997).

155. See *In re Burkhardt*, 220 B.R. 837, 842 (Bankr. D.N.J. 1998) (holding that finding court lacked jurisdiction to compel state agency to return driver's license privilege even though return of license is aspect of confirmed chapter 13 plan); *In re Lush Lawns, Inc.*, 203 B.R. 418, 420 (Bankr. N.D. Ohio 1996); see also *Teresa K. Goebel, Comment, Obtaining Jurisdiction Over States in Bankruptcy Proceedings After Seminole Tribe*, 65 U. CHI. L. REV. 911 (1998).

156. See *Mt. Healthy City Sch. Dist. Bd. of Educ. v. Doyle*, 429 U.S. 274, 280 (1977); *Hadley v. North Ark. Community Technical College*, 76 F.3d 1437, 1438 (8th Cir. 1996) ("Eleventh Amendment immunity does not extend to independent political subdivisions created by the State, such as counties and cities."); *Ruehman v. Sheahan*, 34 F.3d 525, 528 (7th Cir. 1994) ("[A]lthough states and their agencies are protected by the eleventh amendment, counties and municipalities are not."); *In re Christie*, 218 B.R. 27, 31 (Bankr. D.N.J. 1998).

157. Because a local governmental unit cannot shield itself behind the Eleventh Amendment, it is subject to the automatic stay provisions in § 362 and may be compelled to appear in federal court to have its tax assessments determined pursuant to § 505.

158. See, e.g., *Doyle*, 429 U.S. at 280. The Ninth Circuit has articulated a five-prong test for determining whether, under state law, a particular governmental unit is an agent of a state:

To determine whether a governmental agency is an arm of the state, the following factors must be examined: [1] whether a money judgment would be satisfied out of state funds, [2] whether the entity performs central governmental functions, [3] whether the entity may sue or be sued, [4] whether the entity has the power to take property in its own name or only the name of the state, and [5] the corporate status of the entity.

*Belanger v. Madera Unified Sch. Dist.*, 963 F.2d 248, 250-51 (9th Cir. 1992).

159. As the court in *Belanger* noted, California school districts, unlike school districts in most of the states, have budgets that are controlled and funded by state government rather than by local school districts. See *Belanger*, 963 F.2d at 251. Because school

B. States Are Protected Only Against "Suits In Law Or Equity"

By its plain language, the Eleventh Amendment applies only to "suits in law or equity."<sup>164</sup> As a consequence, several courts have attempted to limit the applicability of *Seminole Tribe* on the ground that bankruptcy cases, or at least particular matters within a bankruptcy case, do not constitute "suits" within the scope of the Eleventh Amendment.<sup>162</sup>

The Court of Appeals for the Fifth Circuit, for example, has held that the Eleventh Amendment did not per se preclude the bankruptcy court's discharge of a claim held by a state because the bankruptcy case in which the discharge was granted did not constitute a "suit" against the state for Eleventh Amendment purposes:

In a bankruptcy case, in its simplest terms, a debtor turns over his assets, which constitute the estate, for liquidation by a trustee for the benefit of creditors according to their statutory priorities. Bankruptcy law modifies the state's collection rights with respect to claims against the debtor, but it also affords the state an opportunity to share in the collective recovery. Bankruptcy operates by virtue of the Supremacy Clause and *without forcing the state to submit to suit in federal court*. From this standpoint, [the debtor's] entitlement to assert his discharge against the state's claims invoked no Eleventh Amendment consequences [because] [t]he state never was hauled into federal court against its will in the bankruptcy.<sup>163</sup>

Other courts have reached the same conclusion with respect to the determination of a debtor's tax liability to a state pursuant to section 505 of the Bankruptcy Code<sup>164</sup> and with respect to the treatment and discharge of a state's claim under a chapter 11 plan of reorganization<sup>165</sup> or a chapter 13 plan of adjustment.<sup>166</sup> Moreover, prior to *Seminole Tribe*, the Supreme Court had held that the objection to a proof of claim filed by a state in a bankruptcy case did not constitute a "suit" within the meaning of the Eleventh Amendment.<sup>167</sup>

Although appearing to be a neat solution to the "problem" of Eleventh Amendment immunity in bankruptcy cases and proceedings, the actual application of the "bankruptcy cases are not suits for Eleventh Amendment purposes" line of reasoning is quite limited. For example, the Fifth Circuit itself expressly noted that the Eleventh Amendment does apply to preclude the "commencement of certain adversary proceedings directly against a state."<sup>168</sup> Thus, courts have held repeatedly that *adversary proceedings* to determine the dischargeability of a debt to a state in fact are "suits" within the scope of the Eleventh Amendment.<sup>169</sup> Courts have reached the same conclusion with respect to other complaints that request declaratory judgments regarding other aspects of the operation of the bankruptcy laws.<sup>170</sup>

The recent case *In re Burkhardt*<sup>171</sup> nicely illustrates the illusory nature of this "limitation" on the Eleventh Amendment. In *Burkhardt*, a bankruptcy court held that it could enter an order *confirming* a chapter 13 plan and discharging the debtor's debt to the state because confirmation of the plan did not result in a "suit in law or equity" that would trigger application of the Eleventh Amendment.<sup>172</sup> The court, however, concluded that the Eleventh Amendment precludes *enforcement* of the discharge and thus the plan against the state:

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district funding comes from the state, a judgment against a California school district will be paid out of the state treasury. *See id.* at 252. Thus, in California, school districts are arms of the state. This result differs from that in *Doyle*, where the Supreme Court concluded that Ohio school districts were not arms of the state of Ohio. *Doyle*, 429 U.S. at 280.

160. Compare *Moore v. Alameda*, 411 U.S. 693, 717-21 (1973) (holding that a county is not arm of the state under California law) with *DeKalb County Div. of Family & Children's Servs. v. Platter (In re Platter)*, 140 F.3d 676, 679 n.1 (7th Cir. 1998) (implying county family services division is an arm of the state).

161. U.S. CONST. amend. XI.

162. See *Virginia v. Collins (In re Collins)*, 173 F.3d 924, 929 (4th Cir. 1999) (finding a motion to reopen bankruptcy to determine whether a debt owed to state was dischargeable was not a suit against the state).

163. *Texas v. Walker*, 142 F.3d 813, 822 (5th Cir. 1998), *cert. denied*, 119 S. Ct. 865 (1999) (emphasis added); *see also Collins*, 173 F.3d at 929.

164. See *Smith v. Psychiatric Hosps., Inc. (In re Psychiatric Hosps., Inc.)*, 216 B.R. 660, 661 (M.D. Fla. 1998).

165. See *In re Barrett Refining Corp.*, 221 B.R. 795, 801-08 (Bankr. W.D. Okla. 1998).

166. See *In re Burkhardt*, 220 B.R. 837, 847-50 (Bankr. D.N.J. 1998).

167. See *Gardner v. New Jersey*, 329 U.S. 565, 573 (1947) ("If the claimant is a state, the procedure of proof and allowance is not transmuted into a suit against the state because the court entertains objections to the claim.").

168. *Walker*, 142 F.3d at 823.

169. See, e.g., *Mitchell v. California Franchise Tax Bd. (In re Mitchell)*, 222 B.R. 877, 882-84 (B.A.P. 9th Cir. 1998); *cf. Ranstrom v. IRS (In re Ranstrom)*, 215 B.R. 454, 455-56 (Bankr. N.D. Cal. 1997).

170. See, e.g., *NVR Homes, Inc. v. Clerks of the Circuit Courts (In re NVR, LP)*, Nos. 98-2211, 98-2244, 98-2271, 98-2272, 98-2273, 1999 U.S. App. LEXIS 15499, \*18-\*27 (4th Cir. July 12, 1999) (finding a debtor's motion for declaratory relief against the state to recover transfer taxes is a suit subject to the Eleventh Amendment); *Sacred Heart Hosp. v. Pennsylvania (In re Sacred Heart Hosp.)*, 204 B.R. 132, 137-39 (E.D. Pa. 1997), *aff'd*, 133 F.3d 1237 (3d Cir. 1998) (adversary proceeding for a declaratory judgment regarding applicability of section 108(a) of the Bankruptcy Code); *Guiding Light Corp. v. Louisiana (In re Guiding Light Corp.)*, 213 B.R. 489, 492 (Bankr. E.D. La. 1997) (adversary proceeding for declaratory judgment regarding extent of property of the estate).

171. *In re Burkhardt*, 220 B.R. 837, 838 (Bankr. D.N.J. 1998).

172. *Id.* at 849.

With its holding herein, the Court fully recognizes that in confirming a Chapter 13 plan which contemplates a discharge of a debtor's motor vehicle violations upon completion of all payments under the Plan, *the Bankruptcy Court is in effect granting a "right without a remedy,"* insofar as the ability of this Court to compel the restoration of a state issued driver's license. While acutely aware of this anomaly created by the recognition of the discharge of the debt under the federal bankruptcy statutes, without the jurisdictional ability to compel the sovereign to enforce the discharge, the proper redress lies with the United States Congress and is beyond the prerogative of this Court.<sup>173</sup>

As such, even though a bankruptcy case may not constitute a "suit" for Eleventh Amendment purposes and a bankruptcy court accordingly may have the power to enter orders in a case that directly affects the rights of a state, the bankruptcy court may be powerless to enforce its orders against the state. If so, at least with respect to the state, the debtor and its creditors may be no better off than if the bankruptcy court lacked jurisdiction in the first place.<sup>174</sup>

### C. Waiver of Immunity

States always may consent to be sued in federal court and can waive their Eleventh Amendment immunity expressly.<sup>175</sup> Thus, proof of a voluntary waiver of immunity by a state would constitute another way to gain jurisdiction over a state consistent with constitutional sovereign immunity.<sup>176</sup>

The doctrine of waiver, however, is quite narrow in scope. For example, a state waives its Eleventh Amendment immunity only if it unequivocally expresses an intent to waive its constitutional immunity protection,<sup>177</sup> and a state's intent to waive is strictly construed. Indeed, even a state's waiver of sovereign immunity in its own state courts is insufficient to waive the state's Eleventh Amendment immunity to permit it to be sued in federal court.<sup>178</sup>

Moreover, in *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board*, the Court overturned the "implied waiver" doctrine,<sup>179</sup> holding that a state does not waive its sovereign immunity, constructively or by implication, merely by participating in a federal program.<sup>180</sup> In *College Savings Bank*, the petitioner argued that Florida waived its immunity to suits brought under the Trademark Remedy Clarification Act ("TRCA") because Florida voluntarily engaged in activities covered by the TRCA. A five-member majority of the Court rejected the petitioner's argument, reasoning that the "implied waiver" doctrine "stands as an anomaly in the jurisprudence of sovereign immunity, and indeed in the jurisprudence of constitutional law."<sup>181</sup>

Nevertheless, it is possible for a state to explicitly waive its Eleventh Amendment immunity. Such a potential waiver presents two important issues. First, what constitutes a sufficient waiver of Eleventh Amendment immunity? Second, who has the authority to waive immunity on behalf of a state?

When a state commences an adversary or similar proceeding in a federal forum, whether a bankruptcy court or otherwise, it waives its sovereign and Eleventh Amendment immunity at least with respect to the subject matter of that proceeding and any defenses, counterclaims, and causes of action against the state that arise out of the same transaction or occurrence on which the state's proceeding is based.<sup>182</sup> This comports with the general rule that a state waives its immunity by "voluntarily invoking [federal court] jurisdiction."<sup>183</sup>

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173. *Id.* at 850 (emphasis added); see also *Franchise Tax Bd. v. Lapin* (*In re Lapin*), 226 B.R. 637, 646 (B.A.P. 9th Cir. 1998) (holding that a bankruptcy court had no jurisdiction to sanction a state for violating a discharge order). But query whether the bankruptcy judge could issue an *Ex parte Young* injunction against a state official to reinstate the debtor's driver's license?

174. But see *infra* Part III.E (discussing the possibility of enforcing bankruptcy court orders against states in state courts).

175. See, e.g., *Atascadero State Hosp. v. Scanlon*, 473 U.S. 234, 238 n.1 (1985) (stating that a state may expressly consent to suit in federal court through a clear statement in its constitution or a statute).

176. See *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2204 (1999).

177. See *Pennhurst State Sch. & Hosp. v. Halderman*, 465 U.S. 89, 99 (1984); see also *Port Auth. Trans-Hudson Corp. v. Feeney*, 495 U.S. 299, 305 (1990) ("The Court will give effect to a State's waiver of Eleventh Amendment immunity 'only where stated by the most express language or by such overwhelming implication from the text as [will] leave no room for any other reasonable construction.'") (quoting *Edelman v. Jordan*, 415 U.S. 651, 673 (1974)); *Magnolia Venture Capital Corp. v. Prudential Secs., Inc.*, 151 F.3d 439, 443-44 (5th Cir. 1998), *cert. denied*, 119 S. Ct. 1115 (1999); *V-1 Oil Co. v. Utah State Dep't of Pub. Safety*, 131 F.3d 1415, 1421 (10th Cir. 1997).

178. See *Florida Prepaid*, 119 S. Ct. at 2205; *Atascadero*, 473 U.S. at 241. In *Atascadero*, the Court stated, "[a]lthough a State's general waiver of sovereign immunity may subject it to suit in state court, it is not enough to waive the immunity guaranteed by the Eleventh Amendment 'absent a clear' intention to subject itself to suit in federal court." *Id.*; accord *Smith v. Reeves*, 178 U.S. 436, 441-45 (1900).

179. See *Parden v. Terminal Ry. Co.*, 377 U.S. 184, 192 (1964).

180. See *Florida Prepaid*, 119 S. Ct. at 2204-05; see also *Welch v. Texas Dep't of Highways & Pub. Transp.*, 483 U.S. 468, 478 (1987); *Atascadero*, 473 U.S. at 246-47; *Kit Kinports, Implied Waiver After Seminole Tribe*, 82 MINN. L. REV. 793, 800-01 (1998).

181. *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2228 (1999). The Court stated the "implied waiver" doctrine violated the rule that a state's express waiver of sovereign immunity be unequivocal. See *id.* The fact that the TRCA placed states on notice that they could be subject to suit for conduct did not satisfy the unequivocal express waiver test. Justice Scalia explained: "the most that can be said with certainty is that the State has been put on notice that Congress intends to subject [the State] to suits brought by individuals. That is very far from concluding that the State made an 'altogether voluntary' decision to waive its immunity." *Id.* (quoting *Beers v. Arkansas*, 61 U.S. (20 How.) 527, 529 (1857)).

182. See, e.g., *In re Platter*, 140 F.3d 676, 679-80 (7th Cir. 1998) (holding that a state waived sovereign immunity by commencing an adversary proceeding for declaratory relief that its claim was nondischargeable); *Confederated Tribes v. White* (*In re White*), 139

Courts have extrapolated that concept to hold that a state's active participation in a bankruptcy case, even absent the commencement of an adversary proceeding against the debtor, suffices to waive the state's applicable immunity.<sup>184</sup> Moreover, the Supreme Court long ago held that a state also waives its immunity when it files a proof of claim in a debtor's bankruptcy case, even if it otherwise does not participate in the bankruptcy case, at least with respect to matters regarding allowance of that claim.<sup>185</sup> Specifically, the Court reasoned as follows:

It is traditional bankruptcy law 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. If the claimant is a State, the procedure of proof and allowance is not transmuted into a suit against the State because the court entertains objections to the claim. The State is seeking something from the debtor. No judgment is sought against the State. The whole process of proof, allowance, and distribution is, shortly speaking, an adjudication of interests claimed in a res. It is none the less such because the claim is rejected in toto, reduced in part, given a priority inferior to that claimed, or satisfied in some other way than payment in cash. *When the State becomes an actor and files a claim against the fund, it waives any immunity which it otherwise might have had respecting the adjudication of the claim.*<sup>186</sup>

Based on such reasoning, Congress has enacted an express waiver of sovereign immunity through section 106(b) of the Bankruptcy Code, which provides for the following:

A governmental unit that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose.<sup>187</sup>

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F.3d 1268, 1271 (9th Cir. 1998) ("Initiation of a lawsuit is an action that 'necessarily establishes consent to the court's adjudication of the merits of that particular controversy,' including the risk of being bound by an adverse determination.") (quoting *McClendon v. United States*, 885 F.2d 627, 630 (9th Cir. 1989)). *But see* *United States v. Murdock Mach. & Eng'g Co.*, 81 F.3d 922, 931 (10th Cir. 1996) (Applying pre-Bankruptcy Code law, the Tenth Circuit held that the United States does not waive its sovereign immunity, absent consent, when its agents institute an action or file a claim in court.); *United States v. Forma*, 42 F.3d 759, 764 (2d Cir. 1994) (Absent unequivocal waiver of sovereign immunity, a court does not have jurisdiction to hear a counterclaim against the United States, even though the United States initiated the action. The court recognized, however, that the counterclaim could be asserted by way of setoff or recoupment.). *Murdock* and *Forma* appear to conflict with the Supreme Court's decision in *Gardner v. New Jersey*, 329 U.S. 565, 573 (1947), in which the Court held that a state waives its immunity when it files a proof of claim in a debtor's bankruptcy case. Moreover, *Murdock* and *Forma* have little application in bankruptcy cases and proceedings where Congress has explicitly waived federal sovereign immunity under section 106(b) of the Bankruptcy Code. *See also* *Davis v. U.S. Postal Serv. (In re Leeth Constr., Inc.)*, 170 B.R. 684, 688 (Bankr. D. Ariz. 1994).

183. *College Sav. Bank*, 119 S. Ct. at 2228; *see* *Gunter v. Atlantic Coast Line Ry. Co.*, 200 U.S. 273, 284 (1906); *see also* *Sutton v. Utah State Sch. for the Deaf & Blind*, 173 F.3d 1226, 1235 (10th Cir. 1999) (The state waived Eleventh Amendment immunity by removing the case from state court to federal court and litigating the merits of the case).

184. *See, e.g., Wyoming Dep't of Transp. v. Straight (In re Straight)*, 143 F.3d 1387, 1389-90 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (1998); *In re White*, 139 F.3d at 1270-71 (holding that Native American Tribe waived its immunity by twice voting on the debtor's plan of reorganization, objecting to confirmation of the plan, submitting an order denying confirmation, and otherwise participating in the bankruptcy case). The prospect that a state may waive its Eleventh Amendment immunity creates a potential conflict with traditional notions of jurisdiction. Similar to a claim that a federal court lacks subject matter jurisdiction, *see Farmers Ins. Co. v. Hubbard*, 869 F.2d 565, 570 (10th Cir. 1989), a state may assert its Eleventh Amendment immunity to bar federal jurisdiction at any point in litigation, including on appeal for the first time. *See Ambus v. Granite Bd. of Educ.*, 975 F.2d 1555, 1559 (10th Cir. 1992) ("The Eleventh Amendment defense is jurisdictional [and, therefore, is a threshold issue]."). Generally a party cannot waive the requirement that a federal court must have subject matter jurisdiction over the matter being litigated; that is, the parties cannot confer subject matter jurisdiction on a federal court. *See Insurance Corp. of Ireland v. Compagnie Des Bauxites*, 456 U.S. 694, 702 (1982). But the Supreme Court has held consistently that a state may waive its Eleventh Amendment immunity defense. *See, e.g., Wisconsin Dep't of Corrections v. Schacht*, 118 S. Ct. 2047, 2052 (1998) ("The State can waive the defense."); *Great N. Life Ins. Co. v. Read*, 322 U.S. 47 (1944); *Clark v. Barnard*, 108 U.S. 436, 447 (1883). The reason for the distinction between Eleventh Amendment immunity and subject matter jurisdiction lies in the history of the Eleventh Amendment. The amendment has its roots in the ancient doctrine of sovereign immunity, *see Monaco v. Mississippi*, 292 U.S. 313, 322-23 (1934), which could always be waived with proper consent. *See The Siren*, 74 U.S. (7 Wall.) 152, 154 (1868). The Court explained in *Clark v. Barnard* that "immunity from suit belonging to a State, which is respected and protected by the Constitution within the limits of the judicial power of the United States, is a personal privilege which it may waive at pleasure." *Clark*, 108 U.S. at 447. "The Amendment, in other words, enacts a sovereign immunity from suit, rather than a nonwaivable limit on the federal judiciary's subject matter jurisdiction." *Idaho v. Coeur d'Alene Tribe*, 521 U.S. 261, 267 (1997). "The Eleventh Amendment . . . does not automatically destroy original jurisdiction." *Schacht*, 118 S. Ct. at 2052. For an excellent overview of the debate whether the Eleventh Amendment implicates subject matter or personal jurisdiction, *see Glauberman, supra* note 117, at 69-70 & n.39.

185. *See Gardner*, 329 U.S. at 573; *New York v. Irving Trust Co.*, 288 U.S. 329, 330 (1933); *see also* *Virginia v. Collins (In re Collins)*, 173 F.3d 924, 929-30 (4th Cir. 1999).

186. *See Gardner*, 329 U.S. at 573-74 (emphasis added); *see also Irving Trust Co.*, 288 U.S. at 332 ("If a state desires to participate in the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated.")

187. *In re Straight*, 143 F.3d at 1390 (finding that section 106(b) codifies the *Gardner* rule). *See also* 11 U.S.C. § 106(c) (1994) ("Notwithstanding any assertion of sovereign immunity by a governmental unit, there shall be offset against a claim or interest of a governmental unit any claim against such governmental unit that is property of the estate."). Critics of this view might assert that section 106(b) is an abrogation of immunity rather than a waiver, because the filing of a proof of claim is an act by a state that does not implicate immunity. On the contrary, however, Congress has imposed a condition on the right of a state to file a proof of claim:



Thus, section 106(b) expressly deems the filing of a state's proof of claim to be a waiver of immunity with respect to claims against the state that arose out of the "same transaction or occurrence out of which the claim of such governmental unit arose."<sup>188</sup>

Notwithstanding long-standing Supreme Court authority regarding a state's waiver of sovereign immunity on the filing of a proof of claim, however, several courts have held and commentators have speculated, post-*Seminole Tribe*, that section 106(b) is an unconstitutional attempt to "deem" a waiver on the part of the states.<sup>189</sup> The courts finding section 106(b) to be unconstitutional instead have adopted the standards used to identify compulsory counterclaims under Rule 13(a) of the Federal Rules of Civil Procedure, holding that the "fundamental fairness of judicial process" requires only that a state's proof of claim waives immunity with respect to matters that would constitute compulsory counterclaims to a typical complaint.<sup>190</sup>

These critics may find support in the Supreme Court's decision in *College Savings Bank* in which Justice Scalia specifically distinguishes between notice to the states that Congress intended for the states to be subject to suits in federal court and actual waivers of immunity by the states.<sup>191</sup> Under the *College Savings Bank* rationale, section 106(b)'s effect should be no more than to notify states that Congress intended for the states to be subject to federal court jurisdiction. Thus, under *College Savings Bank*, it may be said that section 106(b)'s abrogation of immunity is unconstitutional.

Other courts, however, have held that section 106(b) is constitutional notwithstanding *Seminole Tribe*.<sup>192</sup> These opinions represent the better view because they recognize the states are voluntarily invoking federal jurisdiction by filing a proof of claim.<sup>193</sup> Nevertheless, because section 106(b) imposes a "same transaction or occurrence" test that is similar, if not identical, to the standards used to determine compulsory counterclaims, the same results generally will occur under both lines of authority.<sup>194</sup>

Finally, a minority of courts has determined that a state's filing of a proof of claim represents a broad consent to suit in federal court, regardless of the nature of claim at issue.<sup>195</sup> Notwithstanding the persuasive reasoning followed by this line of cases, the conclusion that a proof of claim amounts to a broad waiver is difficult to defend in light of the language of section 106(b) and the Supreme Court's insistence on strictly construing waivers of Eleventh Amendment immunity.<sup>196</sup> Of course even if immunity is not waived, the estate may still assert any of the debtor's defenses to disallow the state's claim.<sup>197</sup>

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under section 106(b) the state's election to file a proof of claim is deemed a waiver of immunity with respect to compulsory counterclaims, even if they exceed the amount of the claim and result in an affirmative recovery. Moreover, a state cannot argue that it is deprived of a right of access to the courts without due process of law. The Fifth Amendment to the Constitution requires due process when the federal government deprives a person of life, liberty or property. A state is not a "person" within the meaning of the Fifth Amendment. See *South Carolina v. Katzenbach*, 383 U.S. 301, 323 (1966); *In re Herndon*, 188 B.R. 562, 565 n.8 (Bankr. E.D. Ky. 1995).

188. 11 U.S.C. § 106(b).

189. See, e.g., *Schlossberg v. Maryland (In re Creative Goldsmiths, Inc.)*, 119 F.3d 1140, 1147 (4th Cir. 1997); *Rose v. U.S. Dep't of Educ. (In re Rose)*, 215 B.R. 755 (Bankr. W.D. Mo. 1997); *Grabscheid v. Michigan Employment Sec. Comm'n (In re C.J. Rogers, Inc.)*, 212 B.R. 265 (E.D. Mich. 1997); *In re NVR, L.P.*, 206 B.R. 831, 239 (Bankr. E.D. Va. 1997); see also *Harden v. Texas Dep't of Transp. (In re Aer-Aerotron, Inc.)*, 104 F.3d 677, 683 (4th Cir. 1997) (Niemeyer, J., concurring). One commentator notes that filing a proof of claim in bankruptcy may be an insufficient voluntary act by the state to constitute a waiver because the state has no alternative forum in which to collect on its claim. See S. Elizabeth Gibson, *Sovereign Immunity in Bankruptcy: The Next Chapter*, 70 AM. BANKR. L.J. 195, 212 (1996). Another flatly states that Congress does not have the power to decree that a state's filing a proof of claim constitutes a waiver of its Eleventh Amendment immunity. See *Glauberman, supra* note 117, at 89.

190. See *Brewer v. New York State Dep't of Correctional Servs. (In re Value-Added Communications, Inc.)*, 224 B.R. 354, 357 (N.D. Tex. 1998).

191. See *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2228 (1999).

192. See, e.g., *In re Straight*, 143 F.3d at 1391-92; *Texas v. Walker*, 142 F.3d 813, 820-23 (5th Cir. 1998), cert. denied, 119 S. Ct. 865 (1999); *Dekalb County Div. of Family & Children's Servs. v. Platter (In re Platter)*, 140 F.3d 676, 678-80 (7th Cir. 1998); *In re Aer-Aerotron*, 104 F.3d at 680; *Confederated Tribes v. White (In re White)*, 139 F.3d 1268, 1271 (9th Cir. 1998); *In re Fennelly*, 212 B.R. 61, 63 (D.N.J. 1997); *Schulman v. California State Water Resources Control Bd. (In re Lazar)*, 200 B.R. 358, 377 (Bankr. C.D. Cal. 1996).

193. See cases cited *supra* note 185.

194. See, e.g., *Georgia Dep't of Revenue v. Burke (In re Burke)*, 146 F.3d 1313, 1317 n.8 (11th Cir. 1998), cert. denied, 119 S. Ct. 2410 (1999); *Mather v. Oklahoma Employment Sec. Comm'n (In re Southern Star Foods, Inc.)*, 190 B.R. 419, 426 (Bankr. E.D. Okla. 1995); *In re Value-Added Communications, Inc.*, 216 B.R. at 550 (noting that the same result occurs under section 106(b) and the compulsory counterclaim test) *Burke v. Georgia (In re Burke)*, 203 B.R. 493, 497 (Bankr. S.D. Ga. 1996) (noting that "§ 106(b) may well be a correct restatement of the jurisprudence regarding waiver of Eleventh Amendment immunity").

195. See, e.g., *In re Fennelly*, 212 B.R. at 64 (holding that, irrespective of section 106, a state may consent to be sued in federal court, and filing a proof of claim constitutes consent); *Ossen v. Connecticut Dep't of Soc. Servs. (In re Charter Oaks Assocs.)*, 203 B.R. 17, 22 (Bankr. D. Conn. 1996) ("In short, because section 106[b] unambiguously alerts the states as to the consequence of filing a bankruptcy claim . . . a governmental unit that does so waives its sovereign immunity.") (quoting *WJM, Inc. v. Massachusetts Dep't of Pub. Welfare*, 840 F.2d 996, 1003 (1st Cir. 1988)); *Burke v. Georgia (In re Burke)*, 200 B.R. 282, 287 (1996); *In re Barrett Refining Corp.*, 221 B.R. 795, 810 (Bankr. W.D. Okla. 1998).

196. See *Edelman v. Jordan*, 415 U.S. 651, 673 (1974).

197. See 11 U.S.C. § 558 (1994); *Gardner v. New Jersey*, 329 U.S. 565, 573 (1947).



Waiver will likely continue to be one of the most vigorously contested issues in disputes between states and other parties to a bankruptcy proceeding. As one commentator recognized, "the doctrine of waiver of Eleventh Amendment immunity . . . provides a foothold for the efforts of bankruptcy trustees and courts to assert authority over states in the bankruptcy process, while also respecting federalism concerns."<sup>198</sup> Despite the courts' splintering, debtors and creditors, other than a state, should take comfort with what appears to be a rough majority rule—that a state waives its Eleventh Amendment immunity when it files a proof of claim, at least with respect to that claim and other claims satisfying the transaction/occurrence test.

Another limitation on the waiver doctrine, however, is that not all agents of a state have authority to waive the state's Eleventh Amendment immunity. The law of a particular state determines who has the authority to waive its Eleventh Amendment immunity,<sup>199</sup> and in many cases, state law requires an act of the state legislature to effectuate a valid waiver of immunity.<sup>200</sup> As a result, at least one court has held that since the state had not authorized a state attorney general to waive its Eleventh Amendment immunity, the attorney general's proof of claim simply was not sufficient to effect a waiver, notwithstanding section 106(b).<sup>201</sup> Moreover, a split of authority exists with respect to the question whether, even if there has been a duly authorized waiver of Eleventh Amendment immunity as a result of a proof of claim filed by one state agency or arm of a state, such a waiver eliminates Eleventh Amendment immunity just for that one agency or for the entire state and other agencies of the state.<sup>202</sup> Consonant with what constitutes a waiver, the issue whether a state official is authorized to waive Eleventh Amendment immunity and bind all other arms of the state will continue to be significant for the courts. The split in authority over these issues merely reflects the overall problem created by *Seminole Tribe*—trying to vindicate the need for a centralized, efficient, and just reorganization or distribution of resources in a context where a state, by virtue of the Supreme Court's strained interpretation of the Eleventh Amendment, can seize a preferred position.

#### D. Ex parte Young Injunctions.

Another "exception" to the Eleventh Amendment is the *Ex parte Young* doctrine.<sup>203</sup> Under *Ex parte Young*, a federal court may exercise "federal jurisdiction over a suit against a state official when that suit seeks only prospective injunctive relief in order to 'end a continuing violation of federal law.'"<sup>204</sup> Thus, although a federal bankruptcy judge presumably cannot, after *Seminole Tribe*, issue a money judgment against a state without a waiver of immunity, he or she may be able, under *Ex parte Young*, to issue a prospective injunction to enjoin state officials from violating the provisions of the Bankruptcy Code. But a prospective injunction will not be effective to recover preferences or fraudulent transfers paid into the state treasury or property transferred to the state before the commencement of a bankruptcy case or property seized by the state after the commencement of the bankruptcy case before the injunction issues.

The Court in *Seminole Tribe*, however, made it difficult to invoke the *Ex parte Young* exception.<sup>205</sup> In fact, in *Seminole Tribe* itself, the plaintiff actually had sought an injunction against the Governor of the State of Florida for prospective injunctive relief under *Ex parte Young*.<sup>206</sup> The Court, however, refused to permit even that aspect of the

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198. Goebel, *supra* note 155, at 928.

199. See *Ford Motor Co. v. Department of Treasury*, 323 U.S. 459, 467 (1945); *Magnolia Venture Capital Corp. v. Prudential Sec., Inc.*, 151 F.3d 439, 444 (5th Cir. 1998), *cert. denied*, 119 S. Ct. 1115 (1999) ("[T]he state's waiver must be accomplished by someone to whom that power is granted under state law."); Mark Browning, *Who Can Waive State Immunity*, AM. BANKR. INST. J., Jan. 15, 1997, at 10 (contending that states may only waive immunity by constitution or statute).

200. See *Gardner*, 329 U.S. at 573; *Ford Motor Co.*, 323 U.S. at 467.

201. See *Midland Mechanical Contractors, Inc. v. Board of Regents*, 200 B.R. 453, 459 (Bankr. N.D. Ga. 1996); see also *Magnolia Venture Capital Corp.*, 151 F.3d at 444, (holding that authority to waive Eleventh Amendment immunity cannot be inferred from a general authorization to enter into contracts); *Georgia Dep't of Revenue v. Burke (In re Burke)*, 146 F.3d 1313, 1318 (11th Cir. 1998), *cert. denied*, 119 S. Ct. 2410 (1999); *Mather v. Oklahoma Employment Sec. Comm'n (In re Southern Star Foods, Inc.)*, 190 B.R. 419, 426 (Bankr. E.D. Okla. 1995); *Burke v. Georgia (In re Burke)*, 203 B.R. 493, 497 (Bankr. S.D. Ga. 1996); see also *Estate of Porter v. Illinois*, 36 F.3d 684, 691 (7th Cir. 1994) (holding that under Illinois law, the state attorney general is not authorized to waive Eleventh Amendment immunity in a non-bankruptcy context).

202. Compare *Wyoming Dep't of Transp. v. Straight (In re Straight)*, 143 F.3d 1387, 1390 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 446 (1998) (holding that the waiver on behalf of one state agency constitutes a waiver for all state agencies), *Brewer v. New York State Dep't of Correctional Servs. (In re Value-Added Communications, Inc.)*, 216 B.R. 547, 549 (Bankr. N.D. Tex. 1997) (same), and *Ossen v. Connecticut Dep't of Soc. Servs. (In re Charter Oak Assocs.)*, 203 B.R. 17, 22 (Bankr. D. Conn. 1996) (same), with *Schulman v. California State Water Resources Control Bd. (In re Lazar)*, 200 B.R. 358, 378 (Bankr. C.D. Cal. 1996) (holding waiver limited to waiving agency), and *Rocchio & Sons, Inc. v. Rhode Island Dep't of Transp. (In re Rocchio & Sons, Inc.)*, 165 B.R. 86, 88 (Bankr. D.R.I. 1994).

203. See *Ex parte Young*, 209 U.S. 123, 149 (1908).

204. *Seminole Tribe v. Florida*, 517 U.S. 44, 73 (1996) (quoting *Green v. Mansour*, 474 U.S. 64, 68 (1985)).

205. See *id.*; see ANR Pipeline Co. v. Lafaver, 150 F.3d 1178, 1189 (10th Cir. 1998), *cert. denied*, 119 S. Ct. 904 (1999). See also Gibson, *supra* note 189, at 213. Indeed, one commentator has speculated that "*Young* may not be good law for long." Glauberman, *supra* note 117, at 80.

206. See *Seminole Tribe*, 517 U.S. at 73.

plaintiff's case to proceed because "Congress ha[d] prescribed a *detailed remedial scheme* for the enforcement against a State of a statutorily created right."<sup>207</sup> Thus, the Court reasoned, Congress "chose to impose upon the state a liability that is significantly more limited than would be the liability imposed upon the State officer under *Ex parte Young*,"<sup>208</sup> and Congress therefore must have intended not to impose *Ex parte Young* liability on a state official.<sup>209</sup>

Simply put, under *Seminole Tribe*, congressional intent regarding enforcement of federal statutes against the states is important in the *Ex parte Young* context.<sup>210</sup> Specifically, with respect to bankruptcy law, the question is whether the Bankruptcy Code provides a detailed remedial scheme for the enforcement against a state of a statutorily created right.<sup>211</sup> At least one bankruptcy court has concluded that it does not,<sup>212</sup> a result that appears to be correct. Specifically, a "detailed remedial" scheme, as described by *Seminole Tribe*, exists where Congress has crafted an intricate statutory scheme that limits or prohibits potential remedies.<sup>213</sup> Although the Bankruptcy Code is certainly an intricate weaving of various policies and considerations, there is nothing in the Code that indicates Congress intended to limit or prevent certain remedies against a state or state officials.<sup>214</sup>

Moreover, the Supreme Court recently recognized yet another limitation on the use of *Ex parte Young*. In *Idaho v. Coeur d'Alene Tribe*, the Court held that the *Ex parte Young* doctrine does not apply where the requested injunctive relief implicates a state's "special sovereignty interests."<sup>215</sup> Because the ability of a state to levy and collect

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207. *Id.* at 74 (emphasis added). Under IGRA, on request of a tribe, a state is required to negotiate in good faith with a tribe to create a class III tribal-state gaming compact. See 25 U.S.C. § 2710(d)(3)(A) (1994). If the state is not responsive, the tribe may sue the state in federal district court where the state has the burden of proving that it has negotiated in good faith. See *id.* § 2710(d)(7). If the district court finds that the state has failed to negotiate in good faith, then a detailed negotiation and mediation procedure is prescribed from which a state-tribal compact must result. See *id.* § 2710(d)(7)(B). The district court is not authorized to award monetary damages or any other remedy against the state.

208. *Seminole Tribe*, 517 U.S. at 75.

209. See *id.*; see also Gibson, *supra* note 189, at 214.

210. See Gibson, *supra* note 189, at 214.

211. See *Seminole Tribe*, 517 U.S. at 75; *supra* note 210.

212. See *Guiding Light Corp. v. Louisiana Dep't of Health & Hosps. (In re Guiding Light Corp.)*, 213 B.R. 489, 492 (Bankr. E.D. La. 1997); see also Schmitt v. Missouri Western State College (*In re Schmitt*), 220 B.R. 68, 79 (Bankr. W.D. Mo. 1998). As one commentator noted, the statutory scheme in *Seminole Tribe* is distinguishable from the bankruptcy enforcement mechanism because in *Seminole Tribe*, the IGRA permitted only substantially limited relief against a state in federal court. More importantly, Congress had established a "system of mediation and possible intervention by the Secretary of the Interior." Gibson, *supra* note 197, at 215. The Bankruptcy laws do not substantially limit relief in federal court; if anything, the opposite is true. See 11 U.S.C. § 105(a); cf. *Ellis v. University of Kan. Med. Ctr.*, 163 F.3d 1186, 1198 (10th Cir. 1998) (Congress did not craft a detailed remedial scheme when it enacted 42 U.S.C. § 1981 because there was "nothing in § 1981 that shows Congress intended to limit or bar remedies generally available to an aggrieved party."). Although the United States Trustee has standing to be heard on any bankruptcy matter, the Trustee's standing flows from the need to protect the rights of the United States and not, like the Secretary of the Interior, to facilitate a specific mediation between a Native American tribe and a state. See 25 U.S.C. § 2710(d)(7)(B)(iii)-(v).

213. See *ANR Pipeline Co. v. Lafaver*, 150 F.3d 1178, 1192 (10th Cir. 1998). In *ANR Pipeline*, the Tenth Circuit considered the issue of whether the Tax Injunction Act, 28 U.S.C. § 1341, was a "detailed remedial scheme" that precluded use of the *Ex parte Young* doctrine. See *ANR Pipeline*, 150 F.3d at 1188. The court held the Tax Injunction Act was a "detailed remedial scheme" under *Seminole Tribe* because Congress expressly limited the power of federal courts to issue certain types of remedies pertaining to the assessment, levy or collection of state taxes. See *id.* at 1191.

214. Although section 362(a) is an automatic stay against creditors, it is not a limit on the debtor's remedies, except perhaps for section 362(h), which grants individual debtors detailed remedies for willful violations of the stay. "An individual injured by any willful violation of a stay provided by [section 362] shall recover actual damages, including costs and attorneys' fees, and in appropriate circumstances, may recover punitive damages." 11 U.S.C. § 362(h); cf. *Pinkstaff v. United States (In re Pinkstaff)*, 974 F.2d 113 (9th Cir. 1992) (explaining that if the United States waives sovereign immunity, an individual debtor can assert a compulsory counterclaim for actual damages under section 362(h)). Nor is there a detailed remedial scheme in section 105 of the Code. It provides in relevant part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). In enacting section 105, Congress intended to not limit, but expand, remedies available to aggrieved parties. "[A]lthough the waters may have been muddied a bit, it appears to continue to be permissible to sue state officials in the bankruptcy court in their official capacities to prevent future violations of the bankruptcy laws." Gibson, *supra* note 189, at 215.

215. *Idaho v. Coeur d'Alene Tribe*, 521 U.S. 261, 281 (1997); *id.* at 289 (O'Connor, J., concurring). In *Coeur d'Alene*, a Native-American tribe sought a declaratory judgment against the State of Idaho establishing the Tribe's right to quiet enjoyment over submerged lands located in Idaho as well as prospective injunctive relief against state officials to prevent them from exercising the state's asserted regulatory jurisdiction over the lands. *Id.* at 265-66. The Court held that *Ex parte Young* may not be used when the requested injunctive relief was "functional[ly] equivalent" to an award of money damages: "[i]t is apparent . . . that if the Tribe were to prevail, Idaho's sovereign interest in its land and waters would be affected in a degree fully as intrusive as almost any conceivable retroactive levy upon funds in its Treasury." *Id.* at 287. Moreover, in *Coeur d'Alene*, two Justices further attempted to limit the *Ex parte Young* doctrine by imposing a case-by-case, fact-specific inquiry into whether (a) an available forum existed to vindicate the federal rights at issue, and (b) the matter involves the interpretation of novel questions of important federal law. *Id.* at 270. A majority of the Court, however, held that the appropriate inquiry under *Ex parte Young* remains "a straightforward inquiry into whether the complaint alleges an ongoing violation of federal law and seeks relief properly characterized as prospective." *Id.* at 296 (O'Connor, Scalia, & Thomas, JJ., concurring in part); *id.* at 298-99 (Souter, Stevens, Ginsberg, & Breyer, JJ., dissenting); see also *Earles v. State Bd. of Certified Pub. Accountants*, 139 F.3d 1033, 1039 (5th Cir. 1998), *cert. denied*, 119 S. Ct. 444 (1998); *Doe v. Lawrence Livermore Nat'l Lab.*, 131 F.3d 836, 839 (9th Cir. 1997). However, a 5-4 majority in *Coeur d'Alene* recognized the special sovereignty interest exception to *Ex parte Young*. See *Coeur d'Alene*, 521 U.S. at 269 (Kennedy, Rehnquist, O'Connor, Scalia, & Thomas, JJ.). At least one circuit has stated that *Coeur d'Alene* places a new limitation on the application of *Ex parte Young*. See *ANR*

taxes is a "special sovereignty interest,"<sup>216</sup> prospective injunctive relief in bankruptcy, granted pursuant to the *Ex parte Young* doctrine, might conceivably implicate a state's "special sovereignty interest" in its power to levy and collect taxes and therefore be inapplicable.<sup>217</sup> On the other hand, because Congress has created exclusive jurisdiction over property of the estate in the federal district courts,<sup>218</sup> a court could conclude that the state's sovereignty interest does not extend to the federally created bankruptcy estate.<sup>219</sup>

#### E. The In Rem Exception

Bankruptcy courts have exclusive *in rem* jurisdiction "of all property, wherever located, of the debtor as of the commencement of [the bankruptcy case], and of property of the estate."<sup>220</sup> Such *in rem* jurisdiction enables bankruptcy courts to determine the claims and interests in and to property of the estate,<sup>221</sup> including the claims and interests of a state in and to such property notwithstanding a state's assertion of Eleventh Amendment immunity.<sup>222</sup> The reason for this is that, unlike an adversary proceeding that causes the bankruptcy court "to issue process summoning the state to appear," the exercise of *in rem* jurisdiction simply is not a "suit against one of the United States by a private party."<sup>223</sup> Rather, it is a "suit," if at all, against the property itself.

*Maryland v. Antonelli Creditors' Liquidating Trust*<sup>224</sup> is a good example of this concept. In that case, the State of Maryland and two local counties brought suit in state court to collect taxes on transfers of estate property made pursuant to a confirmed plan of reorganization and the bankruptcy court's confirmation order, which exempted the relevant transfers from state taxes.<sup>225</sup> Although the state taxing authorities had received adequate notice of the bankruptcy case, they declined to participate by filing a proof of claim or otherwise.<sup>226</sup> After the case was removed to federal court, the taxing authorities asserted that the Eleventh Amendment barred the bankruptcy court from exercising jurisdiction over them in the confirmation proceeding and that, as a result, its confirmation order could not and did not bind the taxing authorities to the plan.<sup>227</sup>

The Court of Appeals for the Fourth Circuit rejected the state's argument. Among other things, the court reasoned that a confirmation order "was not entered in a suit 'against one of the United States' filed by a private party,"<sup>228</sup> and that the power to enter a confirmation order was derived, not from jurisdiction over a state or creditors, but rather from jurisdiction over the debtor and the property of its estate.<sup>229</sup> Thus, a party's status or assertion of

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*Pipeline*, 150 F.3d at 1193; see also James E. Pfander, *An Intermediate Solution to State Sovereign Immunity: Federal Appellate Court Review of State-Court Judgments After Seminole Tribe*, 46 UCLA L. REV. 161, 188 (1998).

216. See *ANR Pipeline*, 150 F.3d at 1194 ("The [appellants'] request to rewrite Kansas' property tax code with respect to its application against the personal property of natural gas pipelines is certainly a major intrusion into Kansas' special sovereignty interests.").

217. See, e.g., 11 U.S.C. § 362(a) (the automatic stay); 11 U.S.C. § 505 (determination of tax liability).

218. See 28 U.S.C. § 1334(e) (1994).

219. Like the federal government, see U.S. CONST. art. I, § 8, cl. 1, states have the power to lay and collect taxes. The power to tax is a critical function of government, see *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 428 (1819), and the issue whether a state may levy a tax has formed the substance of one of American jurisprudence's most recognized statements in one of its most famous cases. *Id.* at 431 ("That the power to tax involves the power to destroy.").

220. 28 U.S.C. § 1334(e); see also *Maryland v. Antonelli Creditors' Liquidating Trust*, 123 F.3d 777, 787 (4th Cir. 1997); *O'Brien v. Vermont Agency of Natural Resources (In re O'Brien)*, 216 B.R. 731, 737 (Bankr. D. Vt. 1998). Section 1334(e) was intended to eliminate jurisdictional disputes arising from the equity principle that makes *in rem* jurisdiction over an item of property exclusive in the first court to assert jurisdiction over it. A creditor might file a lien against property of the debtor in a court in State A and shortly afterward the debtor might declare bankruptcy in State B. Control over the debtor's property would be shared by the court in A and the bankruptcy court in B—it might even be the same piece of property. . . . Section 1334(d) gives the bankruptcy court control of all the property. Creditors who want to enforce their liens have to do so in that court regardless of the location of the creditor or the property.

*In re United States Brass Corp.*, 110 F.3d 1261, 1268 (7th Cir. 1997).

221. See *In re O'Brien*, 216 B.R. at 737 (quoting JAMES WM. MOORE ET AL., 16 MOORE'S FED. PRACTICE 108-06 (3d ed. 1997)):

Our *in rem* jurisdiction over property of the debtor and the estate empowers us "to determine all claims that anyone, whether named in the action or not, has to the property or thing in question. The proceeding is one 'against the world.' The practical effect of such an action is to establish unquestionable title to the property because no one can later claim exemption from the effect of the judgment on the ground that the court lacked jurisdiction.

222. See *Antonelli*, 123 F.3d at 786. *But see French v. Georgia Dep't of Revenue (In re ABEPP Acquisition Corp.)*, 215 B.R. 513, 517 (B.A.P. 6th Cir. 1997) (holding that Eleventh Amendment immunity applied to a debtor's adversary proceeding to recover prepetition tax payments, noting (questionably) that the debtor "has not alleged that the 3% tax remained an identifiable res").

223. *Antonelli*, 123 F.3d at 786-87; see *supra* Part III.B.

224. *Antonelli*, 123 F.3d 777.

225. See 11 U.S.C. § 1146(c) (1994) ("the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title[ ] may not be taxed under any law imposing a stamp tax or similar tax").

226. See *Antonelli*, 123 F.3d at 780.

227. See *id.* at 786.

228. *Id.*; see *supra* Part III.B. If, however, the debtor pays transfer taxes and sues the state to recover the transfer taxes, the state may assert Eleventh Amendment immunity to bar the suit. See *NVR Homes, Inc. v. Clerks of the Circuit Courts (In re NVR, LP)*, Nos. 98-2211, 98-2244, 98-2271, 98-2272, 98-2273, 1999 U.S. App. LEXIS 15499, at \*18-27 (4th Cir. July 12, 1999).

229. See *Antonelli*, 123 F.3d at 786.

immunity had no bearing "on the bankruptcy court's power to determine whether the terms of a reorganization plan comply with federal law."<sup>230</sup>

The court further noted that, if the state wanted to challenge a bankruptcy court's order of which it had notice, it could waive Eleventh Amendment immunity and submit to federal jurisdiction.<sup>231</sup> Recognizing that such may present a Hobson's choice for the states, the court noted that the choice resulted from "Congress' constitutionally authorized legislative power to make federal courts the exclusive venue for administering the bankruptcy law."<sup>232</sup>

The Supreme Court recently examined the *in rem* "exception" to Eleventh Amendment immunity in *California and State Lands Commission v. Deep Sea Research, Inc.*,<sup>233</sup> which was decided after *Seminole Tribe*. In *Deep Sea Research*, the Court held that, at least in cases where a state does not have actual possession of the vessel at issue, the Eleventh Amendment does not preclude a suit pursuant to the federal courts' *in rem* admiralty jurisdiction<sup>234</sup> to determine title to an abandoned shipwreck, even where the state is one of the potential title holders.<sup>235</sup>

Given that result, and the Fourth Circuit's reasoning in *Antonelli*, states may be unable to raise their Eleventh Amendment immunity to avoid the application of orders entered generally in a bankruptcy case, such as, for example, orders confirming a plan of reorganization, orders authorizing the sale of property of the estate, or, perhaps, orders enforcing the automatic stay.<sup>236</sup> As long as the order pertains to property of the bankruptcy estate, the Eleventh Amendment should not be an obstacle to its enforcement where the debtor is in possession of the property.<sup>237</sup>

However, as with those cases that hold that bankruptcy cases generally are not "suits" within the meaning of the Eleventh Amendment,<sup>238</sup> the scope of this *in rem* "exception" is not limitless. In fact, the Supreme Court specifically has held that an *in rem* jurisdictional basis, standing alone, does not provide authorization for the issuance of process directly against a state:

The fact that a suit in a federal court is *in rem*, or *quasi in rem*, furnishes no ground for the issuance of process against a non-consenting State . . . [W]hen the State does not come in and withholds its consent, the court has no authority to issue process against the State to compel it to subject itself to the court's judgment, whatever the nature of the suit.<sup>239</sup>

Moreover, the Court specifically has noted, in the bankruptcy context, that "we have never applied an *in rem* exception to the sovereign-immunity bar against *monetary recovery*, and have suggested that no such exception

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230. *Id.* at 787.

231. *See id.*

232. *Id.*; *see also* *O'Brien v. Vermont Agency of Natural Resources (In re O'Brien)*, 216 B.R. 731, 737 (Bankr. D. Vt. 1998) ("The Eleventh Amendment is not violated, because [the state] cannot be compelled to appear and defend. It can choose to stay home."); *Schulman v. California State Water Resources Control Bd. (In re Lazar)*, 200 B.R. 358, 380 (Bankr. C.D. Cal. 1996) (The fact that a state "finds these choices unattractive does not convert the choice into an involuntary decision: if this were so, many of the choices that people make in many different contexts of life would be 'involuntary,' and some people could live virtually their entire lives without making any voluntary choices at all."); *cf.* *New Jersey v. Mocco*, 206 B.R. 691, 693 (D.N.J. 1997) ("The very object and purpose of the [Eleventh] Amendment [is] to prevent the indignity of subjecting a State to the coercive process of judicial tribunals at the instance of private parties . . . . In the present case, the state is not a defendant and, as such, cannot invoke the protection of the Eleventh Amendment."). The question of a compulsory waiver of immunity is developed more fully *supra* notes 179-94 and accompanying text.

233. *California & State Lands Comm'n v. Deep Sea Research, Inc.*, 118 S. Ct. 1464 (1998).

234. *See* 28 U.S.C. § 1333(1) (1994). Federal admiralty jurisdiction encompasses "maritime causes of action begun and carried on as proceedings *in rem*, that is, where a vessel or thing itself is treated as the offender and made the defendant by name or description in order to enforce a lien." *Madruga v. Superior Court*, 346 U.S. 556, 560 (1954). Even though suits in admiralty are not suits in "law or equity," the Supreme Court has applied the Eleventh Amendment to admiralty suits generally. *See Ex parte New York*, 256 U.S. 490, 498 (1921).

235. *See Deep Sea Research*, 118 S. Ct. at 1472. Four concurring Justices in *Deep Sea Research* (Justices Stevens, Kennedy, Ginsburg, and Breyer) indicated that they would reach the same result regardless of whether the property at issue was in the possession of the state. *Id.* at 1473-74 (Stevens, J., concurring); *id.* at 1474 (Kennedy, Ginsburg, & Breyer, JJ., concurring).

236. For example, the *in rem* theory has been applied to a discharge order, which was subsequently used as an affirmative defense against a state in state court, *see Texas v. Walker*, 142 F.3d 813, 820-22 (5th Cir. 1998), *cert. denied*, 119 S. Ct. 865 (1999), and an adjudication of dischargeability where the state filed an adversary proceeding. *See Dekalb County Div. of Family & Children's Servs. v. Platter (In re Platter)*, 140 F.3d 676, 679-80 (7th Cir. 1998).

237. The *in rem* exception is not necessarily limited only to those circumstances where the debtor possesses the property, as long as the state does not have possession. In *Bouchard Transportation Co. v. Updegraff*, the court, interpreting *Deep Sea Research*, held that a state is not entitled to Eleventh Amendment immunity where the plaintiff neither named the state in a suit or served the state with process and the *res* was in the possession of the court. *Bouchard Transp. Co. v. Updegraff*, 147 F.3d 1344, 1349 (11th Cir. 1998) ("Florida does not have possession of the disputed *res*—the [res is] part of the record in this case, currently in the possession of the federal judiciary.").

238. *See supra* notes 161-70 and accompanying text.

239. *Missouri v. Fiske*, 290 U.S. 18, 28 (1933); *see also O'Brien v. Vermont Agency of Natural Resources (In re O'Brien)*, 216 B.R. 731, 737 (Bankr. D. Vt. 1998) (citing *Freeman v. Alderson*, 119 U.S. 185, 189 (1886) ("[N]o personal liability . . . can be created against the absent [state]; the power of the court being limited to the disposition of the property, which is alone within its jurisdiction").

exists."<sup>240</sup> As a result, the *in rem* nature of bankruptcy cases and proceedings likely does not enable a trustee or debtor in possession to bring affirmative causes of action for monetary recovery, such as preference or fraudulent conveyance actions, against a state in bankruptcy court absent the state's consent. It is unclear whether the trustee or debtor in possession can obtain an order requiring the state to turn over property of the estate in the state's possession.

Finally, following *Alden*, it is not clear that the *in rem* "exception" or, indeed, any limitation of state immunity based upon the text of the Eleventh Amendment, retains any practical viability whatsoever. If, as discussed above,<sup>241</sup> *Alden* means that the Court now has enshrined common law sovereign immunity with Constitutional status and essentially rendered the Eleventh Amendment underinclusive and redundant,<sup>242</sup> the *in rem* doctrine simply has no further applicability because, unlike the Eleventh Amendment, the common law doctrine of sovereign immunity is not limited merely to "suits in law or equity." If not limited to "suits," the foundations of the *in rem* doctrine fall away, leaving *Alden's* concept of constitutional common law sovereign immunity to preclude *all* actions that affect non-consenting states, even those that may not be deemed to be "suits" within the meaning of the Eleventh Amendment.

#### F. The Takings Clause

The Fifth Amendment Takings Clause presents an intriguing constitutional possibility in overcoming a state's Eleventh Amendment defense. The Clause provides: "nor shall private property be taken for public use, without just compensation."<sup>243</sup> A person who is deprived of a vested legal cause of action by the government<sup>244</sup> is deprived of property and must be justly compensated.<sup>245</sup> Courts have held that the United States may not assert its sovereign immunity as a defense to a Takings Clause claim.<sup>246</sup> By asserting a sovereign immunity defense, the state acts to deprive a debtor's estate of vested legal causes of action, such as preferences and fraudulent conveyances, for money damages.

Prior to *Alden*, the Takings Clause argument stopped short of success. If the state itself provided a forum for compensation, there could be no impermissible taking of private property, and as a result, a state could continue to assert an Eleventh Amendment immunity defense. In *Harbert International, Inc. v. James*, the plaintiff asserted a Fifth Amendment "takings" claim for money damages against state officials, alleging the state's failure to make payments and perform contractual duties in connection with the construction of a bridge constituted a taking without just compensation.<sup>247</sup> The state asserted the Eleventh Amendment as a bar to federal court jurisdiction.<sup>248</sup> The Court of Appeals for the Eleventh Circuit agreed that the state could assert the Eleventh Amendment defense because "Alabama state courts do provide Harbert with a means of redress for its claim."<sup>249</sup> Thus, if the state provides a forum in which it may be sued, there is no taking of a debtor's estate's cause of action for money damages.

*Alden* dramatically changes the analysis. By allowing a state to use sovereign immunity to defeat federal claims brought in state courts, unless the state has consented to suit, *Alden* leaves parties with no ability to seek a money damages remedy for the deprivation of a federal right. The practical effect of leaving no forum to enforce vested causes of action is to deprive the parties possessing those actions of "property" without just compensation. Takings claims could be legitimate options for parties seeking to enforce their bankruptcy rights against those states that have not consented to be sued in state courts.<sup>251</sup>

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240. *United States v. Nordic Village, Inc.*, 503 U.S. 30, 38 (1992) (emphasis added).

241. *See supra* Part II.C.

242. *See supra* notes 68-78 and accompanying text.

243. U.S. CONST. amend. V.

244. The Takings Clause applies to both the federal government and, through the Fourteenth Amendment, the states. *See, e.g., Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 160 (1980). *See also infra* note 251.

245. *See Alliance of Descendants of Tex. Land Grants v. United States*, 37 F.3d 1478, 1481 (Fed. Cir. 1994) (explaining that a legal cause of action is property within the meaning of the Fifth Amendment.); *cf. McGrath v. Rhode Island Retirement Bd.*, 906 F. Supp. 749, 769 (D.R.I. 1995) ("Contract rights are as much private property under the Takings Clause as they are under the Due Process Clause.").

246. *See Arnsberg v. United States*, 757 F.2d 971, 980 n.7 (9th Cir. 1985) ("Actions brought under the taking clause of the fifth amendment are, of course, an exception to the rule that sovereign immunity is a bar to damages against the United States for direct constitutional violations.").

247. *See Harbert Int'l, Inc. v. James*, 157 F.3d 1271, 1274 (11th Cir. 1998).

248. *See id.* at 1276.

249. *Id.* at 1277.

250. Any "Takings" claim must first exhaust existing state law "just compensation" remedies. *See Suitum v. Tahoe Reg. Planning Agency*, 520 U.S. 725, 734 (1997). Usually a takings claimant will need to show an exhaustion of state "inverse condemnation" causes of action. *See id.* at 734 n.8 ("Ordinarily, a plaintiff must seek compensation through state inverse condemnation proceedings before initiating a takings suit in federal court, unless the state does not provide adequate remedies for obtaining compensation."); *see also Villas of Lake Jackson, Ltd. v. Leon County*, 121 F.3d 610, 612 (11th Cir. 1997). If a state does not provide a forum for bringing inverse condemnation claims against the state, either by failing to provide a cause of action by statute or through assertion of constitutional sovereign immunity, then the exhaustion prerequisite has been satisfied. *See Suitum*, 520 U.S. at 734 n.8.

The Takings claim will fail, however, for the simple reason that in order to enforce the Takings Clause against a state, a party must rely on the Fourteenth Amendment.<sup>251</sup> But the Fourteenth Amendment by itself does not abrogate a state's immunity<sup>252</sup> and the current statutory vehicle for bringing such a claim, section 1983 of title 42, does not abrogate a state's sovereign immunity.<sup>253</sup>

#### V. CONGRESS MAY EXERCISE POWER TO LIMIT THE IMPACT OF *SEMINOLE TRIBE*, *ALDEN*, AND THE ELEVENTH AMENDMENT

As explained above,<sup>254</sup> the Supreme Court's construction of the Eleventh Amendment under *Seminole Tribe* and establishment of the new constitutional sovereign immunity doctrine under *Alden* risk undermining the paramount bankruptcy policies of a debtor's discharge and "fresh start," and of the fair and equitable distribution of the estate's assets to creditors. Indeed, at its most basic level, *Seminole Tribe's* and *Alden's* discovery of a constitutional right to sovereign immunity undermines essential aspects of bankruptcy law by elevating states to preferred positions relative to other creditors. Except to any extent the states consent to be sued, states appear to be free to infringe upon the bankruptcy rights of other parties without fear of suit for money damages in any court.<sup>255</sup>

Moreover, as noted above, the existing options to ameliorate the effects of constitutional sovereign immunity are only of limited effectiveness in the bankruptcy context. As a result, Congress should consider enacting legislation to neutralize some of the deleterious effects of the Supreme Court's decisions, and this Article sets forth five potential avenues that Congress could explore.<sup>256</sup> First, Congress could purport to re-enact section 106(a) of the Bankruptcy Code pursuant to its powers under the Fourteenth Amendment. Second, Congress could authorize United States trustees, and possibly private trustees or debtors-in-possession, to sue states for bankruptcy causes of action in the name of the United States. Third, Congress could amend the Bankruptcy Code to provide for a standing injunction against state officials pursuant to the *Ex parte Young* doctrine. Fourth, Congress could amend the Bankruptcy Code to provide for disallowance of a state's claim, unless the state waived sovereign immunity and Eleventh Amendment immunity regarding the claim and compulsory counterclaims. Fifth, Congress could encourage a waiver of Eleventh Amendment immunity through conditions to the receipt of federal funds.

#### A. Reenactment Under the Fourteenth Amendment

Because legislation enacted pursuant to the Section 5 of the Fourteenth Amendment may abrogate a state's Eleventh Amendment immunity<sup>257</sup> or sovereign immunity,<sup>258</sup> Congress conceivably could purport to reenact section 106(a) under the guise of its Fourteenth Amendment Enforcement Clause authority.<sup>259</sup> The reenacted section 106(a), however, likely would fail as an unconstitutional abrogation of Eleventh Amendment and sovereign immunity, notwithstanding the nominal imprimatur of the Fourteenth Amendment, except perhaps for legislation enacted under the Due Process Clause.

On its face, legislation enacted pursuant to the Fourteenth Amendment must be rationally related to recognized Fourteenth Amendment aims.<sup>260</sup> However, bankruptcy is not connected to the traditional Fourteenth Amendment purposes of preventing discrimination against individuals on the basis of suspect classifications like

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251. The Fifth Amendment, according to its literal language, applies only to the federal government. However, the substantive protections of the Fifth Amendment are applied to the states through the Fourteenth Amendment. See *Chicago, Burlington & Quincy R.R. Co. v. Chicago*, 166 U.S. 226, 236 (1897).

252. See *Alabama v. Pugh*, 438 U.S. 781, 782 (1978).

253. See *Quern v. Jordan*, 440 U.S. 332, 340 (1979). Of course Congress could abrogate the states' immunity for section 1983 actions or enact other appropriate legislation to redress monetarily the wrongs asserted under the Takings Clause. See *Garrett v. Illinois*, 612 F.2d 1038, 1040 (7th Cir. 1980). We address this point further in Part IV.A.

254. See *supra* notes 4-12 and accompanying text.

255. *Alden* asserts that the fear of the unrestrained state is without merit:

We are unwilling to assume the States will refuse to honor the Constitution or obey the binding laws of the United States.

The good faith of the States thus provides an important assurance that "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land."

*Alden v. Maine*, 119 S. Ct. 2240, 2266 (1999) (quoting U.S. CONST. art. VI.).

256. Other commentators have analyzed congressional options after *Seminole* with respect to a broader range of federal regulatory issues. See, e.g., Glauberman, *supra* note 125, at 100-16 (discussing conditional spending power, suit by the United States, and amendment of exclusive jurisdiction statutes); Meltzer, *supra* note 114, at 49-61 (discussing Section 5 of the Fourteenth Amendment, conditional spending power, and suit by the United States).

257. See *Seminole Tribe v. Florida*, 517 U.S. 44, 65-66 (1996); *Fitzpatrick v. Bitzer*, 427 U.S. 445, 456 (1976).

258. See *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2224 (1999) (reaffirming the test to abrogate state sovereign immunity set forth in *City of Boerne v. Flores*, 521 U.S. 507, 519 (1997)).

259. Congress is not required to expressly state that it enacts legislation pursuant to the Fourteenth Amendment. See *EEOC v. Wyoming*, 460 U.S. 226, 243 n.18 (1983); *Crawford v. Davis*, 109 F.3d 1281, 1283 (8th Cir. 1997). Section 5 of the Fourteenth Amendment empowers Congress to enforce any provision of the Fourteenth Amendment to achieve its ends. See, e.g., *United States v. Price*, 383 U.S. 787, 789 (1966).

260. See *Flores*, 521 U.S. at 532; *Velasquez v. Frapwell*, 160 F.3d 389, 391 (7th Cir. 1998); *Wilson-Jones v. Caviness*, 99 F.3d 203, 208 (6th Cir. 1996).

race or gender.<sup>261</sup> As noted above,<sup>262</sup> some cases attempt to link section 106(a), through the Privileges and Immunities Clause,<sup>263</sup> with recognized Fourteenth Amendment aims. The better reasoned view, however, is that bankruptcy is not a privilege or immunity of national citizenship that is protected by the Fourteenth Amendment.<sup>264</sup> Indeed, the Supreme Court has determined there is no constitutional right to a bankruptcy discharge,<sup>265</sup> one fundamental feature of the federal bankruptcy laws.

More importantly, the Privileges and Immunities Clause has been rendered of little use in this context due to the Supreme Court's century-old decision in the *Slaughter-House Cases*, in which the Court determined that the Privileges and Immunities Clause protects only rights "which owe their existence to the Federal government, its National character, its Constitution, or its laws."<sup>266</sup> The Court's list of recognized privileges and immunities under that standard is very limited,<sup>267</sup> and, notwithstanding the Court's recent decision in *Saenz v. Roe*, the Court is unlikely to "discover" a new bankruptcy-related right that falls within the scope of the Fourteenth Amendment, as noted recently by a bankruptcy court:

Against such a backdrop, this court can conceive of no ground which might warrant the "discovery" of a bankruptcy privilege in the Fourteenth Amendment. Although the United States Department of Justice has referred to the "right to obtain a fresh start" as belonging to the national citizenry . . . no authority has been cited as elevating that right to constitutional status.<sup>268</sup>

Thus, legislation that merely reenacts section 106(a) with an express statement that the stated abrogation of state Eleventh Amendment and sovereign immunity is achieved pursuant to the Fourteenth Amendment is unlikely to survive judicial scrutiny.<sup>269</sup>

The *Velasquez v. Frapwell*<sup>270</sup> case provides a good analogy. In *Velasquez*, the Seventh Circuit considered whether the Uniformed Services Employment and Reemployment Rights Act ("USERRA")<sup>271</sup> was enacted pursuant to Section 5 of the Fourteenth Amendment to permit suits against a state in federal court without running afoul of the Eleventh Amendment.<sup>272</sup> The court held that Section 5 of the Fourteenth Amendment did not provide the constitutional basis for enacting USERRA because the statute was too remotely connected to the policies of the Fourteenth Amendment.<sup>273</sup> Courts probably would reach a similar result if Congress purported to reenact the Bankruptcy Code under Section 5 of the Fourteenth Amendment.

Although Congress cannot rely on the Equal Protection Clause and the Privileges and Immunities Clause as a means of reenacting section 106(a), the *Florida Prepaid* decision leaves some room for Congress to abrogate a state's Eleventh Amendment immunity for bankruptcy purposes to further the protections guaranteed by the Fourteenth Amendment's Due Process Clause. In *Florida Prepaid*, College Savings Bank was the owner of a patent for a

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261. See *Wilson-Jones*, 99 F.3d at 210. A court must apply three factors to determine whether a congressional enactment is pursuant to the Equal Protection Clause of the Fourteenth Amendment: (1) whether the statute was enacted to enforce the Equal Protection Clause; (2) whether it is "plainly adapted to that end"; and (3) whether it is consistent with the "letter and spirit of the constitution." *Katzenbach v. Morgan*, 384 U.S. 641, 651 (1966).

262. See *supra* notes 129-33 and accompanying text.

263. "The citizens of each State shall be entitled to all privileges and immunities of citizens in the several States." U.S. CONST. art. IV, § 2, cl. 1.

264. See U.S. CONST. art IV, § 2, cl. 14; *Kish v. Verniere (In re Kish)*, 212 B.R. 808, 817 (D.N.J. 1997) (holding that bankruptcy does not constitute a privilege or immunity under the Fourteenth Amendment, and criticizing contrary cases for failing to consider, under the "privileges and immunities" theory, whether section 106(a) was enacted for remedial or preventive purposes). Moreover, in order to fall within the scope of the Fourteenth Amendment, bankruptcy itself would have to be a privilege or immunity because "the judiciary has recognized that the 'privileges and immunities of national citizenship do not . . . encompass the right to have a federal question heard in a federal forum.'" *In re NVR, L.P.*, 206 B.R. 831, 841 n.23 (Bankr. E.D. Va. 1997) (quoting *Carr v. Axelrod*, 798 F. Supp. 168, 172 (S.D.N.Y. 1992)).

265. See *United States v. Kras*, 409 U.S. 434, 446-47 (1973).

266. *The Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 79 (1873); see *In re NVR, L.P.*, 206 B.R. at 842.

267. These include: the right to become a citizen of the state in which a citizen of the United States resides, see *Saenz v. Roe*, 119 S. Ct. 1518, 1530 (1999); the right to take and hold real property, see *Oyama v. California*, 332 U.S. 633, 640 (1948); the right to carry on interstate commerce, see *Crutcher v. Kentucky*, 141 U.S. 47, 56 (1891); the right to be free from violence while in the lawful custody of a United States marshal, see *Logan v. United States*, 144 U.S. 263, 266 (1892); the right to vote in national elections, see *The Ku-Klux Cases*, 110 U.S. 651, 664 (1884); the right to enter the public lands, see *United States v. Waddell*, 112 U.S. 76, 79 (1884); the right to petition Congress for redress of grievances, see *United States v. Cruikshank*, 92 U.S. 542, 552 (1875); the right to pass freely from state to state, see *Crandall v. Nevada*, 73 U.S. (6 Wall.) 35, 49 (1867); and the right to inform federal officials of violations of federal law, see *In re Quarles*, 158 U.S. 532, 537 (1895).

268. *In re NVR, L.P.*, 206 B.R. at 842.

269. Indeed, at least one court has warned that allowing Congress to enact bankruptcy law pursuant to Section 5 of the Fourteenth Amendment would "render Eleventh Amendment state sovereign immunity meaningless and eviscerate the fundamental construct of federalism in our constitutional form of government." *In re Fernandez*, 123 F.3d 241, 245 (5th Cir. 1997).

270. *Velasquez v. Frapwell*, 160 F.3d 389, 391 (7th Cir. 1998).

271. 38 U.S.C. §§ 4301-4333 (1994).

272. See *Frapwell*, 160 F.3d at 391.

273. See *id.* (noting that military personnel are not members of a discrete or insular minority)



methodology for the financing of future college expenses.<sup>274</sup> It brought suit against the Florida Prepaid Postsecondary Education Expense Board (the "Board"), alleging the Board infringed upon College Savings Bank's patent.<sup>275</sup> By the time College Savings Bank had brought its suit, Congress had enacted the Patent and Plant Variety Protection Remedy Clarification Act ("Patent Remedy Act"),<sup>276</sup> which purported to subject states to suit in federal court for infringements of patents.<sup>277</sup> The Board, which the Court concluded was an "arm of the State" of Florida,<sup>278</sup> asserted that congressional abrogation of its Eleventh Amendment immunity was unconstitutional under *Seminole Tribe*. The Court of Appeals for the Federal Circuit rejected the immunity defense, reasoning that patents are property subject to the protections of the Due Process Clause and that Congress's "objective in enacting the Patent Remedy Act was permissible because it sought to prevent states from depriving patent owners of this property without due process."<sup>279</sup> The Supreme Court reversed the Court of Appeals, holding that the Patent Remedy Act was not legislation appropriately enacted under Section 5 of the Fourteenth Amendment. In order for legislation to be "appropriate" under Section 5, Congress "must identify conduct transgressing the Fourteenth Amendment's substantive provisions, and must tailor its legislative scheme to remedying or preventing such conduct."<sup>280</sup> The Patent Remedy Act failed to meet *Florida Prepaid's* test because, in legislating the Act, Congress failed to consider the availability of state remedies for patent infringement, and the Act failed to detail a history of widespread and persisting deprivation of property rights "of the sort Congress has faced in enacting proper prophylactic § 5 legislation."<sup>281</sup> This lack of information made the abrogation provisions of the Patent Remedy Act "so out of proportion to a supposed remedial or preventive object that [they] cannot be understood as responsive to, or designed to prevent, unconstitutional behavior."<sup>282</sup>

But *Florida Prepaid* expressly accepts the proposition that Congress can abrogate a state's sovereign immunity in order to vindicate property rights protected under the Due Process Clause. The Court stated: "if the Due Process Clause protects patents, we know of no reason why Congress might not legislate against their deprivation without due process under § 5 of the Fourteenth Amendment."<sup>283</sup> Bankruptcy concerns property rights that are protected by the Due Process Clause.<sup>284</sup> Thus, Congress could re-enact the Bankruptcy Code pursuant to Section 5 of the Fourteenth Amendment if Congress can show a widespread and persistent pattern of state deprivations of property rights protected under the Bankruptcy Code. Given the numerous times states have been found to violate the automatic stay, one of many instances of potential state abuse, it seems fairly simple for Congress to establish such a pattern.<sup>285</sup>

Additionally, Congress could reenact section 1983 of title 42 to provide for abrogation of the states' sovereign immunity. Such abrogation would allow takings claims to proceed in federal court against a state for money damages.<sup>286</sup> Although a takings claim will not lie if a state has provided a forum in state court, at least with

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274. See *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2201 (1999).

275. See *id.*

276. 35 U.S.C. § 271(h), 296(a) (1994).

277. See *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2223 (1999). Congress had passed the statute to meet the *Atascadero* requirement of a "clear statement" of abrogation of Eleventh Amendment immunity.

278. In the companion *College Savings Bank* case, Justice Stevens, in dissent, disputes the conclusion that the Board may assert sovereign immunity. *Id.* at 2233-34 (Stevens, J., dissenting). Justice Stevens argues that a state should not be able to assert sovereign immunity where the state engages in "commercial activities." *Id.* at 2234.

279. *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 148 F.3d 1343, 1349-50 (Fed. Cir. 1998), *rev'd*, 119 S. Ct. 2199 (1999).

280. *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2201 (1999).

281. *Id.* at 2202.

282. *Id.* at 2210 (quoting *City of Boerne v. Flores*, 521 U.S. 507, 532 (1997)).

283. *Id.* at 2208.

284. Although bankruptcy law does not create property rights, see, e.g., *Butner v. United States*, 440 U.S. 48, 55 (1979), *Abele v. Phoenix Suns Ltd. Partnership (In re Harrell)*, 73 F.3d 218, 219 (9th Cir. 1996), it does determine what is "property of the estate," 11 U.S.C. § 541 (1994), and provides protections against interference with estate property. See *Id.* §§ 362(a), 549(a). For example, welfare benefits may constitute "property of the estate." See *Howell v. Commonwealth of Penn., Dep't of Pub. Welfare (In re Howell)*, 138 B.R. 484, 486 (W.D. Pa. 1992). The denial of welfare benefits under certain circumstances constitutes a violation of the Due Process Clause. See *Goldberg v. Kelly*, 397 U.S. 254, 261 (1970). If a state asserts sovereign immunity to a valid claim for welfare benefits in bankruptcy, it "deprives" the claimant of the claimant's property rights without just compensation. See *supra* note 251; see also *Air Line Pilots Ass'n, Int'l v. American Nat'l Bank & Trust Co. (In re Ionosphere Clubs, Inc.)*, 156 B.R. 414, 436-37 (holding that causes of action are property of the estate).

285. Justice Stevens noted in dissent that the Copyright Remedy Clarification Act of 1990, unlike the Patent Remedy Act, did include a study of state infringements of copyrights and potential state remedies. See *Florida Prepaid*, 119 S. Ct. at 2215, n.9 (Stevens, J., dissenting). Congress could use such information to model similar Bankruptcy legislation. But see *Alsbrook v. City of Maumelle*, No. 97-1825, 1999 U.S. App. LEXIS 16945, \*23-\*28 (8th Cir. Jan. 11, 1999) (holding that extensive legislative record alone did not suffice to bring title II of the Americans with Disability Act under the umbrella of Section 5 of the Fourteenth Amendment where legislation goes beyond rational relationship standard and forces states to make modifications).

286. See *Garrett v. Illinois*, 612 F.2d 1038, 1040 (7th Cir. 1980).



respect to the causes of action against states, like Maine,<sup>287</sup> that have not waived sovereign immunity broadly or at all, some forum would be provided for aggrieved bankruptcy parties.

### B. Suing in the Name of the United States

Congress also could authorize suits against states by a United States Trustee,<sup>288</sup> or possibly by a private trustee or debtor-in-possession, on behalf of the United States.<sup>289</sup> *Alden* recognized that suits brought in the name of the United States differ "in kind from the suit of an individual."<sup>290</sup> In fact, one court already has provided a post-*Seminole Tribe* bankruptcy law roadmap for Congress to do so. Specifically, in *Department of Transportation and Development v. PNL Asset Management Co. (In re Fernandez)*, the Court of Appeals for the Fifth Circuit considered whether a judgment creditor, who had acquired a judgment from the Federal Deposit Insurance Corporation ("FDIC") and thereafter contested a state's title to property purchased from the debtor, could step into the shoes of the United States to sue the state in federal court.<sup>291</sup>

The court first noted that the "Eleventh Amendment does not bar the United States government from filing suit in federal court against a state."<sup>292</sup> However, the court ultimately held that the judgment creditor's suit could not proceed because "a private successor to the FDIC cannot by implication enjoy the status accorded the national government for Eleventh Amendment purposes."<sup>293</sup> Thereafter, in denying a petition for a rehearing, the Fifth Circuit noted that:

we are persuaded that there must be a *clear expression of purpose* to abrogate the Eleventh Amendment in any extension of agency status to a private party for the purpose of jurisdiction. We find no such clarity of purpose [in section 106(a)] as required by the Supreme Court in *Seminole Tribe*.<sup>294</sup>

Although it is clear from the *Fernandez* decision that private parties cannot merely step into the shoes of the federal government to sue states at will, Congress probably could authorize bankruptcy trustees and debtors-in-possession to bring suits based on federally created bankruptcy claims for relief in the name of the United States as long as it made such authorization clear and unequivocal.<sup>295</sup> Congress also likely would have to create a stronger

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287. See *Alden v. Maine*, 119 S. Ct 2240, 2268 (1999).

288. Meltzer believes that authorizing suit by the United States Trustee perhaps "would alleviate the serious problems otherwise posed by *Seminole* for the administration of bankruptcy." Meltzer, *supra* note 114, at 57 & n.264. Glauberman doubts whether Meltzer's analysis is correct, noting that many bankruptcy suits arise under state law and questioning whether Congress may authorize the United States to bring actions against states that do not arise as federal causes of action. See Glauberman, *supra* note 117, at 104-06 & n.259.

289. This could work in at least two ways. First, the United States Trustee could sue a state for bankruptcy causes of action held by the federal bankruptcy estate and not by any private plaintiff. See *United States v. Mississippi*, 380 U.S. 128, 140 (1965); *United States v. Minnesota*, 270 U.S. 181 (1926) (holding that the state could not maintain an Eleventh Amendment defense against a suit brought by the United States even though the suit was brought for the benefit of a Native American tribe; however, under section 307 of the Bankruptcy Code, the United States Trustee has standing to do so.) The important issue is whether the United States has a sufficient interest in the suit to justify an elimination of a state's Eleventh Amendment defense. The interest need not be a direct pecuniary interest. See *North Dakota v. Minnesota*, 263 U.S. 365, 375 (1923); *United States v. University of N.M.*, 731 F.2d 703, 705 (10th Cir. 1984) (The United States may bring suit against a state as a trustee for a Native American tribe in a trespass action.); *Multi-district Vehicle Air Pollution M.D.L. No. 31 v. Automobile Mfrs. Ass'n, Inc. (In re Multidistrict Vehicle Air Pollution)*, 481 F.2d 122, 131 (9th Cir. 1973) (holding that the United States may sue as *parens patriae* to vindicate the interests of its citizens.). On the other hand, the United States may not delegate its own power to sue a state to a private party. See *Blatchford v. Native Village of Noatak*, 501 U.S. 775, 783 (1991) (dictum) (not permitting Native American tribes to sue in the name of the United States to redress injury to the tribes.).

Second, within the constraints of *Alden* and *Blatchford*, Congress could authorize a private party, like a chapter 7 trustee or chapter 11 debtor in possession, to bring suits on behalf of the United States. See Joseph F. Riga, *State Immunity in Bankruptcy After Seminole Tribe v. Florida*, 28 SETON HALL L. REV. 29, 59 (1997). Thus, the suits would have to assert claims for relief created as a matter of federal bankruptcy law that do not belong to a private plaintiff. Whether this proposal will avoid Eleventh Amendment and sovereign immunity depends on whether courts will consider injury to a federally created bankruptcy estate to be injury to the United States and whether the United States Trustee's supervisory authority over trustees and debtors in possession constitutes sufficient government control over the litigation. See *United States ex rel. Stevens v. Vermont Agency of Natural Resources*, 162 F.3d 195, 202-03 (2d Cir. 1998), *cert. granted*, 119 S. Ct. 2391 (1999) (holding that *qui tam* suits against States are not barred by the Eleventh Amendment); *infra* notes 311-20 and accompanying text.

290. *Alden*, 119 S. Ct. at 2267.

291. *Department of Transp. & Dev. v. PNL Asset Management Co. (In re Fernandez)*, 123 F.3d 241, 245-46 (5th Cir. 1997), *amended* by 130 F.3d 1138, 1138-39 (5th Cir. 1997).

292. *In re Fernandez*, 123 F.3d at 245; 130 F.3d at 1138 (citing *United States v. Mississippi*, 380 U.S. 128, 140 (1965)). When states entered into the Union, they consented to be sued by the United States. See *id.* 123 F.3d at 246; 130 F.3d at 1138.

293. *Id.* 130 F.3d at 1139 (emphasis added).

294. *Id.* at 1139 (emphasis added).

295. See Janger, *supra* note 148, at 1438 (suggesting Congress could vest power in the United States trustee to bring avoidance actions). Under current law, the private trustee or debtor in possession stands in the shoes of all of the debtor's unsecured creditors, including the United States when it is an unsecured creditor. See 11 U.S.C. § 544(b) (1994). Under *Fernandez* this statute might meet the requirement that the private trustee or debtor in possession enjoys the status accorded the national government for Eleventh Amendment purposes because section 106(a) of the Bankruptcy Code clearly and expressly abrogates sovereign immunity with

nexus between the United States Trustee and the private trustee, such as requiring the United States to receive a percentage of any funds recovered from a state.<sup>296</sup> Indeed, Congress already has done so in the analogous context of *qui tam* suits brought in the name of the United States. In these suits, a state's Eleventh Amendment immunity cannot be asserted successfully.<sup>297</sup> The *qui tam* statute presents a simple model for Congress to follow:

A person may bring a civil action for a violation of section 3729 for the person and for the United States government. The action shall be brought in the name of the Government. The action may be dismissed only if the court and the Attorney General give written consent to the dismissal and their reasons for consenting.<sup>298</sup>

In a *qui tam* suit, a private plaintiff may sue in the name of the United States<sup>299</sup> to seek civil damages for violation of the False Claims Act.<sup>300</sup> Under the False Claims Act, a person who makes a false monetary claim to the United States government is liable to the government for treble damages plus a \$5,000-\$10,000 civil penalty.<sup>301</sup> The United States is given control over the litigation through the power to intervene,<sup>302</sup> settle,<sup>303</sup> or terminate<sup>304</sup> the suit. If the United States does not intervene, the private plaintiff conducts the action,<sup>305</sup> but any recovery belongs to the United States, subject to the right of the private plaintiff to receive a percentage of the proceeds of the suit.<sup>306</sup>

Delegating the power to sue in the name of the United States to private parties is not without substantial criticism. Allowing private parties to sue in the federal government's name in bankruptcy, essentially for the purpose of circumventing Eleventh Amendment and sovereign immunity, distorts the principles of federalism by removing the states' constitutional protection against non-consensual appearances in federal court.<sup>307</sup> The Court of Appeals for the Fifth Circuit, in recognizing the blatant end-run around the Eleventh Amendment, held that the Eleventh Amendment bars *qui tam* suits brought by private parties where the United States declines to intervene.<sup>308</sup> The court reasoned that when the federal government takes a passive role in a *qui tam* action, "it is difficult to treat it as the party that has 'commenced or prosecuted' the suit."<sup>309</sup> Moreover, the *qui tam* statute does not contain the clear expression of abrogation of Eleventh Amendment immunity in its extension of agency status to private parties.<sup>310</sup>

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respect to section 544. *Cf., e.g.,* Pate v. Hunt (*In re* Hunt), 136 B.R. 437, 450-51 (Bankr. N.D. Tex. 1991) (holding that trustee's claim asserted on behalf of the United States was not barred by the state statute of limitations since the trustee was empowered to assert rights of the United States as a creditor); United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 583 (M.D. Pa. 1983), *aff'd sub nom.,* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986) (same). In our view it is unlikely, however, that the Supreme Court would accord such a charitable construction to the Bankruptcy Code. Relying on *City of Boerne*, the Court would probably hold that there is no clear statement that Congress intended in section 544(b) to lend the name of the United States to abrogate immunity and there is not a sufficient nexus between the United States and the private trustee to allow such a suit. Moreover, even if congressional intent was clear, we think the Court would find delegation of the power to sue in the name of the United States to transgress the constraints of *Blatchford*. See *supra* note 289 and accompanying text.

296. See *United States ex rel. Stevens v. Vermont Agency of Natural Resources*, 162 F.3d 195, 202-03 (2d Cir. 1998). Providing the United States a monetary incentive is not itself dispositive, see *supra* note 295, but it would strongly favor an indication that the United States is the real party in interest.

297. See *Stevens*, 162 F.3d at 202-03; *United States ex rel. Berge v. Board of Trustees*, 104 F.3d 1453, 1458 (4th Cir. 1997) (holding that the Eleventh Amendment does not apply in *qui tam* context); *United States ex rel. Milam v. University of Tex. M.D. Anderson Cancer Ctr.*, 961 F.2d 46, 50 (4th Cir. 1992); *United States v. University of Mich.*, 860 F. Supp. 400, 404 (E.D. Mich. 1994) (dismissing on Eleventh Amendment grounds a retaliation suit brought by individual against state pursuant to False Claims Act but noted that Eleventh Amendment would not bar a private suit brought under main *qui tam* action.); Jonathan R. Siegel, *The Hidden Source of Congress's Power to Abrogate State Sovereign Immunity*, 73 Tex. L. Rev. 539, 550 (1995); Justin V. Switzer, Note, *Did they really think this is over?* *Seminole Tribe v. Florida and the Bankruptcy Code*, 34 Hous. L. Rev. 1243, 1275 (1999) (analogizing to *qui tam* actions). But see Glauberman, *supra* note 117, at 102-04 (finding this analysis to be fatally flawed once it is extended beyond traditional *qui tam* suits).

298. 31 U.S.C. § 3730(b)(1) (1994). However, *qui tam* actions might be distinguished from bankruptcy actions on one important ground. Unlike *qui tam* actions, in bankruptcy, the United States is often a creditor itself. Thus, one commentator has suggested that vesting power in the bankruptcy trustee to bring suits in the name of the United States may create a conflict of interest. See Janger, *supra* note 148, at 1440. But since the United States stands to benefit from any recovery from the state that is distributed to creditors, the conflict is more appearance than real.

299. See 31 U.S.C. § 3730(b)(1).

300. 31 U.S.C. §§ 3729-3731.

301. See *id.* § 3729(a).

302. See *id.* § 3730(c).

303. See *id.* § 3730(c)(2)(B).

304. See *id.* § 3730(c)(2)(A).

305. See *id.* § 3730(b)(4)(B).

306. See *id.* § 3730(d).

307. See *Seminole Tribe v. Florida*, 517 U.S. 44, 58 (1996) ("The Eleventh Amendment . . . serves to avoid the 'indignity of subjecting a State to the coercive process of judicial tribunals at the instance of private parties' . . .") (quoting *Puerto Rico Aquaduct & Sewer Auth. v. Metcalf & Eddy, Inc.*, 506 U.S. 139, 146 (1993)); see also Siegel, *supra* note 297, at 558. *Qui tam* actions, unlike bankruptcy, do not adversely affect federalism principles because such actions directly vindicate the interests of the federal government. See Siegel, *supra* note 244, at 561 (delegating of authority to sue in the name of the United States should be permitted for *qui tam* actions because they are "genuinely actions in which the United States is the plaintiff").

308. *United States ex rel. Foulds v. Texas Tech Univ.*, 171 F.3d 279, 294 (5th Cir. 1999).

309. *Id.* at 291. The *Foulds* decision has placed the Fifth Circuit at odds with the Eighth Circuit's decision in *United States ex rel. Rodgers v. Arkansas*, 154 F.3d 865, 868 (8th Cir. 1998), *cert. dismissed*, 119 S. Ct. 2387 (1999), the Second circuit's decision in *United States ex rel. Stevens v. Vermont Agency of Natural Resources*, 162 F.3d 195, 201-03 (2d Cir. 1998), *cert. granted*, 119 S. Ct. 2391 (1999), and

This issue should be resolved by the Supreme Court in the October 1999 term. The Court granted certiorari to review the Second Circuit's decision in *United States ex rel. Stevens v. State of Vermont Agency of Natural Resources*.<sup>311</sup> In *Stevens*, the plaintiff had filed a *qui tam* action under the False Claims Act, alleging the Vermont agency had made fraudulent claims against the United States.<sup>312</sup> The United States declined to intervene in the suit.<sup>313</sup> The state agency moved to dismiss the complaint, arguing that the state was not a "person" within the meaning of the False Claims Act<sup>314</sup> and, more importantly, the Eleventh Amendment barred the suit.<sup>315</sup> The majority opinion in *Stevens* concluded that the term "person" included states within the meaning of the False Claims Act and further decided that the Eleventh Amendment defense had no application.<sup>316</sup> The court first noted that the states have no sovereign immunity as against the United States.<sup>317</sup> The court then concluded that the False Claims Act's statutory design indicates that the real party in interest is the federal government, even in suits where the United States declines to intervene.<sup>318</sup> Thus, a private *qui tam* suit is still a cause of action that belongs to the federal government<sup>319</sup> and the immunity states enjoy must yield to it. Assuming that the Court does not reverse *Stevens*, an assumption that is dubious in the current climate of the balance of power between the federal government and the states,<sup>320</sup> then modeling the Bankruptcy Code after the False Claims Act is constitutional and reasonably feasible.

### C. Self-Executing Ex parte Young Injunction

As noted above,<sup>321</sup> the Supreme Court in *Seminole Tribe* recognized that individuals may sue state officials for prospective injunctive relief in federal court under the *Ex parte Young* doctrine as long as Congress has not already crafted a "detailed remedial scheme" in the statute at issue.<sup>322</sup> In *Alden*, the Supreme Court reaffirmed the vitality of the *Ex parte Young* doctrine.<sup>323</sup> Accordingly, one additional avenue that Congress should consider to ameliorate the effects of *Seminole Tribe* in the bankruptcy context is the promulgation of a statutory provision that automatically creates, on the date of the filing of a bankruptcy petition, a standing injunction applicable to state officials and proscribing the violation of federal bankruptcy laws.<sup>324</sup> Such an injunction could supplement and reinforce the existing injunctive provisions of section 362(a) of the Bankruptcy Code, which state that the commencement of a bankruptcy case automatically operates as a stay of certain actions and conduct.<sup>325</sup>

Creating a standing *Ex parte Young* injunction would be beneficial in at least three respects. First, it would save the bankruptcy estate the litigation costs and the bankruptcy court system the administrative costs that would be incurred in bringing a separate proceeding for prospective injunctive relief against state officials at the com-

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the Fourth Circuit's decision in *United States ex rel. Milam v. University of Tex. M.D. Anderson Cancer Ctr.*, 961 F.2d 46, 50 (4th Cir. 1992). The *Foulds* decision rests on the notion that although the United States stands to recover, at minimum, seventy percent of any recovery against a state and thus must be considered the "real party in interest," the Eleventh Amendment will bar suit because it is the private party that invests resources in bringing the suit and makes the day-to-day litigation decisions. *Foulds*, 171 F.3d at 293. ("With the merely chimerical presence of the United States in this case, the relator's significant control over the litigation process plainly impinges on state sovereignty.")

310. See *Foulds*, 171 F.3d at 294.

311. *United States ex rel. Stevens v. State of Vermont Agency of Natural Resources*, 162 F.3d 195, cert. granted, 119 S. Ct. 2391 (1999).

312. See *id.* at 198.

313. See *id.* at 199.

314. The False Claims Act authorizes suits only against "persons" who defraud the federal government. 31 U.S.C. § 3729(a) (1994).

315. See *Stevens*, 162 F.3d at 199.

316. See *id.* at 205.

317. See *id.* at 201 (citing *West Virginia v. United States*, 479 U.S. 305, 311 (1987)).

318. See *id.* at 202.

319. See *id.* at 203. Because the cause of action belongs to the federal government, the Supreme Court's rule in *Blatchford* does not apply. See *id.*

320. Given this Court's makeup, we would not be surprised to find the Court agreeing with the dissent's view in *Stevens*, which remarkably foretold many of the arguments expressed in *Alden*, see *id.* at 211 (Weinstein, district judge, dissenting), that the *qui tam* suit against a state is barred by the Eleventh Amendment. *Id.* at 229. *But cf.* *Alden v. Maine*, 119 S. Ct. 2240, 2267 (1999). Justice Kennedy's opinion hinted that a suit brought in the name of the United States overcomes sovereign immunity as long as the suit does not represent a "broad delegation to private persons to sue nonconsenting States." *Id.* at 2267. Thus, the most promising course for Congress should be to authorize suits against states by the United States trustee in the name of the United States.

321. See *supra* notes 205-15 and accompanying text.

322. *Seminole Tribe v. Florida*, 517 U.S. 44, 74 (1996).

323. See *Alden*, 119 S. Ct. at 2263.

324. The Automatic Stay of section 362(a) already enjoins a state official who pursues the state's interest as a prepetition creditor. See 11 U.S.C. § 362(a) (1994). Section 362 is a statutory injunction, equivalent to a court-ordered injunction, that arises without any court action. See, e.g., *Johnston Envtl. Corp. v. Knight (In re Goodman)*, 991 F.2d 613, 620 (9th Cir. 1993); *Carver v. Carver*, 954 F.2d 1573, 1578 (11th Cir. 1992); *Atkins v. Martinez (In re Atkins)*, 176 B.R. 998, 1004 (Bankr. D. Minn. 1994) ("The automatic stay in bankruptcy comes into existence as a matter of law; it is self-effectuating."); *In re Xavier's, Inc.*, 172 B.R. 667, 672 (Bankr. M.D. Fla. 1994). Although the stay is imposed by statute rather than court order, courts have considered the statutory stay to be the equivalent of a court-ordered injunction. Thus, section 362 provides a model for Congress for enacting a statutory injunction embodying *Ex parte Young*.

325. See 11 U.S.C. § 362(a) which arguably already serves this purpose.

mencement of every case. Second, it could act as a deterrent against willful violations of the Bankruptcy Code by a state, because it would place state officials on notice that they could be held accountable for such violations.<sup>326</sup> Third, it would avoid litigation over any existing ambiguity regarding the ability to bring *Ex parte Young* actions in bankruptcy cases or proceedings.

At the very least, Congress should make clear in the Bankruptcy Code its intent to authorize parties in interest from commencing *Ex parte Young* actions in bankruptcy courts to enforce some or all of the provisions of the statute.

#### D. Conditional Claims Allowance

Congress could amend the Bankruptcy Code to allow a state's claim for purposes of voting and distribution<sup>327</sup> only if the state has waived sovereign immunity and Eleventh Amendment immunity regarding the claim and compulsory counterclaims.<sup>328</sup> Under current law, the state may file a proof of claim which is deemed allowed unless an objection is timely filed.<sup>329</sup> As noted above,<sup>330</sup> section 106(b) of the Bankruptcy Code purports to deem the filing of a proof of claim by the state to be a waiver of sovereign immunity regarding compulsory counterclaims.<sup>331</sup> Some courts have questioned whether section 106(b) is unconstitutional.<sup>332</sup>

Even if section 106(b) is impotent to waive state sovereign immunity, Congress could amend section 502(b) of the Bankruptcy Code<sup>333</sup> to disallow a state's claim unless the state has waived Eleventh Amendment and sovereign immunity regarding the claim and compulsory counterclaims. Under the Bankruptcy Clause of the Constitution,<sup>334</sup> Congress has the power to enact uniform laws on the subject of bankruptcies throughout the United States. Congress has enacted a Bankruptcy Code that creates an estate comprised of all property of the debtor on the date of the filing of a bankruptcy petition.<sup>335</sup> It is solely within the province of Congress to determine who has the right to share in the estate and the priority of distribution of the estate's assets.<sup>336</sup> Congress could simply amend the Bankruptcy Code to provide that if the state wants access to share in the distribution of the estate, the state must agree, perhaps through an act of its legislature, to surrender its immunity as the price of admission. At least where the state holds an unsecured claim, there should be no Constitutional impediment to the imposition of such a condition.<sup>337</sup>

#### E. Conditional Spending

Finally, as a last resort, Congress could encourage the waiver of state Eleventh Amendment immunity through conditions to the receipt of federal funds.

The Supreme Court has held that, pursuant to the Spending Clause power,<sup>338</sup> Congress may condition the receipt of federal funds to "further broad policy objectives,"<sup>339</sup> and Congress repeatedly has used its Spending Clause power to condition receipt of federal funds to influence states to regulate or act in a federally-desired manner.<sup>340</sup>

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326. Notwithstanding the Eleventh Amendment, state officials may be required to pay money damages as "costs" for violating a court's equitable order. See *Hutto v. Finney*, 437 U.S. 678, 690-92 (1978). The *Hutto* Court reasoned that the cost of disobeying a federal court order is ancillary to enforcement of federal law. See *id.* at 690. Thus, a state official who willfully disobeys the automatic stay, or any other bankruptcy court order, may be held in contempt and ordered to pay money damages to the aggrieved party.

327. In a chapter 11 case, a creditor may have a claim allowed for two separate purposes. First, the claim may be allowed for purposes of voting on a plan of reorganization. See 11 U.S.C. §§ 502, 1111(a), 1126; FED. R. BANKR. P. 3018(a). Second, the claim may be allowed for purposes of distribution even if the creditor was not permitted to vote on the plan. See 11 U.S.C. §§ 1123(a)(3), 1124.

328. Based on his view that the constructive waiver doctrine is defunct and that Congress cannot use its Article I power to abrogate Eleventh Amendment immunity, Glauberman sharply disagrees that Congressional action of this kind will work. See Glauberman, *supra* note 117, at 87 (discussing conditional patent or copyright legislation). But Glauberman is more optimistic about congressional legislation that would condition access to the bankruptcy court on the state legislature's having passed a law waiving the state's Eleventh Amendment immunity. See *id.* at 87 n.145 (discussing possible copyright and patent legislation).

329. See 11 U.S.C. §§ 501(a), 502(a).

330. See *supra* note 187 and accompanying text.

331. See 11 U.S.C. § 106(b).

332. See *supra* notes 189-90 and accompanying text.

333. 11 U.S.C. § 502(b) (providing nine bases to disallow claims under current law).

334. U.S. CONST. art. I, § 8, cl. 4.

335. See 11 U.S.C. § 541(a).

336. See *id.* §§ 507(a), 726(a).

337. As stated above in note 187, the state may not assert a due process or takings defense under the Fifth Amendment because the state is not a "person" within the meaning of the Amendment.

338. The Spending Clause provides that Congress has the power to "lay and collect Taxes, Duties, Imposts, and Excises, to pay for the Debts and provide for the common Defence and general Welfare of the United States." U.S. CONST. art. I, § 8, cl. 1.

339. *Fullilove v. Klutznick*, 448 U.S. 448, 474 (1980).

340. See *South Dakota v. Dole*, 483 U.S. 203, 208 (1987) (National Minimum Drinking Age Act); *Del A. v. Edwards*, 855 F.2d 1148, 1149 (5th Cir. 1988) (Adoptive Assistance and Child Welfare Act of 1980); *Kit Kinsport, Implied Waiver After Seminole*, 82 MINN. L. REV. 793, 822-23 (1998). In response to the Supreme Court's decision in *United States v. Lopez*, 514 U.S. 549 (1995) (holding that the Gun-Free School Zones Act of 1990 exceeded the scope of congressional power under the Commerce Clause), President Clinton announced that the federal government should "encourage states to ban guns from school zones by linking Federal funds to

Presumably, Congress could require that states agree to waive their Eleventh Amendment immunity with respect to bankruptcy-related actions in order to receive, for example, federal highway funds.<sup>341</sup>

Although there are several limits to Congress's authority in this regard, none would appear to prevent Congress from enacting such a bankruptcy-related provision. The first such limitation is found within the Spending Clause itself—exercise of the power must be in pursuit of the “general Welfare.”<sup>342</sup> This limitation has little substantive application, however, because the Supreme Court has given substantial deference to the judgment of Congress regarding the nature of the “general Welfare.”<sup>343</sup> Thus, in the bankruptcy context, Congress likely could justify use of its Spending Clause power to further the goals of the Bankruptcy Code, which is a legal scheme crafted in the interest of the general welfare.<sup>344</sup>

A second limitation might arise from dictum that conditions on federal funds “might be illegitimate if they are unrelated ‘to the federal interest in particular national projects or programs.’”<sup>345</sup> The relationship between the conditions and the federal interest involved, however, need only be reasonable, and there need not be a direct relationship.<sup>346</sup> Additionally, the relationship only needs to run between the condition and the federal interest that is served; the interest need *not* be related to the purpose of the funds.<sup>347</sup> Conditioning waiver of Eleventh Amendment immunity with respect to bankruptcy matters clearly would be reasonably related to the important federal interests in fostering a debtor’s “fresh start” and a level playing field for creditors, both of which would be enhanced by eliminating a state’s ability to secure a preferred position relative to other creditors through the assertion of Eleventh Amendment or sovereign immunity.<sup>348</sup>

Third, the Supreme Court has noted “other constitutional provisions may provide an independent bar to the conditional grant of federal funds.”<sup>349</sup> This limitation, however, is designed to prevent Congress from requiring states to engage in discriminatory treatment of individuals on the basis of suspect classifications, engage in the restriction of free speech or free exercise of religion, and the like. It does not limit use of the Spending Clause to require a waiver of Eleventh Amendment immunity. Specifically, courts have held that although Congress may not use the Spending Clause power to require states to engage in unconstitutional activity in order to receive federal funds, it in fact may require a waiver of Eleventh Amendment immunity as a condition to receipt of federal funds because such a condition would not require the state to engage in any unconstitutional activity (since states always are free to waive their Eleventh Amendment immunity).<sup>350</sup>

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enactment of school-zone gun bans.” Todd S. Purdum, *Clinton Seeks Way to Retain Gun Ban in School Zones*, N.Y. TIMES, Apr. 30, 1995, at A1.

341. Kinsport discusses the general subject at some length and concludes that there is nothing in the Eleventh Amendment that would bar such conditioning. See Kinsport, *supra* note 340, at 826. In particular, Kinsport notes that because the Eleventh Amendment itself envisions the possibility of a waiver, “asking the states to exercise their waiver rights does not require them to violate any ‘independent constitutional bar.’” *Id.*; see *Petty v. Tennessee-Missouri Bridge Comm’n*, 359 U.S. 275, 281-82 (1959) (finding a state’s agreement in compact to congressional condition subjected it to suit). Moreover, the Court of Appeals for the Sixth Circuit stated in *Tennessee Department of Human Services v. United States Department of Education*, 979 F.2d 1162, 1166 (6th Cir. 1992): “A state can waive its immunity explicitly when it opts to participate in a federal program in which Congress clearly has conditioned participation on such waiver.”

342. U.S. CONST. art. I, § 8, cl. 1; see also *Dole*, 483 U.S. at 207.

343. See *Dole*, 483 U.S. at 207. The “general Welfare” by its very terms includes a broad range of activities and necessarily includes concerns beyond what the Constitution directly grants Congress the power to legislate. See *United States v. Butler*, 297 U.S. 1, 66 (1936) (explaining that the spending clause power is not “limited by the direct grants of legislative power found in the Constitution”). The Court in *Dole* questioned whether the “general Welfare” limitation is at all a judicially enforceable restriction on congressional power. *Dole*, 483 U.S. at 207 n.2; see also Lynn A. Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911, 1929 (1995).

344. *Dole* instructs the courts to “defer substantially to the judgment of Congress” when determining whether the first element of the Spending Clause test has been met. *Dole*, 483 U.S. at 207.

345. *Id.* (quoting *Massachusetts v. United States*, 435 U.S. 444, 461 (1978) (plurality opinion)).

346. The Supreme Court left this issue open in *Dole*. *Id.* at 208 n.3. Lower courts, however, have consistently applied the reasonable relationship standard instead of the more exacting direct relationship standard. See, e.g., *California v. United States*, 104 F.3d 1086, 1092 (9th Cir. 1997).

347. See *New York v. United States*, 505 U.S. 144, 167 (1992); see also *Dole*, 483 U.S. at 207; *Oklahoma v. United States Civil Serv. Comm’n*, 330 U.S. 127 (1947) (upholding a condition withholding highway funds from the states when a highway official violated the Hatch Act’s prohibition against participating in a political campaign). This distinction is subtle but important. Consider the highway funds scenario. Bankruptcy has, at best, a very remote relationship to highways. Congress, however, may use highway funds to further an unrelated, constitutionally permissible interest. Thus, Congress could use highway funds to further the federal interest in bankruptcy law (clearly a permissible interest under Article I of the U.S. Constitution) as long as the condition imposed (a waiver of the Eleventh Amendment immunity) and the federal interest in bankruptcy are reasonably related.

348. *But see Meltzer*, *supra* note 114, at 55. Meltzer speculates that congressional bankruptcy statutes abrogating sovereign immunity “are not now, and could not easily be, associated with federal spending programs.” *Id.*; see also Glauberman, *supra* note 117, at 108 n.274 (agreeing with Meltzer’s proposition).

349. *Dole*, 483 U.S. at 208.

350. See *Clark v. California*, 123 F.3d 1267, 1271 (9th Cir. 1997) (“One way for a state to waive its immunity is to accept federal funds where the funding statute ‘manifest[s] a clear intent to condition participation in the programs funded under the Act on a State’s consent to waive its constitutional immunity.’” (quoting *Atascadero State Hosp. v. Scanlon*, 473 U.S.234, 247 (1985)); *Tennessee Dep’t of Human Servs. v. United States Dep’t of Educ.*, 979 F.2d 1162, 1166 (6th Cir. 1992); *Beasley v. Alabama State*

States may argue that Congress exceeds its permissible use of the Spending Clause power by “coercing” states into waiving their Eleventh Amendment immunity in bankruptcy cases, and, in fact, the Supreme Court has recognized that “in some circumstances the financial inducement offered by Congress might be so coercive as to pass the point at which ‘pressure turns into compulsion.’”<sup>351</sup> The “coercion” theory, however, has not been used in any reported decision as a reason for barring Congressional use of the Spending Clause power.<sup>352</sup> Additionally, a “coercion” theory makes little analytical sense: “can a sovereign state which is always free to increase its tax revenues ever be coerced by the withholding of federal funds—or is the state merely presented with hard political choices?”<sup>353</sup> Recent Supreme Court cases offer little further guidance. In *Alden*, the Court, citing *South Dakota v. Dole*, stated: “[n]or, subject to constitutional limitations, does the Federal Government lack the authority or means to seek the states’ voluntary consent to private suits.”<sup>354</sup> Yet a statement in *College Savings Bank* indicates the current Court’s uneasiness in allowing Congress to condition federal funding on waiver of sovereign immunity. Justice Scalia stated: “we think where the constitutionally guaranteed protection of the states’ sovereign immunity is involved, the point of coercion is automatically passed—and the voluntariness of waiver destroyed—when what is attached to the refusal to waive is the exclusion of the state from otherwise lawful activity.”<sup>355</sup> But Justice Scalia’s statement should not affect Congress’s ability to condition federal funding on waiver of sovereign immunity with respect to bankruptcy cases and proceedings. The Court instead was distinguishing between the withholding of a gift or gratuity of federal funds and exclusion from otherwise permissible activity.<sup>356</sup> Thus while the recent cases appear to breathe some life into the “coercion theory,” requiring states to waive immunity in bankruptcy cases in order to receive federal funds should not result in unconstitutional use of the Spending Clause power.

States also may argue that the Tenth Amendment<sup>357</sup> prohibits Congress from “commandeering” states’ legislative process “by directly compelling them to enact and enforce a federal regulatory program.”<sup>358</sup> This argument similarly fails because the Tenth Amendment “commandeering” theory does not apply to use of the Spending Clause power to condition receipt of federal funds.<sup>359</sup> Congress, by reason of conditioned receipt of federal funds, does not “commandeer” a state’s legislation into waiving that state’s Eleventh Amendment or sovereign immunity. Instead, all that conditioning does is present a state with a choice—either it can accept federal funds and waive its Eleventh Amendment and sovereign immunity for bankruptcy purposes, or it can decline the federal funds in order to maintain its constitutional immunity.

#### F. Federalism Concerns

Although the options outlined above are constitutionally permissible, we must ask whether the threats to bankruptcy law caused by the Eleventh Amendment justify our prescriptions on policy grounds. Given that *Seminole Tribe* and *Alden* establish a constitutional right to sovereign immunity, a proper defense of the listed options requires an analysis of federalism principles.<sup>360</sup> We are certain that despite the apparent harshness of some of our recommended options, federalism justifies all of them.

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Univ., 3 F. Supp. 2d. 1304, 1314 (M.D. Ala. 1998) (“[E]ven the most expansive language in *Seminole Tribe* should not be read as curtailing Congress’s spending clause power to condition receipt of federal funds on states’ waiver of their sovereign immunity.”).

351. *Dole*, 483 U.S. at 211 (quoting *Steward Mach. Co. v. Davis*, 301 U.S. 548, 590 (1937)). Indeed, the state might argue that although Congress can encourage a state to adopt a new program as a condition to receiving federal funds, it cannot require the state to relinquish a property right or immunity as a condition to engaging in commerce. See *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2211 (1999) (“[W]e think where the constitutionally guaranteed protection of the states’ sovereign immunity is involved, the point of coercion is automatically passed—and the voluntariness of waiver destroyed—when what is attached to the refusal to waive is the exclusion of the State from otherwise lawful activity.”).

352. See *California v. United States*, 104 F.3d 1086, 1092 (9th Cir. 1997) (noting that no party challenging the conditioning of federal funds has ever succeeded under the coercion theory). Indeed, the Court in *Dole* noted that “coercion” theory would apply only in the most extraordinary circumstances. *Dole*, 483 U.S. at 210-11.

353. *Nevada v. Skinner*, 884 F.2d 445, 448 (9th Cir. 1989).

354. *Alden v. Maine*, 119 S. Ct. 2240, 2276 (1999). The Court’s reference to “constitutional limitations” is merely a confirmation of the existing limits the Constitution places on the Spending Clause power and does not add any new restrictions.

355. *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2231 (1999).

356. “In the present case, however, what Congress threatens if the State refuses to agree to its condition is not the denial of a gift or gratuity, but a sanction: exclusion of the State from otherwise permissible activity.” *Id.*

357. “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States are reserved to the States respectively, or to the people.” U.S. CONST. amend. X.

358. *New York v. United States*, 505 U.S. 144, 161 (1992) (quoting *Hodel v. Virginia Surface Mining & Reclamation Ass’n*, 452 U.S. 264, 288 (1981)).

359. See *id.* at 168 (“By [use of the Spending Clause power], as by any other permissible method of encouraging a State to conform to federal policy choices, the residents of the State retain the ultimate decision as to whether or not the State will comply.”); *Missouri v. United States*, 918 F. Supp. 1320, 1330 (E.D. Mo. 1996) (“Congress may ‘hold out incentives to the State as a method of influencing a State’s policy choices . . . .’”) (quoting *New York v. United States*, 505 U.S. at 165)).

360. *Alden* premised its decision in part on an appeal to federalism principles. *Alden v. Maine*, 119 S. Ct. 2240, 2263-65 (1999); see also *supra* note 67 and accompanying text. We note there is a marked lack of scholarship on bankruptcy law within the context of federalism. This gap likely is attributable to the pre-*Seminole Tribe* absence of conflict between the federal government and states over bankruptcy issues. We do not intend to transform this Article into a lengthy discussion of federalism. Instead, we attempt

Federalism is a subject that has occupied the attention of lawyers, judges, scholars, and politicians since the earliest days of our republic.<sup>361</sup> Essentially, federalism concerns the allocation of power between the federal government and the states.<sup>362</sup> But such a broad definition offers little guidance unless the investigation is limited to our narrow topic: whether federalism justifies congressional enactments that specifically are designed to circumvent the Eleventh Amendment's bar to the nonconsensual exercise of federal jurisdiction against a state in bankruptcy court. We believe that federalism provides such justification.<sup>363</sup>

Before examining each of our proposed congressional solutions on federalism grounds, it is helpful to note certain considerations that guide the analysis. First, by virtue of the Supremacy Clause, federalism principles favor federal power if the Constitution generally permits the federal government to engage in particular actions.<sup>364</sup> As a corollary to the Supremacy Clause consideration, in areas of federal economic policy-making, the justification for judicial restraint is particularly strong.<sup>365</sup> Congress is granted preemptive authority to enact bankruptcy laws.<sup>366</sup> Thus, even if the new constitutional sovereign immunity, as applied in *Seminole Tribe* and *Alden*, prevents Congress from using its Article I power to abrogate the states' constitutional immunity in bankruptcy, other constitutional methods that achieve the same result should be favored.

The Supreme Court's recent decisions undercut our conclusion to some extent. *Alden* elevates common law sovereign immunity to a constitutional status that trumps the use of Article I power. *Florida Prepaid* restricts the use of the Due Process Clause to overcome constitutional sovereign immunity. *College Savings Bank* eliminates the implied waiver doctrine. All three cases must be interpreted as a triumph of states' rights.<sup>367</sup> But the Court did not reject the well-grounded theory that federalism favors federal power if that power is lawfully exercised, even if the purpose of the use of lawful power is to diminish the states' sovereign immunity.<sup>368</sup> The Court carefully recognized the limitations on sovereign immunity and noted that the states are bound to follow federal law.

Second, the traditional justifications for protecting states on federalism grounds have little application to bankruptcy law. These traditional concerns include the "indignity of subjecting a state to the coercive process of judicial tribunals at the instance of private parties,"<sup>369</sup> fear of the tyranny of the federal government,<sup>370</sup> the states' better ability to respond to its citizens' needs,<sup>371</sup> and the benefit of having states act as laboratories for social and economic change.<sup>372</sup> To the extent such justifications are legitimate,<sup>373</sup> none affect bankruptcy. There cannot be fear

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only initially to defend on federalism grounds the potential solutions available to Congress to overcome the *Seminole Tribe* and *Alden* decisions.

361. See Louise Weinberg, *Fear and Federalism*, 23 OHIO N.U. L. REV. 1295, 1299 (1997).

362. See Erwin Chemerinsky, *Federalism Not as Limits, But as Empowerment*, 45 U. KAN. L. REV. 1219, 1220 (1997).

363. Because appearing in state courts to enforce bankruptcy rights would undercut the policy of uniformity and is a practice most bankruptcy practitioners would care to avoid, our policy discussion is limited to abrogating immunity to suit in federal court. Nevertheless, the inability to sue states in state courts undercuts traditional bankruptcy jurisdiction that allows the estate's representative to sue in state courts. See 11 U.S.C. § 1334(b) (1994).

364. A clear example of this consideration is the Court's venerable decision in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 427 (1819). There the Court held that a Maryland tax on the National Bank of the United States violated Congress's power to legislate under the Necessary and Proper Clause. Particular to our inquiry, Justice Marshall stated that "congress should exercise its discretion as to the means by which it must execute the powers conferred upon it." *Id.* at 326.

365. See Herbert Hovenkamp, Essay, *Judicial Restraint and Constitutional Federalism: The Supreme Court's Lopez and Seminole Tribe Decisions*, 96 COLUM. L. REV. 2213, 2220 (1996).

366. See *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 195-96 (1819); *supra* notes 97-101 and accompanying text.

367. See Joan Biskupic, *Justices, 5-4, Strengthen State Rights*, WASH. POST, June 24, 1999, at A1.

368. The Court's affirmation of the principles of *Ex parte Young* and *Dole* indicates approval.

369. *In re Ayers*, 123 U.S. 443, 505 (1887); see *Idaho v. Coeur d'Alene Tribe*, 521 U.S. 261, 287-88 (1997).

370. See Erwin Chemerinsky, *The Values of Federalism*, 47 FLA. L. REV. 499, 525 (1995). The *Lopez* decision reasoned that if Congress could enact a law banning guns around schools on Commerce Clause grounds, then Congress could fairly justify a law regulating school curriculum on the same theory. See *United States v. Lopez*, 514 U.S. 549, 565 (1995). Implicit in this reasoning is the fear that Congress's regulation of local school curricula is an exercise of tyrannical federal power. Fear of federal power has roots extending to earliest years of the United States, see Weinberg, *supra* note 361, at 1302-03 (noting that the Kentucky and Virginia Resolutions were a response to the Sedition Act of 1798), and has provided a powerful platform for electoral candidates. See Hovenkamp, *supra* note 365, at 2221.

371. See Chemerinsky, *supra* note 370, at 527.

372. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). Justice Brandeis stated: To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the Nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.

*Id.*

373. George Washington once stated: "To be fearful of vesting Congress, constituted as that body is, with ample authorities for national purposes, appears to me the very climax of popular absurdity and madness." Weinberg, *supra* note 361, at 1299 (quoting Letter from George Washington to John Jay (Aug. 15, 1786) in 3 THE CORRESPONDENCE AND PUBLIC PAPERS OF JOHN JAY 207-08 (Henry P. Johnson ed., 1970)). The reliance on federalism to favor states' rights has, on numerous occasions throughout American history, produced terrible results. Before the Civil War, southern legislators consistently relied upon notions of federalism to defend the institution of slavery. See *id.* at 1301. Federalism and the protection of the states was invoked to defeat national labor laws. See Hovenkamp, *supra* note 365, at 2213-14. During the Civil Rights Movements of the 1950s and 1960s, the principles of federalism



of federal tyranny by the mere creation of a neutral forum for marshaling, sorting through, and distributing a debtor's assets. Moreover, preventing a suit against a state in bankruptcy court does not further a state's responsiveness to its citizens. And because bankruptcy is the paramount domain of Congress, state insolvency laws are superseded by any federal bankruptcy law.<sup>374</sup> Thus, the benefit of states as laboratories for social and economic development simply does not exist in the bankruptcy context.<sup>375</sup> Last, the argument that states ought not be subject to the indignity of the coercive process, while bandied about by the current majority of the Supreme Court in a slew of cases, has little merit in American jurisprudence.<sup>376</sup>

Third, states have the ability to protect their interests in bankruptcy both inside the courthouse and in Congress. States already receive some preference in bankruptcy.<sup>377</sup> States also have a unique lobbying power at the national level that safeguards their autonomy and insures that Congress does not abuse its power.<sup>378</sup>

Fourth, there is a strong, uniquely national, interest in bankruptcy<sup>379</sup> and a specific national interest in the bankruptcy court as a neutral forum.<sup>380</sup> As we stated in the introduction, bankruptcy provides resolution to competing claims that often cross state lines. The Court's apparent disregard in *Florida Prepaid* for the national interest in patent law uniformity, as a justification for overcoming sovereign immunity, must cause some concern for bankruptcy advocates, but even in *Florida Prepaid* the Court accepted the basic premise that patent law needs to be uniform in order to be effective.<sup>381</sup>

Armed with these considerations,<sup>382</sup> we examine whether the options available to Congress may be justified. We begin with the easiest suggestion—the enactment of the self-executing *Ex parte Young* injunction. As mentioned above, Congress could amend the Bankruptcy Code to provide for a standing *Ex parte Young* injunction. Such an enactment would promote bankruptcy interests by saving private and public litigation costs and deterring state officials from willfully violating Bankruptcy Code provisions. In light of the federalism principles we discuss, clearly such a provision favors federal power. *Ex parte Young* provides for the supremacy of federal law.<sup>383</sup> It applies only to prospective injunctive relief claims and thus does not directly affect a state's treasury. And such an enactment would significantly deter state officials from willfully abusing the automatic stay, thereby helping to maintain the level playing field among creditors.

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were consistently paraded by the southern states in their attempts to defeat desegregation and implementation of the Voting Rights Act. See *South Carolina v. Katzenbach*, 383 U.S. 301, 323 (1966). In a challenge to a provision of the Voting Rights Act that required all voting changes by covered states to be "precleared" by the United States Department of Justice, South Carolina premised its attack on federalism grounds. See *id.* Justice Black, in concurring and dissenting in the case, echoed South Carolina's argument:

[The Voting Rights Act], by providing that some of the States cannot pass state laws or adopt state constitutional amendments without first being compelled to beg federal authorities to approve their policies, so distorts our constitutional structure of government as to render any distinction drawn in the Constitution between state and federal power almost meaningless.

*Id.* at 358 (Black, J., concurring and dissenting); see also SAMUEL H. BEER, *TO MAKE A NATION: THE REDISCOVERY OF AMERICAN FEDERALISM* 19-20 (1993). In each case the rhetoric of federalism was used to hide the desire of the states to continue repugnant practices.

374. See *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 195-96 (1819).

375. See Chemerinsky, *supra* note 370, at 539 (noting that the National Labor Relations Act's weaknesses have led states to enact laws that better guarantee fair working conditions for all employees). If anything, changes in the national economy require flexibility and experimentation at the national level, which counsel for more deference to federal decision-making. See Hovenkamp, *supra* note 365, at 2221.

376. See Alden v. Maine, 119 S. Ct. 2240, 2289 (1999) (Souter, J., dissenting). Justice Souter aptly noted that the theory of "dignity" as a justification for state sovereign immunity is anomalous to a republican form of government. See *id.* The very concept of sovereign immunity has its roots in separating the royal from his subjects. See *id.* Under the American form of government, the people are the government. See *id.*

377. See 11 U.S.C. § 362(b)(4) (1994) (automatic stay apparently does not apply to a governmental unit's commencement or continuation of a proceeding to enforce the governmental unit's police or regulatory power); *id.* § 503(b)(1)(B) (administrative expense priority for certain types of tax claims); *id.* § 507(a)(8) (some unsecured pre-petition tax claims entitled to priority ahead of general unsecured creditors).

378. See Albert J. Rosenthal, *Conditional Federal Spending and the Constitution*, 39 STAN. L. REV. 1103, 1163 (1987). The "political safeguards" theory is not without its critics. See Baker, *supra* note 343, at 1940; H. Geoffrey Moulton, Jr., *The Quixotic Search for a Judicially Enforceable Federalism*, 83 MINN. L. REV. 849, 911-12 (1999). Moulton does concede that the "political safeguards" theory at least "rightly focuses attention on the fact that most of the hard work of allocating responsibility among levels of government happens outside the courtroom." *Id.* at 913.

379. The national interest in uniform bankruptcy laws has been recognized for over two hundred fifty years. See *Sturges*, 17 U.S. (4 Wheat.) at 124 ("[C]ongress only can make laws on the subject of bankruptcies. It is a national subject . . .").

380. See Elizabeth Warren, *Why Have a Federal Bankruptcy System?*, 77 CORNELL L. REV. 1093, 1094-95 (1992). A bankruptcy court is not only beneficial as a neutral forum for debtors and creditors, but by virtue of its federal character, it prevents the need to resort to state courts to vindicate national interests. See Chemerinsky, *supra* note 362, at 1229. James Madison once stated: "Confidence cannot be put in State Tribunals as guardians of the National authority and interests." *Id.* (quoting 2 MAX FARRAND, *THE RECORDS OF THE FEDERAL CONVENTION* 27 (1913)).

381. See *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2209 (1999).

382. We by no means assume our list is exhaustive. Considerations governing federalism no doubt span well beyond the scope of this Article. See *supra* note 360.

383. See Chemerinsky, *supra* note 362, at 1228.



Amending the Bankruptcy Code to disallow a state's claim unless it waives immunity with respect to the claim and compulsory counterclaims that may be asserted against a state also respects federalism principles. It is perfectly reasonable to require a state, the one kind of creditor that can assert an Eleventh Amendment and sovereign immunity, to surrender those defenses in order to participate in a federal bankruptcy *res*. Such a prescription restores the level playing field bankruptcy requires in order to fulfill its purpose. And the state's invocation of federal jurisdiction to vindicate its claim should distinguish our proposal from the Court's attack on involuntary waivers in *College Savings Bank*.<sup>384</sup>

The last three options appear to be more difficult to justify on federalism grounds. Reenacting the Bankruptcy Code pursuant to the Due Process Clause and Section 5 of the Fourteenth Amendment sets a potentially dangerous precedent.<sup>385</sup> Any federal program enacted pursuant to Article I might be made to apply to the states through the Due Process Clause, assuming that Congress could satisfy the conditions that the Court set in *Florida Prepaid*.<sup>386</sup> However, the resolution of property rights in bankruptcy has direct connections to legitimate due process concerns.<sup>387</sup> Moreover, the rate of state abuse of the bankruptcy laws is something Congress easily can catalog and present as evidence of a continuing and pervasive pattern of state violations of the Due Process Clause. Thus, although concerns that Congress could stretch the Fourteenth Amendment exception to tyrannical levels are noteworthy, cloaking bankruptcy with the protections of the Due Process Clause is justified.<sup>388</sup>

Our fourth option, conditional receipt of federal funds, does not have the grandeur of the Due Process Clause. And despite its continued constitutional vitality,<sup>389</sup> conditional spending has been attacked routinely by critics of federal power.<sup>390</sup> Conditioning a state's receipt of federal funds on waiver of the Eleventh Amendment and sovereign immunity in bankruptcy smacks of dirty politicking<sup>391</sup> and blatant intimidation by the federal government. The Spending Clause power works only when Congress makes the receipt of federal funds irresistible.<sup>392</sup> Moreover, it must be conceded that the Eleventh Amendment defense in bankruptcy is difficult to connect with federal funds.<sup>393</sup>

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384. See *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2231 (1999) ("We think where the constitutionally guaranteed protection of the States' sovereign immunity is involved, the point of coercion is automatically passed—and the voluntariness of waiver destroyed—when what is attached to the refusal to waive is the exclusion of the State from otherwise lawful activity.")

385. As explained above, re-enacting the Bankruptcy Code pursuant to the Fourteenth Amendment's Privileges and Immunities Clause and Equal Protection Clause likely exceeds the scope of Congress's power. *But see Saenz v. Roe*, 119 S. Ct. 1518, 1526-27 (1999) (arguably breathing new life into the privileges and immunities clause).

386. See *Department of Transp. & Dev. v. PNL Asset Management Co.* (*In re Fernandez*), 123 F.3d 241, 245 (5th Cir. 1997), *amended by* 130 F.3d 1138, 1138 (5th Cir. 1997).

387. The Due Process Clause prohibits the deprivation of "life, liberty or property without due process of law." U.S. CONST. amend. XIV.

388. Even easier than reenacting the entire Bankruptcy Code pursuant to the Due Process Clause, a congressional amendment to section 1983 of title 42 to abrogate sovereign immunity, thus providing bankruptcy parties potential takings claims, is clearly defensible on federalism grounds. The Fifth Amendment already bars the federal government from asserting sovereign immunity to takings claims. See *Jacobs v. United States*, 290 U.S. 13, 13 (1933). There is nothing in the nature of state sovereign immunity that distinguishes it from federal sovereign immunity for purposes of the Fifth Amendment as made applicable to the states through the Fourteenth Amendment.

389. The 1990s are rife with Supreme Court opinions, beyond the Eleventh Amendment cases, supporting states' rights at the expense of limiting federal power, *see, e.g., Alden v. Maine*, 119 S. Ct. 2240, 2268-69 (1999) (Fair Labor Standards Act cannot abrogate state sovereign immunity from suit in state courts); *Florida Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 119 S. Ct. 2199, 2210-11 (1999) (Patent and Plant Variety Protection Remedy Clarification Act invalidly abrogates state sovereign immunity under section 5 of the Fourteenth Amendment); *United States v. Lopez*, 514 U.S. 549, 567-68 (1995) (The Gun Free School Zones Act exceeds Congress's power under the Commerce Clause.); *New York v. United States*, 505 U.S. 144, 149 (1992) (federal law regulating low-level radioactive waste violated the Tenth Amendment because it coerced state legislative and regulatory regimes); *Gregory v. Ashcroft*, 501 U.S. 452, 460 (1991) (Congress may regulate the retirement age of state judges only by clear language). One would reasonably think that the Spending Clause cases would be an inviting target for the Supreme Court. Yet Chief Justice Rehnquist was the author of the majority opinion in *Dole*, and Justice Scalia recognized its vitality as an exception to constructive waiver of sovereign immunity in *College Savings Bank*. *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 119 S. Ct. 2219, 2231 (1999).

390. These attacks have focused on the lack of constraints on the Spending Clause power and the inability of states to protect themselves from Congress. *See, e.g., Baker, supra* note 343, at 1933; Thomas R. McCoy & Barry Friedman, *Conditional Spending: Federalism's Trojan Horse*, 1988 SUP. CT. REV. 85, 87 (1988).

391. Justice O'Connor noted in her dissent in *FERC v. Mississippi* that "[c]ongressional compulsion of state agencies . . . blurs the lines of political accountability and leaves citizens feeling that their representatives are no longer responsive to local needs." *FERC v. Mississippi*, 456 U.S. 742, 787 (1982) (O'Connor, J., dissenting). The point Justice O'Connor makes is that the federal government can insulate itself from political accountability by influencing the states to enact legislation that the state's citizens may not in fact want (highway speed limits) in order to receive federal funds. Even if Justice O'Connor's point has merit, it only works if in fact state citizens would care about the state's surrender to federal influence. It seems doubtful that state citizens would generate hostility or offer any opinion on whether a state waives its Eleventh Amendment immunity and consents to be sued in federal court.

392. See William Van Alstyne, "Thirty Pieces of Silver" for the Rights of Your People, 16 HARV. J.L. & PUB. POL'Y 303, 319-20 (1993). States substantially rely upon federal funding to support a wide array of projects. *See McCoy & Friedman, supra* note 390, at 86.

393. For example, receipt of education funds on the condition that states enact gun-free zone laws or receipt of highway funds as a condition of raising minimum drinking ages are logically connected. Justice O'Connor, in her dissent in *Dole*, argued for a rule that required Congress to show a more than attenuated or tangential connection between the federal funds being offered to a state

Yet the power of Congress to influence decision making at the state level through the Spending Clause clearly supports federalism principles. Congress itself is made up of representatives of the states. Congressional members are not immune to the pressures from home to protect specific state interests.<sup>394</sup> Thus, the states can, in some measure, protect themselves against abusive federal conditioning.<sup>395</sup> Moreover, the actual harm to a state in surrendering its constitutional sovereign immunity in bankruptcy is "more rhetoric than fact."<sup>396</sup> Finally, because bankruptcy is an area of federal economic regulation,<sup>397</sup> Congress must be given more deference to promote bankruptcy goals, including, if necessary, conditioning receipt of federal funds on waiver of Eleventh Amendment immunity and sovereign immunity in bankruptcy.

Last, we consider whether authorizing private trustees or debtors in possession to sue in the name of the United States offends or supports federalism principles. Unlike the other solutions, lending the name of the United States to a private party causes a direct confrontation between the federal government and the states. Assuming *arguendo* the constitutionality of such a gambit, such authorizations solve the problem of *Seminole Tribe* and *Alden* only because the Eleventh Amendment must yield to the supremacy of the federal government when the federal government directly confronts a state.

Yet there is a flaw in authorizing private trustees to sue in the name of the United States such that federalism principles suggest abandoning this option. The Supreme Court likely would conclude that the federal government's interest in bankruptcy estates represented by private trustees or debtors-in-possession is at best remote. This is distinguished from *qui tam* suits where the favorable resolution of the suit in fact benefits the United States directly.<sup>398</sup> The direct benefit to the federal government in *qui tam* actions justifies lending the federal government's power to abrogate Eleventh Amendment immunity.<sup>399</sup>

If the "suing in the name of the United States" statute is tailored such that the United States stands to benefit from any bankruptcy recovery, however, then federalism favors such a provision. Moreover, if the United States trustee exercises governmental discretion whether to prosecute the action on behalf of the estate in the name of the United States, then federalism concerns evaporate. *Alden* recognized that the states' constitutional sovereign immunity right must yield to suits brought by the federal government; in fact, one point of contention between the majority and the dissenters was on the likelihood of the federal government actually bringing suits to enforce federal law.<sup>400</sup> Both the *Alden* majority and Justice Souter, in debating the likelihood of federal intervention in Fair Labor Standard Act suits, implicitly accept the notion that federalism principles favor suits against states in federal court where the United States stands to benefit.<sup>401</sup> Thus, granting trustees in bankruptcy cases the right to sue in the name of the United States in order to partially recover for the United States should be preferred.

## VI. CONCLUSION

The Supreme Court's decisions in *Seminole Tribe* and *Alden* render section 106(a) of the Bankruptcy Code unconstitutional as applied to its abrogation of the states' Eleventh Amendment and sovereign immunity. Congress, though providing the necessary unequivocal intent to abrogate the states' immunity, failed to abrogate states' immunity pursuant to a valid exercise of power because the Bankruptcy Clause of Article I is not a source of legislative power that may abrogate the states' Eleventh Amendment immunity. Bankruptcy courts cannot save section 106(a) by applying the Fourteenth Amendment exception to the Eleventh Amendment because there is no

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and the federal program in which Congress wishes the states to participate. See *South Dakota v. Dole*, 483 U.S. 203, 213-15 (1987) (O'Connor, J., dissenting). It is reasonable to believe that a few retirements of current Supreme Court Justices could elevate Justice O'Connor's dissent in *Dole* to majority status.

394. Public choice theory states that most regulatory schemes are enacted to promote the interests of particular groups. See Hovenkamp, *supra* note 365, at 2217. There is no reason why states cannot lobby for self-interested legislation as effectively as a manufacturing lobby, trial lawyers, or the American Association of Retired Persons. See *infra* note 395.

395. See Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543, 559 (1954); see also Hovenkamp, *supra* note 365, at 2221. As Wechsler notes, national level politicking "is intrinsically well adapted to retarding or restraining new intrusions by the center on the domain of the states." Wechsler, *supra* at 558. Not all commentators accept Wechsler's "political safeguards" theory. See Moulton, *supra* note 378, at 911-12.

396. *Dole*, 483 U.S. at 211. As noted above, *supra* note 391, state citizens likely do not care whether the Eleventh Amendment is waived as a condition to receipt of federal funds.

397. See Hovenkamp, *supra* note 365, at 2220.

398. See *United States ex rel. Foulds v. Texas Tech Univ.*, 171 F.3d 279, 290 (5th Cir. 1999); see also *supra* note 306 and accompanying text.

399. Amending the Bankruptcy Code to require the estate to distribute a percentage of any recovery to the United States treasury may solve this problem. The fees to which the United States Trustee is entitled in 28 U.S.C. § 1930 probably are insufficient to create a nexus between a private trustee and the United States because those fees are generated in every bankruptcy case, not just in suits against a state.

400. See *supra* notes 86-87 and accompanying text.

401. See *id.*

legal basis to view bankruptcy as a privilege or immunity of national citizenship. Nor will the Takings Clause be available as long as section 1983 of title 42 does not abrogate sovereign immunity. But, subject to the constraints of *Boerne* and *Florida Prepaid*, Congress might be able to reenact section 106 of the Bankruptcy Code to address Fourteenth Amendment Due Process issues, at least to the extent states act intentionally to seize or destroy property of the estate. Except for possible Due Process redress, it appears that a bankruptcy court may not exercise jurisdiction over a state absent the state's consent or waiver of Eleventh Amendment and sovereign immunity.

Although *Seminole Tribe* and *Alden* have significant adverse effects for enforcing bankruptcy law against states, trustees or debtors-in-possession still have a variety of limited options at their disposals. Governmental units that are not arms of the state, such as counties and cities, may not invoke Eleventh Amendment protections successfully. Trustees may still sue state officials for prospective injunctive relief pursuant to the *Ex parte Young* doctrine. And, there may be a limited *in rem* "exception" to the Eleventh Amendment in the bankruptcy context.

But these limited options provide no relief to debtors and creditors in cases such as *Tri-City Turf Club*, described in this Article's introduction. To provide meaningful resolution to the problems caused by *Seminole Tribe* and *Alden*, Congress should amend the Bankruptcy Code to further the policies of bankruptcy law. Congress might achieve this goal in several ways. First, Congress could amend the Bankruptcy Code to authorize the United States trustee, and possibly private trustees or debtors in possession, to sue states in the name of the United States. Second, Congress could amend the statute to provide for a standing, self-executing *Ex parte Young* injunction against state officials. Third, Congress could condition a state's claim to bankruptcy proceeds on a waiver of Eleventh Amendment and sovereign immunity. Fourth, Congress could resort to the Spending Clause power to condition a state's receipt of federal funds on a waiver of Eleventh Amendment and sovereign immunity.

Although these potential legislative enactments either have a limited scope or cause uneasiness with respect to notions of federalism,<sup>42</sup> they are desirable to remedy the potentially devastating effect of *Seminole Tribe*, *Alden*, and their progeny in bankruptcy cases and proceedings.

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402. See Rosenthal, *supra* note 378, at 1133.

# **TAX ISSUES IN BANKRUPTCY CASES**

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## **BANKRUPTCY TAX REFORM: WHAT'S IN AND WHAT'S OUT**

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**Paul H. Asofsky  
Weil, Gotshal & Manges LLP  
Houston, Texas**



**TAX ISSUES IN BANKRUPTCY CASES  
BANKRUPTCY TAX REFORM: WHAT'S IN AND WHAT'S OUT**

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**PENDING PROPOSALS FOR TAX AMENDMENTS  
TO THE BANKRUPTCY CODE**

**BACKGROUND**

**I. The National Bankruptcy Review Commission**

- A. Creation.** Pub. L. No. 103-392, the Bankruptcy Reform Act of 1994, established the National Bankruptcy Review Commission (the "Commission"). The Commission was created to investigate and study issues relating to the Bankruptcy Code, solicit divergent views of parties concerned with the operation of the bankruptcy system, evaluate the advisability of proposals with respect to such issues and prepare a report to be submitted to the President, Congress and the Chief Justice not later than two years after the date of the first meeting. The Commission, in fact, issued its report on October 20, 1997.
- B. Membership.**
1. Rep. Mike Synar was the original Chairman of the Commission. He resigned due to illness on December 19, 1995 and died on January 9, 1996. He was replaced as Chair on March 29, 1996 by Brady C. Williamson of Madison, Wisconsin. Williamson is a corporate lawyer.
  2. Robert E. Ginsberg, United States Bankruptcy Judge, Illinois.
  3. Jay Alix, CPA, Michigan. Alix is a nationally prominent bankruptcy and turnaround specialist.
  4. M. Caldwell Butler, a former Member of Congress, Virginia.
  5. Babette A. Ceccotti, New York. Ceccotti is a labor lawyer.
  6. John A. Gose, Washington. Gose is a real estate lawyer.
  7. Jeffrey Hartley, Alabama. Hartley is a United States Bankruptcy Judge in Alabama and former staff member of the Senate Judiciary Committee.
  8. Edith Hollan Jones, United States Circuit Judge, Fifth Circuit, Texas.
  9. James I. Shepard, California. Shepard is a lawyer. See I.C.1 below.

**C. The Advisory Committee.**

1. In early February of 1997, Chairman Williamson appointed an informal tax advisory committee (the "Advisory Committee") to assist the Commission in "sifting and winnowing" the Commission's tax agenda. The members of the Advisory Committee were:
  - a. Professor Jack Williams, Georgia State College of Law, Chairman.
  - b. Professor Grant Newton, Pepperdine University.
  - c. Stephen Csontos, Deputy Attorney General, United States Department of Justice.
  - d. Joyce E. Bauchner, Internal Revenue Service. Ms. Bauchner chose not to serve and designated her associate, Robert Miller, as a substitute member.
  - e. Mark Browning, Assistant Attorney General, State of Texas.
  - f. Joan Pilver, Assistant Attorney General, State of Connecticut.
  - g. Paul H. Asofsky, Partner, Weil, Gotshal & Manges, Houston, Texas.
  - h. Robert E. McKenzie, Attorney, small firm practitioner, Chicago, Illinois.
  - i. Mark Segal, Attorney, sole practitioner, Las Vegas, Nevada.
  - j. Kenneth C. Weil, Attorney, sole practitioner, Seattle, Washington.

**D. Report of Advisory Committee.**

1. In August 1997, the Advisory Committee submitted its report to the Commission. The report is published as an appendix to the Commission's final report. The Advisory Committee attempted to divide all of the tax issues raised in the course of the Commission's deliberations according to whether they were non-controversial or important and highly controversial. In all of its recommendations where there was not consensus, the Advisory Committee stated the competing

propositions and recorded the vote by member for each proposition. The Advisory Committee identified 32 proposals as non-controversial (the "consensus proposals"), the most significant of which are as follows:

- a. To adopt a series of rules changes proposed by the Justice Department that would have the effect of giving notice of a bankruptcy case to a governmental unit at a place of its designation and setting forth the nature of the claim of the governmental unit.
- b. To prescribe a uniform statutory rate of interest to be applied when the Bankruptcy Code permits tax payments to be deferred.
- c. To set forth notice rules when a debtor invokes the prompt audit procedures of Bankruptcy Code Section 505(b).
- d. To conform the federal tax treatment and state and local tax treatment as to bifurcating a taxable year when an individual files a bankruptcy petition under Chapter 7 or Chapter 11.
- e. To provide certain tolling rules to prevent debtors from filing successive bankruptcy petitions to avoid the non-dischargeability rules for income taxes.
- f. To clarify the tolling rules for non-dischargeability when the debtor makes an offer in compromise.
- g. To require small business debtors to create and maintain separate bank accounts for trust fund taxes when such debtors file a bankruptcy case.
- h. To except fraudulent taxes from Chapter 11 discharge for corporations.
- i. To make clear that the automatic stay against Tax Court proceedings does not apply to tax periods ending after the filing of the case.
- j. To conform the treatment of secured tax claims with unsecured tax claims that are entitled to six-year deferral under Section 1129(a)(9)(C) of the Bankruptcy Code.

- k. To preclude trustees from taking advantage of the bona fide purchaser rules of Internal Revenue Code § 6323 to invoke Section 545(2) of the Bankruptcy Code.
- l. To require debtors to pay postpetition taxes in the ordinary course of business without the necessity of having a governmental creditor file a request for payment of administrative expenses.
- m. To generally conform state and local tax rules contained in the Bankruptcy Code with federal tax rules.
- n. To make clear that under Section 1398 of the Internal Revenue Code, an individual's bankruptcy estate treated as a separate entity is subject to both alternative minimum tax and preferential capital gains rates.
- o. To provide a Bankruptcy Code definition of the term "assessed" or "assessment" in those cases where a state law does not define the term.
- p. To prescribe standards for tax disclosures in Chapter 11 disclosure statements.
- q. To clarify the time period in which a taxing authority must file a proof of claim for a priority tax in a Chapter 7 case.
- r. To require debtors seeking Chapter 13 relief to have filed at least the last six years worth of tax returns.
- s. To allow debtors to be discharged from tax liabilities in cases where they did not file a return but otherwise agreed to a taxing authority's determination of their tax liability.

Notwithstanding the foregoing, some governmental taxing authorities and private bar groups have opposed some of these consensus items. In addition, in some cases, the consensus has fallen apart in working out the details.

- 2. In addition to the foregoing recommendations, most of which were procedural in nature, the Advisory Committee made a number of recommendations that involved changes to substantive tax law. While these were consensus items, Mr. Csontos from the Department of Justice and Mr. Miller

from the Internal Revenue Service abstained from these votes. The most important of these recommendations were as follows:

- a. To allow the estate to avail itself of any statutory exclusion from gain on the sale of a personal residence.
  - b. To liberalize provisions of Internal Revenue Code §§ 108 and 382 so that Chapter 11 corporate debtors can retain a greater portion of their net operating loss carryovers that were reduced or eliminated as a result of the repeal of the stock for debt exception in 1993.
  - c. To overrule the decision of the Supreme Court in Commissioner v. Tufts, 461 U.S. 300 (1983), and to provide for parallel tax treatment of the use of property to satisfy recourse and non-recourse debt.
3. The Advisory Committee also made a number of recommendations by divided votes, and most of these have not found their way into proposed legislation.

**E. Commission Action.**

1. With one exception dealing with Chapter 9 municipal bankruptcy cases, the Commission rubber stamped all of the consensus proposals of the Advisory Committee without taking a separate vote. However, the Commission did, after debate, adopt a number of specific recommendations on proposals as to which the Advisory Committee was divided. Among the more important of these were:
  - a. To restore secured status to ad valorem tax liens by partially repealing Section 724(b)(2) of the Bankruptcy Code.
  - b. To have the burden of proof in tax disputes in the Bankruptcy Court be the same as the rules prevailing in non-bankruptcy tax tribunals.
  - c. To require periodic payment of deferred taxes under Section 1129(a)(9) of the Bankruptcy Code.
  - d. To permit the government to set off prepetition income tax refunds against undisputed prepetition tax liabilities.



- e. To create a statutory rule for abandonment of property by the trustee which generally treats the abandoned property as having been disposed of by the debtor immediately prior to bankruptcy.
- f. To permit corporate debtors to elect to bifurcate their tax years in a manner similar to that applying to individuals under Section 1398(d)(2) of the Internal Revenue Code.
- g. To grant the Bankruptcy Court jurisdiction to issue declaratory judgments in respect of the tax consequences of a Chapter 11 plan of reorganization.
- h. To provide that where a taxing authority does not respond to a request under Section 505(b) of the Bankruptcy Code, the discharge granted by Section 505(b) applies to the estate itself as well as to the debtor, a successor to the debtor, and a trustee.
- i. To subordinate prepetition non-pecuniary loss tax penalties in Chapters 11, 12 and 13.

**F. Important and Controversial Items as to Which the Commission Made No Recommendation.**

- 1. Whether to retain the Chapter 13 superdischarge in the case of tax liabilities that may not be discharged in Chapter 7.
- 2. Whether to overrule the decision of the Supreme Court in United States v. Energy Resources, 495 U.S. 545 (1990), which allows a Bankruptcy Judge to confirm a plan of reorganization which allocates the first payments of deferred taxes to trust fund liabilities for which individual responsible officers may be personally liable.
- 3. To write a definition of fraud for discharge purposes in the case of an individual. Some cases construe the fraud exception to discharge so broadly that debtors who pay other debts when tax liabilities exist cannot receive a discharge. See, e.g., In re Toti, 24 F.3d 806 (6th Cir. 1994).

**II. Legislative Response to the Commission's Tax Proposals**

- A. S. 1149 (Grassley, Durbin). The Investment in Education Act of 1997. This bill passed the Senate on October 30, 1997. This bill consists only of two tax provisions, described at III and IV below.

- B. H.R. 3150 (Gekas). Reported to the House by the House Judiciary Committee. This bill had a title containing 18 tax provisions. Passed House 6/10/98.
- C. S. 1301 (Grassley). Reported by Senate Judiciary Committee. Merged with H.R. 3150. It was a consumer bankruptcy bill that had no tax provisions. Passed Senate as H.R. 3150, 9/23/98.
- D. S. 1914 (Grassley). Hearings held by Senate Judiciary Committee, but never reported. Contained tax provisions similar to H.R. 3150.
- E. Conference Report on H.R. 3150 printed 10/7/98. Contained House tax provisions. House passed conference bill 10/9/98. Died in Senate.
- F. H.R. 833 (Gekas). This bill largely incorporated the Conference Report on H.R. 3150, including tax provisions. Passed House 5/5/99.
- G. S. 625 (Grassley). Included H.R. 3150 tax provisions. During the course of the consideration of bankruptcy reform by the Senate, the Finance Committee took an interest in the tax provisions of the bill. By agreement with the sponsors, jurisdiction over the tax provisions was ceded to the Finance Committee. The result of the Finance Committee's deliberations was an amendment introduced by Senators Roth and Moynihan. The amendment passed by a voice vote. References in this memorandum to S. 625 are to that bill as amended by the Roth-Moynihan amendment. The Senate has not completed action on S. 625.

### PROPOSALS INCORPORATED IN PENDING LITIGATION

#### III.

##### Repeal of Section 724(b)

- A. **Proposal.** To restore ad valorem tax liens to full secured status in Chapter 7 cases. Under Section 724(b)(2) of the Bankruptcy Code as in effect since 1978, secured tax claims are treated as unsecured priority claims as if no lien existed.
- B. **Source of Proposal.** Local school boards through the National Association of Attorneys General; Department of Justice. Generally, the private bar opposed amendments to Section 724(b), notably the ABA Task Force, the National Bankruptcy Conference and the Association of the Bar of the City of New York. The ABA Task Force has withdrawn its opposition. The National Bankruptcy Conference now supports the amendment as to ad valorem real property taxes.

- C. **Advisory Committee.** The Advisory Committee considered only two proposals, viz, to repeal Section 724(b)(2) altogether, so that all tax liens would be recognized in bankruptcy and, alternatively, to retain present law. By a vote of five to four with one abstention, the Advisory Committee voted to repeal Section 724(b)(2).
- D. **Commission.** The Commission ultimately gave the local taxing authorities most, though not all, of what they wanted. Under the Commission proposal, "11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, non-avoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under 11 U.S.C. § 506(c) prior to subordinating any tax liens under the statute." Since the Commission issued its report, the National Bankruptcy Conference has changed its position to support repeal of Section 724(b)(2) with respect to ad valorem real, but not personal, property taxes. The breaking of ranks by the National Bankruptcy Conference appears to be a significant political development.
- E. **H.R. 833 and S. 625.** Under pressure from local school boards and with the support of Commissioner Shepard, Senator Grassley introduced S. 1149, the Investment in Education Act of 1997, which was co-sponsored by Senator Durbin, the then ranking minority member of the Subcommittee of the Judiciary Committee to which this matter was assigned. Sections 801(a) of H.R. 833 and 701(a) of S. 625, each of which is substantially identical to section 2(a) of S.1149, would exempt ad valorem real or personal property tax liens from the operation of Section 724(b)(2) of the Bankruptcy Code. Thus, if a lien is properly perfected and unavoidable, it would be given effect as a secured claim in accordance with its usual priority, except that it would continue to be subordinated to claims for wages, salaries and commissions entitled to priority under Section 507(a)(3) of the Bankruptcy Code and to claims for contributions to an employee benefit plan entitled to priority under Section 507(a)(4) of the Bankruptcy Code. Other tax liens, for example, federal tax liens, would continue to be subordinated under the current provisions of Section 724(b)(2). However, before subordinating a tax lien in such a case, the trustee would be required to exhaust the unencumbered assets of the estate, and, in a manner consistent with Section 506(c) of the Bankruptcy Code, recover from property securing an allowed secured claim the reasonable and necessary costs and expenses of preserving or disposing of that property. Also, subordination does not apply to administrative expenses in converted chapter 11 cases.
- F. **Issues.**

1. Should expenses of administration in Chapter 7 take priority over secured as well as unsecured tax claims?
2. Is the interest of local school boards in property tax revenue sufficiently important to treat ad valorem secured tax claims on a higher priority than all others, including federal tax liens?
3. Should non-governmental secured creditors bear the burden of these taxes since this is the commercial expectation? Downgrading the tax lien would appear to give such secured creditors a windfall.

IV. **Limitation on Bankruptcy Court's Section 505 Jurisdiction**

- A. **Proposal.** To preclude the Bankruptcy Court from redetermining ad valorem property taxes if the contest period under local law has expired.
- B. **Source of Proposal.** Local school boards through the National Association of Attorneys General.
- C. **Advisory Committee.** The Advisory Committee considered a proposal to limit the jurisdiction of the Bankruptcy Court in determining tax liability to situations in which a non-bankruptcy forum would have jurisdiction to hear the matter. This proposal incredibly received only one vote, that of the Assistant Attorney General from Connecticut. It was defeated seven to one with two abstentions. All four private practitioners, both professors, and the Assistant Attorney General from Texas voted against the proposal.
- D. **Commission.** The Commission did not take up this proposal.
- E. **S. 1149, H.R. 833 and S. 625.** Sections 801(b) of H.R. 833 and 701(b) of S. 625, each of which is substantially identical to section 2(b) of S.1149, would withdraw jurisdiction from the Bankruptcy Court to determine the amount or legality of any ad valorem real or personal property tax if the applicable period for contesting or redetermining that amount under non-bankruptcy law has expired.
- F. **Issues.**
  1. Should the bankruptcy court generally have the power to determine tax controversies under circumstances where the debtor has lost its rights under non-bankruptcy law?
  2. If the answer to this question is yes, is there any justification for making an exception for ad valorem taxes?

V. **Notice to Governmental Units**

- A. **Proposal.** To prescribe statutory rules for the content and method of notice to governmental creditors.
- B. **Source of Proposal.** United States Department of Justice; Commissioner Shepard.
- C. **Advisory Committee.** Recommended Justice Department's proposals as a rules change. These proposals generally would permit a governmental unit to designate an address to which service of process must be addressed and would provide some specificity as to the content of such notice. However, the taxing authority would be required to file such address and specification with each local bankruptcy clerk so that a debtor seeking to comply with the requirements in good faith could readily ascertain them. The Advisory Committee specifically rejected a proposal that would require an individual debtor to red flag a potential trust fund liability, but instead placed the burden on the government by requiring the debtor to list on his schedules all business entities in which the debtor was an officer, director or substantial equity holder. Thus, it would be up to the governmental taxing authority to assert the trust fund penalty in the bankruptcy case, or else the debtor would be discharged.
- D. **Commission.** Recommended Justice Department's proposals as a rules change. For reasons that are not entirely clear, the Advisory Committee on Bankruptcy Rules of the Judicial Conference has not adopted the Justice Department's rules package in spite of the Commission's recommendation, thus precipitating legislative action.
- E. **H.R. 833.**
1. Section 503 of the bill would require a debtor who lists a governmental unit as a creditor in a list or schedule to identify the department, agency or instrumentality through which the debtor is indebted. If the debtor's liability to a governmental unit arises from a debt or obligation owed or incurred by another individual, entity, or organization, or under a different name, the debtor shall identify such individual, entity, organization or name. The clerk of each bankruptcy court is required to keep and update quarterly a register in which a governmental unit may designate a safe-harbor mailing address for service of notice in cases pending in the district. A notice not complying with the requirements of the statute shall have no effect unless the debtor demonstrates by clear and convincing evidence that

timely notice was given in a manner reasonably calculated to satisfy the requirements of the statute, and if the governmental unit does not file a safe harbor mailing address, the debtor's burden includes proving that an officer of the governmental unit who is responsible for the matter or claim had actual knowledge of the case in sufficient time to act.

F. **S. 625.** No provision.

G. **Issues.**

1. Is the statute a proper place to prescribe detail for the content and method of notice, or should such detail be left to the Advisory Committee on Bankruptcy Rules of the Judicial Conference?
2. Should an individual debtor be discharged from an as yet unasserted trust fund tax liability if he has not notified the relevant taxing authority of the potential for such liability?

VI. **Section 505(b) Notice**

- A. **Proposal.** To allow tax authorities to prescribe the form and method of notice when Section 505(b) relief is sought. Present practice is for debtors to file their Section 505(b) requests with their tax returns. The IRS has adopted specific requirements in Rev. Proc. 81-17, 1981-1 C.B. 688, but has met with mixed results in the bankruptcy courts.
- B. **Source of Proposal.** Internal Revenue Service; Commissioner Shepard.
- C. **Advisory Committee.** Adopted substance of proposal but required each governmental unit to file the address for sending notice in a registry maintained by the clerk in each district.
- D. **Commission.** Rubber stamped as part of consensus proposals.
- E. **H.R. 833.** Section 803 of the bill would amend Section 505(b) of the Bankruptcy Code to require that any request for a determination of tax liability under that section must be made "substantially in the manner designated by the governmental unit." There is no requirement for filing these requirements with the court.
- F. **S. 625.** Section 703 of the bill would require the clerk of each district to maintain a listing under which a Federal, state or local taxing authority may designate an address for service of requests

under Section 505(b) and describe where further information concerning additional requirements for filing such requests may be found. If the taxing authority does not make such a filing, any Section 505(b) request may be served at the address for the filing of a tax return or protest with the appropriate taxing authority.

**G. Issues.**

1. Should all taxing authorities be permitted to prescribe the form and method of notices under Section 505(b) of the Bankruptcy Code as the Internal Revenue Service has attempted to do in Rev. Proc. 81-17?
2. If such authority is to be granted, should there be a central office or a computer website in which the taxing authority must post such requirements so that a debtor seeking the benefits of Section 505(b) will be able to readily ascertain such requirements? Most private bar groups would accept the general proposal as so modified.

**VII. Interest Rate on Deferred Tax Payments**

- A. **Proposal.** To provide a uniform rate of interest in respect of tax claims.
- B. **Source of Proposal.** Internal Revenue Service; United States Department of Justice.
- C. **Advisory Committee.** The Advisory Committee adopted as a consensus item that the Bankruptcy Code be amended to prescribe a uniform interest rate in the case of deferred taxes at a stated statutory rate regardless of whether federal, state or local taxes were involved. The report stated, "Although short of a consensus, a majority of members of the Advisory Committee suggest that the fixed federal deficiency rate under IRC § 6621(a)(2), without regard to IRC § 6621(c), be employed."
- D. **Commission.** The Commission adopted the Advisory Committee proposal and specifically adopted the Section 6621(a)(2) deficiency rate.
- E. **H.R. 833.** (Section 804)
  1. In the case of an ad valorem tax claim, whether secured or unsecured, other unsecured tax claims where interest is required to be paid under Section 726(a)(5) of the Bankruptcy Code and secured tax claims, the rate is to be determined under applicable non-bankruptcy law.

2. In the case of all other tax claims, the "minimum" rate of interest is the Federal short-term rate determined under Section 1274(d) of the Internal Revenue Code plus three percentage points. The rate is determined on the basis of the prevailing rate in the calendar month in which a plan of reorganization is confirmed.

F. **S. 625.** Under Section 704 of the bill, the rate is the applicable non-bankruptcy rate, determined as of the calendar month in which a plan is confirmed. The importance of the Senate provision is significantly diluted by its specific provision of a uniform interest rate for deferred payments under Section 1129(a)(9)(C) of the Bankruptcy Code. See XIII below.

G. **Issues.**

1. Should the Bankruptcy Code determine interest rates with respect to tax claims on the basis of bankruptcy policies, or should applicable non-bankruptcy tax deficiency rates apply?

#### VIII. **Tolling of Section 507(a)(8)(A) Time Periods**

A. **Proposal.** To toll the priority/nondischarge periods of Section 507(a)(8)(A) for prior bankruptcy cases, pending offers in compromise and installment payment agreements. Under present law, taxes becoming due within three years or assessed within 240 days of a bankruptcy filing cannot be discharged, but the 240-day period is tolled during the time that an offer in compromise is in effect.

B. **Source of Proposal.** Internal Revenue Service; United States Department of Justice; Commissioner Shepard.

C. **Advisory Committee.** The Advisory Committee proposed as a consensus item a tolling for the time during which a previous bankruptcy case was pending for the three-year nondischarge period of Section 507(a)(8)(A)(i), but did not vote on a six-month, or any other, add-on. The Advisory Committee also adopted a proposal for the tolling of the 240-day nondischarge period of Section 507(a)(8)(A)(ii) during the period when offers in compromise are pending, as well as accepted offers. The Advisory Committee rejected a proposal to apply any tolling to the period during which an installment payment agreement is in effect.

D. **Commission.** The Commission adopted the Advisory Committee consensus.



E. **H.R. 833.** Section 805 of the bill would provide for the tolling of certain time periods provided in Section 507(a)(8)(A) of the Bankruptcy Code. The proposal would add to the three-year nondischargeability period now applicable under Section 507(a)(8)(A)(i) the period of time during which a prior bankruptcy case was pending plus six months. Also, the provision would make the 240-day period under Section 507(a)(8)(A)(ii) for offers in compromise apply to pending as well as to accepted offers. Finally, the bill would toll the 240-day period during the time an installment payment agreement is in effect, plus 30 days, with a maximum period of one year.

F. **S. 625.** Section 705 of the bill would adopt tolling periods as follows:

1. For prior bankruptcy cases, the Section 507(a)(8)(A)(i) priority period would be tolled during the period of the prior case plus 90 days;
2. The 240 day priority period of Section 507(a)(8)(A)(ii) would be tolled during any period of time in which an offer in compromise was pending or in effect plus 30 days;
3. The 240 day priority period of Section 507(a)(8)(A)(ii) would be tolled during any period of time for which a stay of proceedings against collection was in effect during a prior case plus 90 days; and
4. The priority periods under Section 507(a)(8) would be tolled during the time a governmental unit is prohibited under applicable non-bankruptcy law 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 a debtor. This latter tolling period is designed to preserve the government's rights during the time when a taxpayer is invoking hearing and appeal rights given him by the IRS Restructuring and Reform Act of 1997.
5. Note that unlike H.R. 833, there is no tolling in S. 625 applicable to the period of time when an installment payment agreement is in effect.

The private bar does not oppose these provisions. The only disputes involve the add-on periods and the application of the tolling rules to installment payment agreements.

G. **Issues.**

1. Should the nondischarge period of Section 507(a)(8)(A)(i) be tolled during any period in which a prior bankruptcy case was pending? Does the absence of such a tolling provision encourage serial filings?
2. Should there be an additional six months (or any other time) added to any such tolling period? Cf. Section 6503(h) of the Internal Revenue Code.
3. Should the 240-day nondischarge period of Section 507(a)(8)(A)(ii) be tolled for the period during which any offer in compromise is pending but not yet accepted?
4. Should the nondischarge period under Section 507(a)(8)(A)(ii) be tolled for the period during which any installment payment agreement is in effect? Would such a provision favor taxpayers who run away from the IRS over those who try, but fail, to work out their tax debts?

**IX. Definition of Assessment**

- A. **Proposal.** To provide a definition of "assessment" for non-federal taxes in bankruptcy cases.
- B. **Source of Proposal.** National Association of Attorneys General.
- C. **Advisory Committee.** The Advisory Committee adopted as a consensus item that the Bankruptcy Code be amended to provide that the term "assessed" or "assessment" as used in Sections 362(b)(9), dealing with the automatic stay, and 507(a)(8), dealing with nondischargeability periods, shall mean "that time at which a taxing authority may commence an action to collect a tax." This amendment would apply with respect to state and local taxes only, since the definition of assessment for purposes of the Internal Revenue Code is clear.
- D. **Commission.** Rubber stamped as part of the consensus proposals.
- E. **H.R. 833 and S. 625.** Section 806 of H.R. 833 and Section 706 of S. 625 would both substitute the word "incurred" for the word "assessed" where it appears in Section 507(a)(8)(B) of the Bankruptcy Code, providing for a priority for ad valorem real property taxes.
- F. **Issues.**

1. Should the Bankruptcy Code provide a definition of the term "assessment" to cover those cases where that term is not specifically used under a state or local law imposing a tax?
2. Should any such definition apply both for purposes of the automatic stay provisions of Section 362 and the priority provisions of Section 507?
3. These provisions are noncontroversial.

**X. Chapter 13 Discharge**

- A. **Proposal.** To repeal the Chapter 13 "superdischarge." Under present law, a debtor who goes into Chapter 13 and commits future income on a best efforts basis can be discharged from tax liabilities that would survive Chapter 7.
- B. **Source of Proposal.** Internal Revenue Service; United States Department of Justice.
- C. **Advisory Committee.** Divided five/five. No proposal.
- D. **Commission.** Generally rejected proposals to repeal the superdischarge; divided four/four with one abstention on a proposal to deny discharge in the case of tax fraud.
- E. **H.R. 833.** Section 807 of the bill would deny a discharge in Chapter 13 in respect of tax debts that could not qualify for a discharge in Chapter 7.
- F. **S. 625.** Section 707 of S. 625 would deny the superdischarge to taxes that are non-dischargeable under Sections 523(a)(1)(B) and 523(a)(1)(C), i.e., fraudulent returns, unfiled returns, and late filed returns. Other tax liabilities could be discharged.
- G. **Issues.**
  1. What is the justification for granting a discharge from a tax (or other) liability in Chapter 13 if such liability is excepted from discharge in Chapter 7 by Section 523 of the Bankruptcy Code?
  2. Will the availability of a broader discharge in Chapter 13 encourage more delinquent taxpayers to use their best efforts to pay some of their liabilities and come back into the system? If so, do tax authorities really lose anything if a superdischarge is continued?

3. Even if there is room for a "superdischarge" in Chapter 13, should it extend to tax liability attributable to fraud?
4. What is the definition of fraud for purposes of the discharge rules?

This is the most controversial provision in the bill.

## **XI. Chapter 11 Discharge**

- A. **Proposal.** To make an exception to the Chapter 11 discharge for corporations in fraudulent tax cases.
- B. **Source of Proposal.** Commissioner Shepard
- C. **Advisory Committee.** Adopted proposal unanimously.
- D. **Commission.** Rubber stamped as part of the consensus proposals.
- E. **H.R. 833.** Section 808 of the bill would deny Chapter 11 discharge to tax liabilities arising from fraudulent tax returns filed by corporations.
- F. **S. 625.** Section 708 of the Bill is the same as Section 808 of H.R. 833.
- G. **Issues.**
  1. At present, a Chapter 11 discharge is complete. Unlike Chapter 7 discharges for individuals, there are no exceptions in corporate Chapter 11 cases. Are innocent creditors punished by this provision?
  2. Will this proposal, if enacted, open Pandora's box and begin an erosion of the chapter 11 discharge in the same way the chapter 7 discharge has been eroded?

While originally quiescent, all major bar groups dealing with chapter 11 have come out in opposition to this proposal.

## **XII. Tax Court Jurisdiction**

- A. **Proposal.** To give the Tax Court jurisdiction over tax years ending after the filing of the bankruptcy petition and to allow appeals from non-bankruptcy tax tribunals notwithstanding the automatic stay. Under a glitch in present law, the Tax Court has no jurisdiction over an individual's post-petition tax years while the individual is in

chapter 7, notwithstanding that the Bankruptcy Court has no jurisdiction over those years either.

- B. **Source of Proposal.** Internal Revenue Service; National Association of Attorneys General.
- C. **Advisory Committee.** Adopted the proposal as a consensus proposal.
- D. **Commission.** Rubber stamped the consensus proposal.
- E. **H.R. 833.** Section 809 of the bill would provide an exception to the automatic stay for appeals from certain court and administrative decisions determining a tax liability of the debtor. It would also remove the automatic stay from any tax court proceeding involving a taxable year ending after the petition date.
- F. **S. 625.** Contains the provision with respect to the Tax Court, not the more general provision with respect to appeals.
- G. **Issues.**
  - 1. Should the provision limiting the automatic stay to prepetition taxes be confined to individuals in chapter 7 cases? Under the proposal as drafted, the Tax Court would have jurisdiction over administrative taxes in chapter 11 for no apparent reason.
  - 2. Should the bankruptcy court supplant federal and state appeals tribunals as well as courts of original jurisdiction?

### XIII. **Equal Installments of Deferred Taxes**

- A. **Proposal.** To require that installments of deferred tax payments under Section 1129(a)(9)(C) be equal in amount.
- B. **Source of Proposal.** Internal Revenue Service; United States Department of Justice.
- C. **Advisory Committee.** The Advisory Committee did not deal with the equal payments issue explicitly. It did vote to preclude the possibility of balloon payments, voting seven to three to require "periodic" payments that should be monthly or quarterly. A fair reading of the Advisory Committee proposal would be that such payments should be equal or approximately equal. The Advisory Committee also proposed that the six-year payment period run from the date of the order for relief rather than the date of assessment, as is

the case under present law. Secured tax claims would be treated the same as unsecured tax claims.

D. **Commission**. The Commission adopted the Advisory Committee proposal.

E. **H.R. 833**. Section 810 of the bill would require "regular installment payments in cash, but in no case with a balloon provision, and no more than three months apart, beginning no later than the effective date of the plan and ending on the earlier of five years after the petition date or the last date payments are to be made under the plan to unsecured creditors." Secured tax claims are treated the same as unsecured tax claims and no deferral is permitted for ad valorem property taxes.

F. **S. 625**. Section 710 of the bill would:

1. Return to the concept of a value of payments equal to the allowed amount of the claim based upon a discount rate equal to the regular tax deficiency rate under Section 6621(a)(2) of the Internal Revenue Code of 1986, thus nullifying the effect of Section 704 of the bill above in cases to which Section 1129(a)(9)(C) of the Bankruptcy Code applies;
2. Ending the deferral period five years after the date of the entry of the order for relief; and
3. Requiring that such payments be made "in a manner not less favorable than the most favored non-priority unsecured claim provided for in the plan (other than cash payments made to a class of creditors under Section 1122(b)).
4. Secured tax claims are treated the same as unsecured tax claims.

G. **Issues**.

1. What is the justification for allowing prepetition tax claims, which are entitled to a priority, to be deferred over a six-year period in cases where the plan provides that general unsecured creditors are paid at confirmation or under some more accelerated schedule?
2. Should any deferral period be measured from the date of assessment of the tax or the date of the order for relief?

3. Should secured tax claims be entitled to a longer deferral period? Should the debtor have the same flexibility in dealing with these as with secured non-tax claims?
4. Do special considerations apply to ad valorem real property taxes?

State and local Tax authorities here made the uniform interest rate their biggest objection to S. 625.

**XIV. Avoidance of Tax Liens**

- A. **Proposal.** To prevent a bankruptcy trustee from stepping into the shoes of a hypothetical purchaser to create a superpriority under I.R.C. § 6323 and thus avoid a tax lien.
- B. **Source of Proposal.** Commissioner Shepard; Department of Justice.
- C. **Advisory Committee.** Adopted the proposal as a consensus item.
- D. **Commission.** Rubber stamped the Advisory Committee consensus.
- E. **H.R. 833.** Section 811 of the bill would amend Section 545(2) of the Bankruptcy Code by adding the words "except where such purchaser is a purchaser described in Section 6323 of the Internal Revenue Code of 1986 or similar provision of state or local law."
- F. **S. 625.** Section 711 of the bill is substantially the same as Section 811 of H.R. 833.
- G. **Issues.**
  1. Section 6323 allows a purchaser of certain types of property, e.g., securities and automobiles, to take good title notwithstanding a filed federal tax lien so as not to impede commerce in those items. Should a trustee be treated as a purchaser of those items to avoid the lien? Carefully crafted state tax lien provisions preserve the lien in bankruptcy.
  2. The Section of Taxation of the American Bar Association supports this provision. The National Bankruptcy Conference opposes it.

**XV. Administrative Taxes as Course of Business Expense**

- A. **Proposal.** To require that all postpetition taxes be paid as ordinary course of business expenses.
- B. **Source of Proposal.** Department of Justice; Commissioner Shepard.
- C. **Advisory Committee.** Proposed that taxes treated as administrative expenses be paid in the normal course of business, that ad valorem real property taxes be treated as an administrative expense and be treated as a reasonable and necessary cost of administering the estate.
- D. **Commission.** Rubber stamped Advisory Committee's consensus.
- E. **H.R. 833.** Section 812 of the bill would amend the Bankruptcy Code and related statutes to require that postpetition taxes be paid in the ordinary course of business, that ad valorem real property taxes be paid when due, and that no request be required of a governmental unit as a condition for the debtor's payment of an administrative period tax liability in the normal course. Exceptions are made for taxes in respect of real property abandoned by the trustee and Chapter 7 cases where a court makes a finding of probable insufficiency of funds of the estate to pay all administrative expenses, in which case such tax payments may be deferred until final distribution.
- F. **S. 625.** Section 712 of the bill is substantially the same as Section 812 of H.R. 833.
- G. **Issues.**
  - 1. These proposals are noncontroversial.

XVI. **Late Filed Tax Claims in Chapter 7**

- A. **Proposal.** To move the deadline for a taxing authority to file a late tax claim in Chapter 7 (such claims are treated as general unsecured claims not entitled to priority) to a fixed date prior to the commencement of distribution so that the distribution process cannot be disrupted.
- B. **Source of Proposal.** Kenneth C. Weil.
- C. **Advisory Committee.** Proposed that claim must be filed prior to the date on which the court approves the final report and accounting of the trustee.
- D. **Commission.** Rubber stamped the Advisory Committee consensus.



- E. **H.R. 833.** Section 813 of the bill requires the claim to be filed within 10 days following the mailing to creditors of the summary of the trustee's final report, or the date on which the trustee commences distribution under section 726, whichever is earlier.
- F. **S. 625.** Section 713 of the bill is substantially the same as Section 813 of H.R. 833.
- G. **Issues.** None.

**XVII. Definition of Return for Discharge Purposes**

- A. **Proposal.** To allow Chapter 7 discharges to individuals who do not file returns but otherwise settle tax liabilities with taxing authorities.
- B. **Source of Proposal.** ABA Task Force.
- C. **Advisory Committee.** By a vote of eight to one with one abstention, the Advisory Committee recommended that for dischargeability purposes, a written consent to tax liability signed by the debtor, a non-bankruptcy tax tribunal stipulation signed by the taxpayer or an attempt by the debtor to sign a substitute for return prepared by a tax authority all be considered a filed return. A return prepared by a taxing authority but not consented to by the debtor would not be considered a return for any purposes of the Bankruptcy Code.
- D. **Commission.** No action.
- E. **H.R. 833.** Section 814 of the bill would liberalize the exception to discharge under Section 523(a)(1)(B) of the Bankruptcy Code for taxes attributable to unfiled returns and certain late filed returns by providing that a return includes a return filed pursuant to Section 6020(a) of the Internal Revenue Code, or similar state or local law, or a written stipulation to a judgment entered by a non-bankruptcy tribunal. A return prepared by a tax authority under Section 6020(b) or equivalent is not a return.
- F. **S. 625.** Section 714 of the bill is substantially the same as Section 814 of H.R. 833.
- G. **Issues.**
  - 1. Should a debtor who signs a return prepared by a tax authority or who enters into a written stipulation of tax liability in a non-bankruptcy tribunal be entitled to the finality otherwise given to stale tax liabilities under Section 523 of the Bankruptcy Code?

2. On the other hand, does the mere signing of a government prepared return or a stipulation constitute a sufficient good faith disclosure to the government of an individual's financial affairs that he should be protected from further assessment if the taxing authority later determines that additional tax, interest or penalty may be due?

**XVIII. Scope of Section 505(b) Protection**

- A. **Proposal.** To extend Section 505(b) protection to the estate where a taxing authority does not timely respond to notice. This proposal would reject the holdings in In re Fondiller, 125 B.R. 805 (N.D. Cal. 1991); In re Rode, 119 B.R. 697 (Bankr. E.D. Mo. 1990); and In re West Texas Marketing Corp., 54 F.3d 1194 (5th Cir. 1995).
- B. **Source of Proposal.** ABA Task Force.
- C. **Advisory Committee.** By a vote of six to three with one abstention, the Advisory Committee recommended adoption of the ABA Task Force proposal.
- D. **Commission.** The Commission unanimously adopted the ABA Task Force proposal.
- E. **H.R. 833.** Section 815 of the bill would add the estate to the debtor, a successor to the debtor and the trustee as a person who would be protected from a tax claim upon the failure of a governmental unit to respond to a request for a determination of taxes under Section 505(b) of the Bankruptcy Code.
- F. **S. 625.** Section 715 of the bill is the same as Section 815 of H.R. 833.
- G. **Issues.**
  1. If a taxing authority has failed to respond to a properly filed Section 505(b) request within the required sixty-day period, thus discharging the debtor, any successor to the debtor and the trustee from liability for taxes in respect of that administrative tax period, should the taxing authority nevertheless be able to assert a claim to estate assets if distribution has not yet been made?

**XIX. Unfiled Returns in Chapter 13**

- A. **Proposal.** To require debtors to bring tax returns current as a condition for obtaining Chapter 13 relief.

- B. Source of Proposal.** Internal Revenue Service; United States Department of Justice; Commissioner Shepard.
- C. Advisory Committee.** Adopted detailed proposal. As a prerequisite for confirming a Chapter 13 plan, a debtor must have filed tax returns for all tax periods ending within six years prior to the petition date. A debtor's written consent to a substitute for return prepared by a tax authority or written stipulation to a judgment in a nonbankruptcy tax tribunal will constitute a "filed return" for purposes of this proposal. Prepetition tax returns must be properly filed with the appropriate tax authorities at least one day prior to the conclusion of the first meeting of creditors. At or before the conclusion of the first meeting of creditors, the debtor must file with the court a statement certifying, under penalty of perjury, that all required tax returns for the relevant periods have been properly filed with the appropriate tax authorities. The Chapter 13 trustee may require that a debtor submit copies of returns to the trustee. If tax returns have not been filed by the date on which the first meeting of creditors commences, the trustee may continue the first meeting to allow additional time to file returns. The additional time allowed shall be no longer than (1) 120 days from the order for relief for returns that are past due as of the order for relief, or (2) for returns not past due as of the order for relief date, the later of (i) 120 days from the petition date or (ii) the automatic extension date for filing a return under applicable tax law. Failure to timely file tax returns by the above deadline for prepetition returns, or by due dates (including extensions pursuant to applicable tax laws) for postpetition returns, shall constitute cause for conversion or dismissal under section 1307(c). The court, for good cause shown due to circumstances for which the debtor should not justly be held accountable, may extend the return-filing deadline. Dismissal or conversion would be automatic if such extended deadline were missed. The deadline for objecting to plan confirmation shall be at least sixty days after prepetition tax returns are filed with the tax authorities. A debtor may not file an objection to a proof of claim for a tax required to be reported on a return unless the debtor has filed a return for that tax. The section 502(b)(9) "governmental bar date" will be modified (for tax claims only) to allow tax authorities sixty days from the filing of tax returns by debtors to file proofs of claim; provided, however, that this modification will not have the effect of shortening the governmental bar date in any case.
- D. Commission.** Approved Advisory Committee proposal after debate.
- E. H.R. 833.**
1. Section 816 of the bill generally adopts the Advisory Committee's proposal, but (i) reduces the required number of

tax returns to three, and (ii) allows further continuances for the filing of returns to be granted by the Court only where the debtor demonstrates, by clear and convincing evidence, that the failure to file returns is due to circumstances beyond the control of the debtor. This extension for past due returns is limited to 30 days.

2. For purposes of this section only, a return includes a return prepared pursuant to Section 6020(a) or (b) of the Internal Revenue Code of 1986 or similar state or local law, or a written stipulation to a judgment entered by a non-bankruptcy tribunal.

F. S. 625. Section 716 of the bill is the same as Section 816 of H.R. 833, except that six years of returns is required.

G. Issues.

1. In the case of a debtor who is a habitual non-filer, is it practical to require six years of tax returns? Is this a fair condition for obtaining Chapter 13 relief? Would three years be sufficient?

2. If the debtor pleads for more time to file his tax returns and can make a showing, is the clear and convincing standard too high a threshold?

## XX. Chapter 11 Disclosure Statements

A. Proposal. To provide statutory standards for tax discussion in Chapter 11 cases.

B. Source of Proposal. ABA Task Force. The Task Force position was narrowly drafted. It would "amend Bankruptcy Code Section 1125(b) to provide that the bankruptcy court shall not approve a disclosure statement unless it contains (1) a discussion of the material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and (2) with respect to each class of claims and interests, a discussion of the material federal tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests of the relevant class."

C. Advisory Committee. Adopted ABA Task Force proposal as a consensus item.

D. Commission. Rubber stamped as part of consensus proposals.

- E. **H.R. 833.** Section 817 of the bill requires “a full discussion of the potential material federal, state and local tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor domiciled in the state in which the debtor resides or has its principal place of business.”
- F. **S. 625.** Section 717 of the bill requires a discussion [not a “full” discussion] of the material federal [not state or local] tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests.
- G. **Issues.**
1. Should the Bankruptcy Code require a “full” discussion of the tax consequences of a plan of reorganization in a Chapter 11 disclosure statement? Does such a requirement encourage objections to disclosure statements?
  2. Should any such requirement extend to a discussion of state and local tax issues? To the debtor only? To holders of claims and interests? Under H.R. 833, what local tax consequences need be discussed?
  3. Should the requirement vary depending upon the size of the case?

**XXI. Setoff**

- A. **Proposal.** To allow taxing authorities to set off prepetition refunds against prepetition tax liabilities without moving for relief from stay.
- B. **Source of Proposal.** Internal Revenue Service; United States Department of Justice.
- C. **Advisory Committee.** By a vote of eight to one with one abstention, the Advisory Committee voted to allow governmental tax authorities to set off prepetition tax refunds against prepetition tax liabilities. By a vote of six to four with all governmental representatives in the minority, the Advisory Committee rejected a government proposal to allow setoff of postpetition refunds against prepetition tax liabilities.
- D. **Commission.** The Commission adopted a narrow proposal, proposing to allow setoffs of prepetition income tax refunds against “undisputed” prepetition income tax liabilities and did not consider

the proposal to allow setoff of postpetition refunds against prepetition liabilities.

- E. **H.R. 833.** Under Section 818 of the bill, a governmental unit is generally permitted to set off an income tax refund for a prepetition period against an income tax liability for a prepetition period without regard to the automatic stay, unless prior to such setoff an action to determine tax liability under Section 505(a) was commenced. The proposal would further provide that where a setoff of an income tax refund is not permitted because of a pending action under Section 505(a), the governmental unit may hold the refund pending the resolution of the action. These exceptions are meaningless. Effectively, the statute allows setoff of prepetition income tax refunds against prepetition income tax liabilities.
- F. **S. 625.** Section 718 of the bill generally allows a setoff of a prepetition income tax overpayment against a prepetition income tax liability, except that in any case in which the setoff of an income tax refund is not permitted under applicable non-bankruptcy law because of a pending action to determine the amount or legality of a tax liability, the tax authority may hold the refund pending resolution of the action unless the court grants the taxing authority adequate protection for the secured claim of that authority in the setoff.
- G. **Issues.**
1. What is the justification for relieving taxing authorities from the necessity of moving the court to permit a setoff when such requirement applies to all other creditors?
  2. If setoff is to be permitted, should the right be extended to allow setoff of postpetition refunds against prepetition liabilities?
  3. If setoff is to be permitted for uncontested income tax liabilities, what standard should be applied to determine whether a prepetition tax liability is undisputed? Does the requirement of the filing of a contest under Section 505(a) of the Bankruptcy Code go too far?
  4. If this statute passes, what should become of existing local rules and standing orders that currently allow setoffs in individual districts?

## XXII. **Bifurcation of Corporate Taxable Year**

- A. **Proposal.** To provide that corporate income tax liabilities for the year of bankruptcy filing are treated as an administrative expense.

Overrule In re L.J. O'Neill Shoe Co., 64 F.3d 1146 (8th Cir. 1995), In re Pacific-Atlantic Trading Co., 64 F.3d 1292 (9th Cir. 1995) and United States v. Hillsborough Holdings Corp., 116 F.2d 1391 (11th Cir. 1997)..

- B. **Source of Proposal.** Internal Revenue Service; Department of Justice.
- C. **Advisory Committee.** Voted seven to three to adopt the proposal. Divided evenly on a proposal to allow a corporate debtor an election to create two short taxable years.
- D. **Commission.** The Commission adopted a compromise proposal which would generally treat the filing year liability of a corporation as an administrative expense, but give to the debtor an election, similar to that given to individuals by Section 1398(d)(2) of the Internal Revenue Code, to terminate its taxable year on the day before bankruptcy. If the corporate debtor makes such an election, it will have to file another return, but the liability shown on the first short-year return will be subject to the six-year stretchout under Section 1129(a)(9)(C) of the Bankruptcy Code.
- E. **H.R. 833.** No provision.
- F. **S. 625.** Section 705 of the bill takes the language “for a taxable year ending on or before the date of filing of the petition” and moves it from Section 507(a)(8)(A)(i) of the Bankruptcy Code into the introductory language of Section 507(a)(8)(A), so that the relevant portion of Section 507(a)(8)(A) now reads, “Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for – (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition – (iii) ... not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.” Thus, it would appear, that no portion of a straddle year could give rise to a priority claim under Section 507(a)(8), and the claim for the entire year of filing would be an administrative expense under Section 503(b)(1).
- G. **Issues.**
  - 1. Income tax liabilities cannot be determined until the last day of a taxable year, when all items of income and deduction have been accrued. Is there any theoretical justification for treating a tax liability for the year of filing as anything other than an administrative expense?

2. To the extent that the economic activities of the debtor giving rise to a tax liability occur in the portion of the taxable year preceding the filing of the bankruptcy petition, should the debtor be permitted to identify that portion of the filing year tax liability and enjoy the six-year deferral of Section 1129(a)(9)(C) of the Bankruptcy Code?
3. Section 1398(d)(2) of the Internal Revenue Code allows an individual to elect to terminate his taxable year as of the day prior to filing a bankruptcy petition. Should a similar election be given to a corporation?

Tax authorities strongly support this proposal. There is a wide divergence of views in the private bar.

### **XXIII. Conformity of Federal Tax Provisions With State/Local**

- A. **Proposal.** To conform various state and local tax provisions of the Bankruptcy Code with corresponding federal tax provisions of the Internal Revenue Code.
- B. **Source of Proposal.** National Bankruptcy Conference; Professor Grant Newton.
- C. **Advisory Committee.** The Advisory Committee recommended a laundry list of conforming changes as follows:
  1. Repeal Section 1231(b) of the Bankruptcy Code so that no separate taxable entity would be created upon the filing of a family farmer bankruptcy.
  2. Provide debtors with a short year termination election (as opposed to the current mandatory termination) for state and local tax purposes identical to that provided by Section 1398(d)(2) of the Internal Revenue Code.
  3. Section 346(a) should be revised to provide that for state and local tax purposes the provisions of the Internal Revenue Code of 1986 are to be used:
    - a. To determine when a separate estate is created as the result of the filing of a bankruptcy petition;
    - b. To determine which attributes that are available under state and local tax laws are transferred to the estate on the filing of a bankruptcy petition and are transferred back to the individual on termination of the estate;



- c. To determine how income (to the extent provided for under state and local laws) from the estate (when created) is taxed or deductions (to the extent provided for under state and local laws) are allowed;
  - d. To determine how income from the cancellation of debt is to be reported and how basis and other tax attributes (to the extent they are available under state law) are reduced; and
  - e. To determine the tax consequences of transfers between the bankruptcy estate and individual debtor.
4. A new subsection should be added to Section 346 to provide that the applicable state and local tax rates (rather than federal rates) should be used to determine any tax liability or refund for state and local taxes.
  5. A new subsection should be added to Section 346 to provide that it is the responsibility of the trustee to file federal, state and local tax returns (when required under applicable federal, state and local laws) for a separate estate created by the filing of a bankruptcy petition and for partnerships and corporations filing bankruptcy petitions.
  6. Section 346(c) should be repealed. (I.R.C. § 1398 addresses the applicable issues -- when an estate is created, how an estate is taxed and the accounting methods to use).
  7. Section 346(c) should be repealed. (I.R.C. §§ 1398 and 1399 and the proposed change in Section 346 address these issues -- filing status for corporations and partnerships and responsibilities for filing tax returns (item 5 above)).
  8. Section 346(d) should be repealed (Section is not needed if I.R.C. § 1398 applied -- a separate estate is not created in Chapter 13).
  9. Section 346(e) should be repealed (Section is not needed since I.R.C. § 1398 provides for how income is handled by the estate and the allowance of expenses).
  10. Section 346(f) should be modified to provide that the same provisions apply to federal tax law as well -- deals with payment of withheld items.

11. Section 346(g) should be repealed (I.R.C. § 1398 addresses the applicable issues -- transfers between bankruptcy estate and individual debtor).
12. Section 346(h) should be repealed (I.R.C. § 1398 addresses the applicable issues -- preservation of NOL and provides that short tax years do not create a separate year for NOL carryover periods (Note that the current section 346(h) is inconsistent with I.R.C.)).
13. Section 346(i) should be repealed (I.R.C. § 1398 addresses the applicable issues -- attribute carryover and use of NOL carryovers).
14. Section 346(j) should be repealed (I.R.C. §§ 1398 and 108 address the applicable issues -- income from cancellation of debt, tax attribute reduction, etc.).
15. Section 728(a) should be repealed (I.R.C. § 1398 provides that the estate's year ends the day before the petition is filed if the election for a short year is timely filed).
16. Section 728(b) should be repealed (provisions regarding the requirement of the filing of returns are now included in Section 346 (see item 5 above)).
17. Section 728(c) and (d) should be repealed. (With the suggested changes above, there would be no useful purpose for these provisions).
18. Section 1146(a) should be repealed. (I.R.C. § 1398 provides that the estate's year ends the day before the petition is filed if the election for a short year is timely filed).
19. Section 1146(b) should be repealed (provisions regarding the requirement of the filing of returns would be included in Section 346 (see item 5 above)).
20. Section 1231 should be repealed -- a separate estate is not created in Chapter 12.

D. **Commission**. Adopted Advisory Committee consensus.

E. **H.R. 833**. No provision.

F. **S. 625**. Section 719 of the bill would rewrite Section 346 of the Code to largely have substantive provisions of the Bankruptcy Code mirror corresponding provisions of the Internal Revenue Code.

Thus, if a taxable entity is created for Federal income tax purposes, a taxable entity is created for state and local tax purposes as well. If no taxable entity is created for state and local tax purposes, then income tax is imposed directly on the debtor. In combination, these two changes take care of the chapter 12 problem. Taxable years are also conformed, so that if a termination election is made for Federal income tax purposes, it automatically applies for state income tax purposes, but not otherwise. Accounting methods, tax attributes, withholding rules, transfer nonrecognition provisions, discharge of indebtedness and attribute reductions resulting therefrom will all be governed by principles of the Internal Revenue Code. The draftsmen may have created a needless ambiguity by providing that the trustee is only required to file partnership returns for state and local income tax purposes if also required to make such filings for Federal income tax purposes. The Internal Revenue Service takes the position that the trustee of a partnership must file partnership information returns even though the expense involved may have no benefit to creditors. There are some who disagree that the Internal Revenue Service has the authority to make such a rule in the absence of a statute. Otherwise, former rules relieving trustees of filing returns during bankruptcy administration if there was not net taxable income for the entire period of administration of the case have been repealed.

**G. Issues.**

1. None. This proposal is noncontroversial.

**XXIV. Failure to File Post-petition Returns.**

- A. **Proposal.** To require conversion or dismissal of cases in which a debtor does not file post-petition tax returns.
- B. **Source of Proposal.** Unknown.
- C. **Advisory Committee.** No recommendation.
- D. **Commission.** No recommendation.
- E. **H.R. 833.** No provision.
- F. **S. 625.** Section 720 of the bill would add a new subsection (k) to Section 521 of the Bankruptcy Code to provide that notwithstanding any other provision of the Bankruptcy Code, if the debtor fails to file post-petition tax returns a taxing authority may request that the court enter an order converting or dismissing the case, and if the debtor does not file the required return or obtain an extension to do so within 90 days after a request is filed by a taxing authority "the court

shall convert or dismiss the case, whichever is in the best interests of the creditors and the estate.”

**G. Issues.**

1. Bankruptcy is a process (at least in the case of an individual) aimed at sorting out, satisfying and possibly discharging pre-petition debts. What is the relevance of the failure of a debtor to file a post-petition tax return on whether he should be entitled to a discharge?



**SIDE BY SIDE COMPARISON  
OF THE TAX PROVISIONS FROM  
PROPOSED BANKRUPTCY REFORM BILLS  
HR 833 & S 625**



Side by Side Comparison of the Tax Provisions of HR 833 and S 625

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TITLE VIII – BANKRUPTCY TAX PROVISIONS

SEC. 801. TREATMENT OF CERTAIN LIENS.

(a) TREATMENT OF CERTAIN LIENS.—Section 724 of title 11, United States Code, is amended—

(1) in subsection (b), in the matter preceding paragraph (1), by inserting “(other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate)” after “under this title”;

(2) in subsection (b)(2), after “507(a)(1)”, insert “(except that such expenses, other than claims for wages, salaries or commissions which arise after the filing of a petition, shall be limited to expenses incurred under chapter 7 of this title and shall not include expenses incurred under chapter 11 of this title)”; and

(3) by adding at the end the following:

“(e) Before subordinating a tax lien on real or personal property of the estate, the trustee shall—

“(1) exhaust the unencumbered assets of the estate; and

“(2) in a manner consistent with section 506(c) of this title, recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of that property.

“(f) Notwithstanding the exclusion of ad valorem tax liens set forth in this section and subject to the requirements of subsection (e)—

“(1) claims for wages, salaries, and commissions that are entitled to priority under section 507(a)(3) of this title; or

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SEC. 701. TREATMENT OF CERTAIN LIENS.

(a) TREATMENT OF CERTAIN LIENS.—Section 724 of title 11, United States Code, is amended—

(1) in subsection (b), in the matter preceding paragraph (1), by inserting “(other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate)” after “under this title”;

(2) in subsection (b)(2), by inserting “(except that such expenses, other than claims for wages, salaries or commissions which arise after the filing of a petition, shall be limited to expenses incurred under chapter 7 of this title and shall not include expenses incurred under chapter 11 of this title)” after “507(a)(1)”; and

(3) by adding at the end the following:

“(e) Before subordinating a tax lien on real or personal property of the estate, the trustee shall—

“(1) exhaust the unencumbered assets of the estate; and

“(2) in a manner consistent with section 506(c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of that property.

“(f) Notwithstanding the exclusion of ad valorem tax liens under this section and subject to the requirements of subsection (e), the following may be paid from property of the estate which secures a tax lien, or the proceeds of such property:

“(1) Claims for wages, salaries, and commissions that are entitled to priority under section 507(a)(4).



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“(2) claims for contributions to an employee benefit plan entitled to priority under section 507(a)(4) of this title,

may be paid from property of the estate which secures a tax lien, or the proceeds of such property.”.

(b) DETERMINATION OF TAX LIABILITY.—Section 505(a)(2) of title 11, United States Code, is amended—

(1) in subparagraph (A), by striking “or” at the end;

(2) in subparagraph (B), by striking the period at the end and inserting “; or”; and

(3) by adding at the end the following:

“(C) the amount or legality of any amount arising in connection with an ad valorem tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired.”.

**SEC. 802. EFFECTIVE NOTICE TO GOVERNMENT.**

(a) EFFECTIVE NOTICE TO GOVERNMENTAL UNITS.—Section 342 of title 11, United States Code, as amended by section 603, is amended by adding at the end the following:

“(g) If a debtor lists a governmental unit as a creditor in a list or schedule, any notice required to be given by the debtor under this title, any rule, any applicable law, or any order of the court, shall identify the department, agency, or instrumentality through which the debtor is indebted. The debtor shall identify (with information such as a taxpayer identification number, loan, account or contract number, or real estate parcel number, where applicable), and describe the underlying basis for the governmental unit’s claim. If the debtor’s liability to a governmental unit arises from a debt or obligation owed or incurred by another individual, entity, or organization, or under a different name, the debtor shall identify such individual, entity, organization, or name.

“(h) The clerk shall keep and update quarterly, in the form

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“(2) Claims for contributions to an employee benefit plan entitled to priority under section 507(a)(5).”.

(b) DETERMINATION OF TAX LIABILITY.—Section 505(a)(2) of title 11, United States Code, is amended—

(1) in subparagraph (A), by striking “or” at the end;

(2) in subparagraph (B), by striking the period at the end and inserting “; or”; and

(3) by adding at the end the following:

“(C) the amount or legality of any amount arising in connection with an ad valorem tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired.”.

**SEC. 702. TREATMENT OF FUEL TAX CLAIMS.**

Section 501 of title 11, United States Code, is amended by adding at the end the following:

“(e) A claim arising from the liability of a debtor for fuel use tax assessed consistent with the requirements of section 31705 of title 49 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.”.

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and manner as the Director of the Administrative Office of the United States Courts prescribes, and make available to debtors, a register in which a governmental unit may designate a safe harbor mailing address for service of notice in cases pending in the district. A governmental unit may file a statement with the clerk designating a safe harbor address to which notices are to be sent, unless such governmental unit files a notice of change of address.”.

(b) ADOPTION OF RULES PROVIDING NOTICE.—The Advisory Committee on Bankruptcy Rules of the Judicial Conference shall, within a reasonable period of time after the date of the enactment of this Act, propose for adoption enhanced rules for providing notice to State, Federal, and local government units that have regulatory authority over the debtor or which may be creditors in the debtor’s case. Such rules shall be reasonably calculated to ensure that notice will reach the representatives of the governmental unit, or subdivision thereof, who will be the proper persons authorized to act upon the notice. At a minimum, the rules should require that the debtor—

(1) identify in the schedules and the notice, the subdivision, agency, or entity in respect of which such notice should be received;

(2) provide sufficient information (such as case captions, permit numbers, taxpayer identification numbers, or similar identifying information) to permit the governmental unit or subdivision thereof, entitled to receive such notice, to identify the debtor or the person or entity on behalf of which the debtor is providing notice where the debtor may be a successor in interest or may not be the same as the person or entity which incurred the debt or obligation; and

(3) identify, in appropriate schedules, served together with the notice, the property in respect of which the claim or regulatory obligation may have arisen, if any, the nature of such claim or regulatory obligation and the purpose for which notice is being given.

(c) EFFECT OF FAILURE OF NOTICE.—Section 342 of title 11,

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United States Code, as amended by section 603 and subsection (a), is amended by adding at the end of the following:

“(i) A notice that does not comply with subsections (d) and (e) shall not be effective unless the debtor demonstrates, by clear and convincing evidence, that timely notice was given in a manner reasonably calculated to satisfy the requirements of this section was given, and that—

“(1) either the notice was timely sent to the safe harbor address provided in the register maintained by the clerk of the district in which the case was pending for such purposes; or

“(2) no safe harbor address was provided in such list for the governmental unit and that an officer of the governmental unit who is responsible for the matter or claim had actual knowledge of the case in sufficient time to act.”.

**SEC 803. NOTICE OF REQUEST OF A DETERMINATION OF TAXES.**

Section 505(b) of title 11, United States Code, is amended by striking “Unless” at the beginning of the second sentence thereof and inserting “If the request is made substantially in the manner designated by the governmental unit and unless”.

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**SEC 703. NOTICE OF REQUEST OF A DETERMINATION OF TAXES.**

Section 505(b) of title 11, United States Code, is amended.—

(1) in the first sentence, by inserting “at the address and in the manner designated in paragraph (1)” after “determination of such tax”;

(2) by striking “(1) upon payment” and inserting “(2)(A) upon payment”;

(3) by striking “(A) such governmental unit” and inserting “(i) such governmental unit”;

(4) by striking “(B) such governmental unit” and inserting “(ii) such governmental unit”;

(5) by striking “(2) upon payment” and inserting “(B) upon payment”;

(6) by striking “(3) upon payment” and inserting “(C) upon payment”;

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(7) by striking “(b)” and inserting “(2)”; and

(8) by inserting before paragraph (2), as so designated, the following:

“(b)(1)(A) The clerk of each district shall maintain a listing under which a Federal, State, or local governmental unit responsible for the collection of taxes within the district may—

“(i) designate an address for service of requests under this subsection; and

“(ii) describe where further information concerning additional requirements for filing such requests may be found.

“(B) If a governmental unit referred to in subparagraph (A) does not designate an address and provide that address to the clerk under that subparagraph, any request made under this subsection may be served at the address for the filing of a tax return or protest with the appropriate taxing authority of that governmental unit.”.

**SEC. 804. RATE OF INTEREST ON CLAIMS.**

(a) AMENDMENT.—Chapter 5 of title 11, United States Code, is amended by adding at the end the following:

**“§511. Rate of interest on tax claims.**

“If any provision of this title requires the payment of interest on a tax claim or requires the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be as follows:

“(1) In the case of ad valorem tax claims, whether secured or unsecured, other unsecured tax claims where interest is required to be paid under section 726(a)(5) of this title, secured tax claims, and administrative tax claims paid under section 503(b)(1) of this title, the rate shall be determined under applicable nonbankruptcy law.

**SEC. 704. RATE OF INTEREST ON TAX CLAIMS.**

(a) IN GENERAL.—Subchapter I of chapter 5 of title 11, United States Code, is amended by adding at the end the following:

**“§511. Rate of interest on tax claims**

“(a) If any provision of this title requires the payment of interest on a tax claim or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate shall be [sic] determined under applicable nonbankruptcy law.

“(b) In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed.”.

(b) CLERICAL AMENDMENT.—The table of sections for chapter 5 of title 11, United States Code, is amended by inserting after the item relating to section 510 the following:

“511. Rate of interest on tax claims.”.

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“(2) In the case of all other tax claims, the minimum rate of interest shall be the Federal short-term rate rounded to the nearest full percent, determined under section 1274(d) of the Internal Revenue Code of 1986, plus 3 percentage points.

“(A) In the case of claims for Federal income taxes, such rate shall be subject to any adjustment that may be required under section 6621(d) of the Internal Revenue Code of 1986.

“(B) In the case of taxes paid under a confirmed plan or reorganization, such rate shall be determined as of the calendar month in which the plan is confirmed.”.

(b) CONFORMING AMENDMENT.—The table of sections of chapter 5 of title 11, United States Code, is amended by inserting after the item relating to section 510 the following:

“511. Rate of interest on tax claims.”.

**SEC. 805. TOLLING OF PRIORITY OF TAX CLAIM TIME PERIODS.**

Section 507(a)(8)(A) of title 11, United States Code, as so redesignated, is amended—

(1) in clause (i) by inserting after “petition” and before the semicolon “, plus any time, plus 6 months, during which the stay of proceedings was in effect in a prior case under this title”; and

(2) amend clause (ii) to read as follows:

“(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—

“(I) any time plus 30 days during which an offer in compromise with respect of such tax, was pending or in effect during such 240-day period;

“(II) any time plus 30 days during

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**SEC. 705. PRIORITY OF TAX CLAIMS.**

Section 507(a)(8) of title 11, United States Code, is amended—

(1) in subparagraph (A)—

(A) in the matter preceding clause (i), by inserting “for a taxable year ending on or before the date of filing of the petition” after “gross receipts”;

(B) in clause (i)—

(i) by striking “for a taxable year ending on or before the date of filing of the petition”; and

(ii) by inserting before the semicolon at the end, the following: “, plus any time during which the stay of proceedings was in effect in a prior case under this title or during

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which an installment agreement with respect of such tax was pending or in effect during such 240-day period, up to 1 year; and

“(III) any time plus 6 months during which a stay of proceedings against collections was in effect in a prior case under this title during such 240-day period.”.

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which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days”; and

(C) by striking clause (ii) and inserting the following:

“(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—

“(I) any time during which an offer in compromise with respect to that tax was pending or in effect during such 240-day period; plus 30 days; and

“(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period; plus 90 days.”.; and

(2) by adding at the end the following:

“(H) An otherwise applicable time period specified in this paragraph shall be suspended for—

“(i) any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor; plus “(ii) 90 days.”.

**SEC. 806. PRIORITY PROPERTY TAXES INCURRED.**

Section 507(a)(8)(B) of title 11, United States Code, is amended by striking “assessed” and inserting “incurred”.

**SEC. 706. PRIORITY PROPERTY TAXES INCURRED.**

Section 507(a)(9)(B) [sic] of title 11, United States Code, is amended by striking “assessed” and inserting “incurred”.

**TITLE VIII – BANKRUPTCY TAX PROVISIONS****SECTION 807. CHAPTER 13 DISCHARGE OF FRAUDULENT AND OTHER TAXES.**

Section 1328(a)(2) of title 11, United States Code, is amended by inserting “(1),” after “paragraph”.

**SECTION 808. CHAPTER 11 DISCHARGE OF FRAUDULENT TAXES.**

Section 1141(d) of title 11, United States Code, is amended by adding at the end the following:

“(6) Notwithstanding the provisions of paragraph (1), the confirmation of a plan does not discharge a debtor which is corporation from any debt for a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.”.

**SEC. 809. STAY OF TAX PROCEEDINGS.**

(a) SECTION 362 STAY LIMITED TO PREPETITION TAXES.—Section 362(a)(8) of title 11, United States Code, is amended by striking the period at the end and inserting “, in respect of a tax liability for a taxable period ending before the order for relief.”.

(b) APPEAL OF TAX COURT DECISIONS PERMITTED.—Section 362(b)(9) of title 11, United States Code, is amended—

(1) in subparagraph (C) by striking “or” at the end;

(2) in subparagraph (D) by striking the period at the end and inserting “; or”; and

(3) by adding at the end the following:

“(E) the appeal of a decision by a court or administrative tribunal which determines a tax

**TITLE VII – BANKRUPTCY TAX PROVISIONS****SECTION 707. NO DISCHARGE OF FRAUDULENT TAXES IN CHAPTER 13.**

Section 1328(a)(2) of title 11, United States Code, is amended by sections 105, 213, and 314 of this Act, is amended by inserting “(1)(B), (1)(C),” after “paragraph”.

**SECTION 708. NO DISCHARGE OF FRAUDULENT TAXES IN CHAPTER 11.**

Section 1141(d) of title 11, United States Code, is amended by adding at the end the following:

“(5) Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt for a tax or customs duty with respect to which the debtor—

“(A) made a fraudulent return; or

“(B) willfully attempted in any manner to evade or defeat that tax or duty.”.

**SEC. 709. STAY OF TAX PROCEEDINGS LIMITED TO PREPETITION TAXES.**

Section 362(a)(8) of title 11, United States Code, is amended by inserting “, in respect to a tax liability for a taxable period ending before the order for relief under this title” before the semicolon at the end.

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liability of the debtor without regard to whether such determination was made prepetition or postpetition.”.

SEC. 810. PERIODIC PAYMENT OF TAXES IN CHAPTER 11 CASES.

Section 1129(a)(9) of title 11, United States Code, is amended—

(1) in subparagraph (B) by striking “and” at the end;  
and

(2) in subparagraph (C)—

(A) by striking “deferred cash payments, over a period not exceeding six years after the date of assessment of such claim,” and inserting “regular installment payments in cash, but in no case with a balloon provision, and no more than three months apart, beginning no later than the effective date of the plan and ending on the earlier of five years after the petition date or the last date payments are to be made under the plan to unsecured creditors,”; and

(B) by striking the period at the end and inserting “; and”; and

(3) by adding at the end the following:

“(D) with respect to a secured claim which would be described in section 507(a)(8) of this title but for its secured status, the holder of such claim will receive on account of such claim cash payments of not less than is required in subparagraph (C) and over a period no greater than is required in such subparagraph.”.

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SEC. 710. PERIODIC PAYMENT OF TAXES IN CHAPTER 11 CASES.

Section 1129(a)(9) of title 11, United States Code, is amended—

(1) in subparagraph (B) by striking “and” at the end;

(2) in subparagraph (C)—by striking “deferred cash payments, over a period not exceeding six years after the date of assessment of such claim,” and all that follows through the end of the subparagraph, and inserting “regular installment payments in cash—

“(i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;

“(ii) with interest thereon calculated at the rate provided in section 6621(a)(2) of the Internal Revenue Code of 1986;

“(iii) over a period ending not later than 5 years after the date of the entry of the order for relief under section 301, 302 or 303; and

“(iv) in a manner not less favorable than the most favored nonpriority unsecured claim provided for in the plan (other than cash payments made to a class of creditors under section 1122(b)); and”; and

(3) by adding at the end the following:

“(D) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim, the holder of that claim will receive on account of that claim, cash payments, in the same manner and over the same period, as prescribed in subparagraph (C).”.



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**SEC. 811. AVOIDANCE OF STATUTORY TAX LIENS PROHIBITED.**

Section 545(2) of title 11, United States Code, is amended by striking the semicolon at the end and inserting “, except where such purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986 or similar provision of State or local law;”.

**SEC. 812 PAYMENT OF TAXES IN THE CONDUCT OF BUSINESS.**

(a) PAYMENT OF TAXES REQUIRED.—Section 960 of title 28, United States Code, is amended—

- (1) by inserting “(a)” before “Any”; and
- (2) by adding at the end the following:

“(b) Such taxes shall be paid when due in the conduct of such business unless—

“(1) the tax is a property tax secured by a lien against property that is abandoned within a reasonable time after the lien attaches, by the trustee of a bankruptcy estate, pursuant to section 554 of title 11, United States Code; or

“(2) payment of the tax is excused under a specific provision of title 11, United States Code.

“(c) In a case pending under chapter 7 of title 11, payment of a tax may be deferred until final distribution is made under section 726 of title 11, United States Code if—

“(1) the tax was not incurred by a trustee duly appointed under chapter 7 of title 11, United States Code; or

“(2) before the due date of the tax, the court has made a finding of probable insufficiency of funds of the estate to pay in full the administrative expenses allowed under section 503(b) of title 11 that have the same priority in distribution under section 726(b) of title 11 as such tax.”.

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**SEC. 711. AVOIDANCE OF STATUTORY TAX LIENS PROHIBITED.**

Section 545(2) of title 11, United States Code, is amended by striking the semicolon at the end and inserting “, except in any case in which a purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law;”.

**SEC. 712 PAYMENT OF TAXES IN THE CONDUCT OF BUSINESS.**

(a) PAYMENT OF TAXES REQUIRED.—Section 960 of title 28, United States Code, is amended—

- (1) by inserting “(a)” before “Any”; and
- (2) by adding at the end the following:

“(b) A tax under subsection (a) shall be paid on or before the due date of the tax under applicable nonbankruptcy law, unless—

“(1) the tax is a property tax secured by a lien against property that is abandoned within a reasonable period of time after the lien attaches by the trustee of a bankruptcy estate under section 554 of title 11; or

“(2) payment of the tax is excused under a specific provision of title 11.

“(c) In a case pending under chapter 7 of title 11, payment of a tax may be deferred until final distribution is made under section 726 of title 11 if—

“(1) the tax was not incurred by a trustee duly appointed under chapter 7 of title 11; or

“(2) before the due date of the tax, an order of the court makes a finding of probable insufficiency of funds of the estate to pay in full the administrative expenses allowed under section 503(b) of title 11 that have the same priority in distribution under section 726(b) of title 11 as the priority of

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(b) PAYMENT OF AD VALOREM TAXES REQUIRED.— Section 502(b)(1)(B) of title 11, United States Code, is amended in clause (i) by inserting after “estate,” and before “except” the following: “whether secured or unsecured, including property taxes for which liability is in rem only, in personam or both.”

(c) REQUEST FOR PAYMENT OF ADMINISTRATIVE EXPENSE TAXES ELIMINATED.—Section 503(b)(1) of title 11, United States Code, is amended by adding at the end the following:

“(D) notwithstanding the requirements of subsection (a) of this section, a governmental unit shall not be required to file a request for the payment of a claim described in subparagraph (B) or (C);”

(d) PAYMENT OF TAXES AND FEES AS SECURED CLAIMS.— Section 506 of title 11, United States Code, is amended—

(1) in subsection (b) by inserting “or State statute” after “agreement”; and

(2) in subsection (c) by inserting “, including the payment of all ad valorem property taxes in respect of the property” before the period at the end.

**SEC. 813. TARDILY FILED PRIORITY TAX CLAIMS.**

Section 726(a)(1) of title 11, United States Code, is amended by striking “before the date on which the trustee commences distribution under this section” and inserting “on or before the earlier of 10 days after the mailing to creditors of the summary of the trustee’s final report or the date on which the trustee commences final

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that tax.”.

(b) PAYMENT OF AD VALOREM TAXES REQUIRED.— Section 503(b)(1)(B)(i) of title 11, United States Code, is amended by inserting “whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both,” before “except”.

(c) REQUEST FOR PAYMENT OF ADMINISTRATIVE EXPENSE TAXES ELIMINATED.—Section 503(b)(1) of title 11, United States Code, is amended—

(1) in subparagraph (B), by striking “and” at the end;

(2) in subparagraph (C), by adding “and” at the end;

and

(3) by adding at the end the following:

“(D) notwithstanding the requirements of subsection (a), a governmental unit shall not be required to file a request for the payment of an expense described in subparagraph (B) or (C), as a condition of its being an allowed administrative expense;”

(d) PAYMENT OF TAXES AND FEES AS SECURED CLAIMS.— Section 506 of title 11, United States Code, is amended—

(1) in subsection (b) by inserting “or State statute” after “agreement”; and

(2) in subsection (c) by inserting “, including the payment of all ad valorem property taxes with respect to the property” before the period at the end.

**SEC. 713. TARDILY FILED PRIORITY TAX CLAIMS.**

Section 726(a)(1) of title 11, United States Code, is amended by striking “before the date on which the trustee commences distribution under this section;” and inserting the following: “on or before the earlier of —

“(A) the date that is 10 days after the mailing to

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distribution under this section”.

SEC. 814. INCOME TAX RETURNS PREPARED BY TAX AUTHORITIES.

Section 523(a)(1)(B) of title 11, United States Code, is amended—

(1) by inserting “or equivalent report or notice,” after “a return,”;

(2) in clause (i)—

(A) by inserting “or given” after “filed”; and

(B) by striking “or” at the end;

(3) in clause (ii)—

(A) by inserting “or given” after “filed”; and

(B) by inserting “, report, or notice” after “return”; and

(4) by adding at the end the following:

“(iii) for purposes of this subsection a return—

“(I) must satisfy the requirements of applicable nonbankruptcy law, and includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or

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creditors of the summary of the trustee’s final report; or

“(B) the date on which the trustee commences final distribution under this section;”.

SEC. 714. INCOME TAX RETURNS PREPARED BY TAX AUTHORITIES.

Section 523(a) of title 11, United States Code, is amended—

(1) in paragraph (1)(B)—

(A) in the matter preceding clause (i), by inserting “or equivalent report or notice,” after “a return,”;

(B) in clause (i)—

(i) by inserting “or given” after “filed”; and

(ii) by striking “or” at the end; and  
(C) in clause (ii)—

(i) by inserting “or given” after “filed”; and

(ii) by inserting “, report, or notice” after “return”; and

(2) by adding at the end the following flush sentences:

“For purposes of this subsection, the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local

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similar State or local law; and

“(II) must have been filed in a manner permitted by applicable non-bankruptcy law; or”.

**SEC. 815. DISCHARGE OF THE ESTATES LIABILITY FOR UNPAID TAXES.**

Section 505(b) of title 11, United States Code is amended in the second sentence by inserting “the estate,” after “misrepresentation,”.

**SEC. 816. REQUIREMENT TO FILE TAX RETURNS TO CONFIRM CHAPTER 13 PLANS.**

(a) FILING OF PREPETITION TAX RETURNS REQUIRED FOR PLAN CONFIRMATION.—Section 1325(a) of title 11, United States Code, as amended by section 140, is amended—

- (1) in paragraph (6) by striking ‘and’ at the end;
- (2) in paragraph (7) by striking the period at the end and inserting “; and”; and
- (3) by adding at the end the following:
 

“(8) if the debtor has filed all Federal, State, and local tax returns as required by section 1308 of this title.”.

(b) ADDITIONAL TIME PERMITTED FOR FILING TAX RETURNS.—(1) Chapter 13 of title 11, United States Code, as amended by section 135, is amended by adding at the end the following:

**“§1308. Filing of prepetition tax returns**

“(a) On or before the day prior to the day on which the first meeting of the creditors is convened under section 341(a) of this title, the debtor shall have filed with appropriate tax authorities all tax returns for all taxable periods ending in the 3-year period ending on the date of filing of the petition.

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law.”.

**SEC. 715. DISCHARGE OF THE ESTATES LIABILITY FOR UNPAID TAXES.**

The second sentence of section 505(b) of title 11, United States Code, as amended by section 703 of this Act, is amended by inserting “the estate,” after “misrepresentation,”.

**SEC. 716. REQUIREMENT TO FILE TAX RETURNS TO CONFIRM CHAPTER 13 PLANS.**

(a) FILING OF PREPETITION TAX RETURNS REQUIRED FOR PLAN CONFIRMATION.—Section 1325(a) of title 11, United States Code, as amended by section 213 of this Act, is amended—

- (1) in paragraph (6), by striking “and’ at the end;
- (2) in paragraph (7), by striking the period at the end and inserting “; and”; and
- (3) by inserting after paragraph (7) the following:
 

“(8) if the debtor has filed all applicable Federal, State, and local tax returns as required by section 1308.”.

(b) ADDITIONAL TIME PERMITTED FOR FILING TAX RETURNS.—

- (1) IN GENERAL—Chapter 13 of title 11, United States Code, is amended by adding at the end the following:

**“§1308. Filing of prepetition tax returns**

“(a) Not later than the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a), the debtor shall file with appropriate tax authorities all tax returns for all taxable periods ending during the 6-year period ending on the date of the filing of the petition.

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“(b) If the tax returns required by subsection (a) have not been filed by the date on which the first meeting of creditors is convened under section 341(a) of this title, the trustee may continue such meeting for a reasonable period of time, to allow the debtor additional time to file any unfiled returns, but such additional time shall be no more than—

“(1) for returns that are past due as of the date of the filing of the petition, 120 days from such date;

“(2) for returns which are not past due as of the date of the filing of the petition, the later of 120 days from such date or the due date for such returns under the last automatic extension of time for filing such returns to which the debtor is entitled, and for which request has been timely made, according to applicable nonbankruptcy law; and

“(3) upon notice and hearing, and order entered before the lapse of any deadline fixed according to this subsection, where the debtor demonstrates, by clear and convincing evidence, that the failure to file the returns as required is because of circumstances beyond the control of the debtor, the court may extend the deadlines set by the trustee as provided in this subsection for—

“(A) a period of no more than 30 days for returns described in paragraph (1) of this subsection; and

“(B) for no more than the period of time ending on the applicable extended due date for the returns described in paragraph (2).

“(c) For purposes of this section only, a return includes a return prepared pursuant to section 6020 (a) or (b) of the Internal Revenue Code of 1986 or similar State or local law, or a written stipulation to a judgment entered by a nonbankruptcy tribunal.”.

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“(b)(1) Subject to paragraph (2), if the tax returns required by subsection (a) have not been filed by the date on which the meeting of creditors is first scheduled to be held under section 341(a), the trustee may hold open that meeting for a reasonable period of time to allow the debtor an additional period of time to file any unfiled returns, but such additional period of time shall not extend beyond—

“(A) for any return that is past due as of the date of the filing of the petition, the date that is 120 days after the date of that meeting; or

“(B) for any return that is not past due as of the date of the filing of the petition, the later of—

“(i) the date that is 120 days after the date of that meeting; or

“(ii) the date on which the return is due under the last automatic extension of time for filing that return to which the debtor is entitled, and for which request is timely made, in accordance with applicable nonbankruptcy law.

“(2) Upon notice and hearing, and order entered before the tolling of any applicable filing period determined under this subsection, if the debtor demonstrates by clear and convincing evidence that the failure to file a return as required under this subsection is attributable to circumstances beyond the control of the debtor, the court may extend the filing period established by the trustee under this subsection for—

“(A) a period of not more than 30 days for returns described in paragraph (1); and

“(B) a period not to extend after the applicable extended due date for a return described in paragraph (2).

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(2) The table of sections of chapter 13 of title 11, United States Code, is amended by inserting after the item relating to section 1307 the following:

“1308. Filing of prepetition tax returns.”.

(c) DISMISSAL OR CONVERSION ON FAILURE TO COMPLY.—Section 1307 of title 11, United States Code, is amended—

(1) by redesignating subsections (e) and (f) as subsections (f) and (g), respectively; and

(2) by inserting after subsection (d) the following:

“(e) Upon the failure of the debtor to file tax returns under section 1308 of this title, on request of a party in interest or the United States trustee and after notice and a hearing, the court shall dismiss a case or convert a case under this chapter to a case under chapter 7 of this title, whichever is in the best interests of creditors and the estate.”.

(d) TIMELY FILED CLAIMS.—Section 502(b)(9) of title 11, United States Code, is amended by striking the period at the end and inserting “, and except that in a case under chapter 13 of this title, a claim of a governmental unit for a tax in respect of a return filed under section 1308 of this title shall be timely if it is filed on or before 60 days after such return or returns were filed as required.”.

(e) RULES FOR OBJECTIONS TO CLAIMS AND TO CONFIRMATION.—It is the sense of the Congress that the Advisory Committee on Bankruptcy Rules of the Judicial Conference should, within a reasonable period of time after the date of the enactment of this Act, propose for adoption amended Federal Rules of Bankruptcy Procedure which provide that—

(1) notwithstanding the provisions of Rule 3015(f), in cases under chapter 13 of title 11, United States Code, a governmental unit may object to the confirmation of a plan on or before 60 days after the debtor files all tax returns required under section 1308 and 1325(a)(7)

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“(c) For purposes of this section, the term ‘return’ includes a return prepared pursuant to section 6020 (a) or (b) of the Internal Revenue Code of 1986, or a similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal.”.

(2) CONFORMING AMENDMENT.—The table of sections of chapter 13 of title 11, United States Code, is amended by inserting after the item relating to section 1307 the following:

“1308. Filing of prepetition tax returns.”.

(c) DISMISSAL OR CONVERSION ON FAILURE TO COMPLY.—Section 1307 of title 11, United States Code, is amended—

(1) by redesignating subsections (e) and (f) as subsections (f) and (g), respectively; and

(2) by inserting after subsection (d), the following:

“(e) Upon the failure of the debtor to file a tax return under section 1308, on request of a party in interest or the United States trustee and after notice and a hearing, the court shall dismiss a case or convert a case under this chapter to a case under chapter 7 of this title, whichever is in the best interests of the creditors and the estate.”.

(d) TIMELY FILED CLAIMS.—Section 502(b)(9) of title 11, United States Code, is amended by inserting before the period at the end of the following “, and except that in a case under chapter 13, a claim of a governmental unit for a tax with respect to a return filed under section 1308 shall be timely if the claim is filed on or before the date that is 60 days after the date on which such return was filed as required.”.

(e) RULES FOR OBJECTIONS TO CLAIMS AND TO CONFIRMATION.—It is the sense of the Congress that the Advisory Committee on Bankruptcy Rules of the Judicial Conference should, as soon as practicable after the date of the enactment of this Act, propose

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of title 11, United States Code; and

(2) in addition to the provisions of Rule 3007, in a case under chapter 13 of title 11, United States Code, no objection to a tax in respect of a return required to be filed under such section 1308 shall be filed until such return has been filed as required.

**SEC. 817. STANDARDS FOR TAX DISCLOSURE.**

Section 1125(a) of title 11, United States Code, is amended in paragraph (1)—

(1) by inserting after “records,” the following: “including a full discussion of the potential material Federal, State, and local tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor domiciled in the State in which the debtor resides or has its principal place of business typical of the holders of claims or interests in the case,”;

(2) by inserting “such” after “enable”; and

(3) by striking “reasonable” where it appears after “hypothetical” and by striking “typical of holders of claims or interests” after “investor”.

**SEC. 818. SETOFF OF TAX REFUNDS.**

Section 362(b) of title 11, United States Code, as amended by sections 118, 132, 136 and 203, is amended—

(1) in paragraph (29) by striking “or”;

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for adoption amended Federal Rules of Bankruptcy Procedure which provide that—

(1) notwithstanding the provisions of Rule 3015(f), in cases under chapter 13 of title 11, United States Code, an objection to the confirmation of a plan filed by a governmental unit on or before the date that is 60 days after the date on which the debtor files all tax returns required under sections 1308 and 1325(a)(7) of title 11, United States Code; and

(2) in addition to the provisions of Rule 3007, in a case under chapter 13 of title 11, United States Code, no objection to a tax with respect to which a return is required to be filed under section 1308 of title 11, United States Code, shall be filed until such return has been filed as required.

**SEC. 717. STANDARDS FOR TAX DISCLOSURE.**

Section 1125(a)(1) of title 11, United States Code, is amended—

(1) by inserting “including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case,” after “records”; and

(2) by striking “a hypothetical reasonable investor typical of holders of claims or interests” and inserting “such a hypothetical investor”.

**SEC. 718. SETOFF OF TAX REFUNDS.**

Section 362(b) of title 11, United States Code, as amended by section 402 of this Act, is amended—

(1) in paragraph (25) by striking “or” at the end;

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(2) in paragraph (30) by striking the period at the end and inserting “; or”; and

(3) by inserting after paragraph (30) the following:

“(31) under subsection (a) of the setoff of an income tax refund, by a governmental unit, in respect of a taxable period which ended before the order for relief against an income tax liability for a taxable period which also ended before the order for relief, unless—

“(A) prior to such setoff, an action to determine the amount or legality of such tax liability under section 505(a) was commenced; or

“(B) where the setoff of an income tax refund is not permitted because of a pending action to determine the amount or legality of a tax liability, the governmental unit may hold the refund pending the resolution of the action.”.

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(2) in paragraph (26) by striking the period at the end and inserting “; or”; and

(3) by inserting after paragraph (26) the following:

“(27) under subsection (a), of the setoff under applicable nonbankruptcy law of an income tax refund, by a governmental unit, with respect to a taxable period that ended before the order for relief against an income tax liability for a taxable period that also ended before the order for relief, except that in any case in which the setoff of an income tax refund is not permitted under applicable nonbankruptcy law because of a pending action to determine the amount or legality of a tax liability, the governmental unit may hold the refund pending the resolution of the action, unless the court, upon motion of the trustee and after notice and hearing, grants the taxing authority adequate protection (within the meaning of section 361) for the secured claim of that authority in the setoff under section 506(a).”.

**SEC. 719. SPECIAL PROVISIONS RELATED TO THE TREATMENT OF STATE AND LOCAL TAXES.**

(a) IN GENERAL.—Section 346 of title 11, United States Code, is amended to read as follows:

**“SEC. 346. SPECIAL PROVISIONS RELATED TO THE TREATMENT OF STATE AND LOCAL TAXES.**

“(a) Whenever the Internal Revenue Code of 1986 provides that a separate taxable estate or entity is created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of such estate shall be taxed to or claimed by the estate, a separate taxable estate is also created for purposes of any State and local law imposing a tax on or measured by income and such income, gain, loss, deductions and credits shall be taxed to or claimed by the estate and may not be taxed to or claimed by the debtor. The preceding sentence shall not apply if the case is dismissed. The trustee shall make tax returns of income required under any such State or local law.



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“(b) Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed to or claimed by the debtor under a State or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate. The trustee shall make such tax returns of income of corporations and of partnerships as are required under any State or local law, but with respect to partnerships, shall make said returns only to the extent such returns are also required to be made under such Code. The estate shall be liable for any tax imposed on such corporation or partnership, but not for any tax imposed on partners or members.

“(c) With respect to a partnership or any entity treated as a partnership under a State or local law imposing a tax on or measured by income that is a debtor in a case under this title, any gain or loss resulting from a distribution of property from such partnership, or any distributive share of any income, gain, loss, deduction, or credit of a partner or member that is distributed, or considered distributed, from such partnership, after the commencement of the case, is gain, loss, income, deduction, or credit, as the case may be, of the partner or member, and if such partner or member is a debtor in a case under this title, shall be subject to tax in accordance with subsection (a) or (b).

“(d) For purposes of any State or local law imposing a tax on or measured by income, the taxable period of a debtor in a case under this title shall terminate only if and to the extent that the taxable period of such debtor terminates under the Internal Revenue Code of 1986.

“(e) The estate in any case described in subsection (a) shall use the same accounting method as the debtor used immediately before the commencement of the case, if such method of accounting complies with applicable non-bankruptcy tax law.

“(f) For purposes of any State or local law imposing a tax on or measured by income, a transfer of property from the debtor to the estate or from the estate to the debtor shall not be treated as a

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disposition for purposes of any provision assigning tax consequences to a disposition, except to the extent that such transfer is treated as a disposition under the Internal Revenue Code of 1986.

“(g) Whenever a tax is imposed pursuant to a State or local law imposing a tax on or measured by income pursuant to subsection (a) or (b), such tax shall be imposed at rates generally applicable to the same types of entities under such State or local law.

“(h) The trustee shall withhold from any payment of claims for wages, salaries, commissions, dividends, interest, or other payments, or collect, any amount required to be withheld or collected under applicable State or local tax law, and shall pay such withheld or collected amount to the appropriate governmental unit at the time and in the manner required by such tax law, and with the same priority as the claim from which such amount was withheld or collected was paid.

“(i)(1) To the extent that any State or local law imposing a tax on or measured by income provides for the carryover of any tax attribute from one taxable period to a subsequent taxable period, the estate shall succeed to such tax attribute in any case in which such estate is subject to tax under subsection (a).

“(2) After such a case is closed or dismissed, the debtor shall succeed to any tax attribute to which the estate succeeded under paragraph (1) to the extent consistent with the Internal Revenue Code of 1986.

“(3) The estate may carry back any loss or tax attribute to a taxable period of the debtor that ended before the order for relief under this title to the extent that—

“(A) applicable State or local tax law provides for a carryback in the case of the debtor; and

“(B) the same or a similar tax attribute may be carried back by the estate to such a taxable period of the debtor under the Internal Revenue code of 1986.

“(j)(1) For purposes of any State or local law imposing a tax

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on or measured by income, income is not realized by the estate, the debtor, or a successor to the debtor by reason of a discharge of indebtedness in a case under this title, except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986.

“(2) Whenever the Internal Revenue Code of 1986 provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any State or local law imposing a tax on or measured by income to the extent such State or local law recognizes such attributes. Such State or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.

“(k)(1) Except as provided in this section and section 505, the time and manner of filing tax returns and the items of income, gain, loss, deduction, and credit of any taxpayer shall be determined under applicable nonbankruptcy law.

“(2) For Federal tax purposes, the provisions of this section are subject to the Internal Revenue Code of 1986 and other applicable Federal nonbankruptcy law.”.

**(b) CONFORMING AMENDMENTS.—**

(1) Section 728 of title 11, United States Code, is repealed.

(2) Section 1146 of title 11, United States Code, is amended by striking subsections (a) and (b) and by redesignating subsections (c) and (d) as subsections (a) and (b), respectively.

(3) Section 1231 of title 11, United States Code, is amended by striking subsections (a) and (b) and by redesignating subsections (c) and (d) as subsections (a) and (b), respectively.

**SEC. 720 DISMISSAL FOR FAILURE TO TIMELY FILE TAX**

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RETURNS.

Section 521 of title 11, United States Code, as amended by this Act, is amended by adding at the end the following:

“(k)(1) Notwithstanding any other provision of this title, if the debtor fails to file a tax return that becomes due after the commencement of the case or to properly obtain an extension of the due date for filing such return, the taxing authority may request that the court enter an order converting or dismissing the case.

“(2) If the debtor does not file the required return or obtain the extension referred to in paragraph (1) within 90 days after a request is filed by the taxing authority under that paragraph, the court shall convert or dismiss the case, whichever is in the best interests of creditors and the estate.”.

On page 268, line 13, strike “1231(d)” and insert “1231(b)”.

On page 280, strike lines 16 through 19.



**SELECTED ISSUES  
IN  
CHAPTER 13 CASES**

**Beverly M. Burden  
Chapter 13 Trustee  
Lexington, Kentucky**



## SELECTED ISSUES IN CHAPTER 13 CASES

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## SELECTED ISSUES IN CHAPTER 13 CASES

Presented by  
Beverly M. Burden  
Chapter 13 Trustee  
Lexington, Kentucky

for the  
Judge Joe Lee Bankruptcy Institute  
December 10, 1999

### I. ELIGIBILITY - § 109

A. Regular Income – Is debtor an individual with regular income (and is plan feasible) where funding of plan is provided by family member or “significant other”:

1. In re Murphy, 226 B.R. 601 (Bankr. M.D. Tenn. 1998) (debtor shared household with “significant other” for 11 years; “significant other” filed an affidavit agreeing to make the debtor’s plan payments).
2. In re Baird, 228 B.R. 324 (Bankr. M.D. Fla. 1999) (debtor became unemployable due to stroke; son’s payment of debtor’s plan payments for 5 months was “acceptable source of ‘stable and regular’ income”).
3. In re Jordan, 226 B.R. 117 (Bankr. D. Mont. 1998) (no evidence of live-in boyfriend’s assent to making chapter 13 plan payments).
4. Alfaro v. Vazquez (In re Alfaro), 221 B.R. 927 (1st Cir. B.A.P. 1998) (debtor’s plan called for a \$520,000 contribution over a five-year period from debtor’s sister; court found payments from sister “speculative at best”).

**B. Debt Limitations – § 109**

1. In re Scovis, 321 B.R. 336 (9th Cir. B.A.P. 1999) (debt secured by an avoidable judgment lien is treated as an unsecured claim to determine debt limits, even though adversary proceeding will be required at later date).
2. In re Brooks, 216 B.R. 838 (Bankr. N.D. Okla. 1998) (debtor is ineligible where IRS debt was scheduled as unsecured but disputed in the amount of \$271,000).

**C. Pending Cases – § 109(g)**

1. In re Barnes, 231 B.R. 482 (E.D.N.Y. 1999) (chapter 13 case filed while chapter 7 case was still open was dismissed; debtor's attorney was sanctioned \$500).
2. In re Cowan, 235 B.R. 912 (Bankr. W.D. Mo. 1999) (court declined to dismiss chapter 13 case filed after chapter 7 discharge was entered but before case was closed).
3. Transamerica Credit Corp. v. Bullock (In re Bullock), 206 B.R. 389 (Bankr. E.D. Va. 1997) (ok for debtor to file chapter 13 case before entry of discharge in pending chapter 7 case where "equities of a case so dictate and if a second filing will not materially hinder the efficient administration of the debtor's estate").
4. In re Whitmore, 225 B.R. 199 (Bankr. D. Idaho 1998) (debtors' motion to dismiss should be granted even though trustee previously filed motion to dismiss for failure to make payments; debtors would have been ineligible to file second case for 180 days under § 109(g)(1) if case were dismissed on trustee's motion; second chapter 13 case filed after debtors voluntarily dismissed first chapter 13 case but before order dismissing first case was entered; court held that the fact both cases were open simultaneously for a few days did not warrant dismissal of second case).

D. Prior Case Dismissed After Creditor Requested Stay Relief – § 109(g)(2) – Is Dismissal of Second Case Mandatory?

1. Andersson v. Security Federal Savings & Loan of Cleveland (In re Andersson), 209 B.R. 76 (6th Cir. B.A.P. 1997) (section 109(g)(2) is mandatory and requires dismissal of second chapter 13 case filed within 180 days of the voluntary dismissal of a prior chapter 13 case in which a request for relief from stay was filed; stay motion in first case was resolved by the parties prior to a hearing, and debtors' motion to voluntarily dismiss first case was filed six months after motion for relief from stay).
2. In re Sole, 233 B.R. 347 (Bankr. E.D. Va. 1998) (trustee's motion to dismiss second case was overruled where trustee did not show causal connection between creditor's motion to terminate stay in first case and debtor's subsequent request to dismiss first case).
3. In re Roland, 224 B.R. 401 (Bankr. E.D. Mo. 1997) (whether dismissal is mandatory or discretionary, second case will be dismissed to prevent delay of foreclosure action).
4. In re Ramos, 212 B.R. 29 (Bankr. D. P.R. 1997) (court has discretion to suspend enforcement of prohibition against refiling under special circumstances "such as where the request for relief from stay was resolved in favor of the debtor or where the request for relief from stay and the dismissal were separated in time").

## II. AUTOMATIC STAY

### A. Recovery of Car Repossessed Prepetition: Does a Creditor Who Refuses to Return the Car at Debtor's Request Violate the Automatic Stay?

1. In re Sharon (Transouth Financial Corp. v. Sharon), 234 B.R. 676 (6th Cir. B.A.P. 1999) (before bankruptcy petition was filed, creditor repossessed but had not sold debtor's car; withholding possession of debtor's car after demand and tender of adequate protection violates the automatic stay; creditor's right to adequate protection is not grounds for refusal to deliver possession; creditor was required to pay debtor's attorney fees of \$2,122.50) (dissent by Judge Stosberg: chapter 13 debtor lacks standing to recover property of the estate; demand for turnover must be made by adversary proceeding, not motion; creditor should be able to receive adequate protection as a condition of turnover).
2. Charles R. Hall Motors, Inc. v. Lewis (In re Lewis), 137 F.3d 1280 (11th Cir. 1998) (right of redemption became property of the estate, but "We are not convinced . . . that the mere existence of the estate's ability to redeem the automobile renders the automobile itself 'property of the estate,' at least to the extent that it should be turned over pursuant to 11 U.S.C. § 542(a).").
3. Spears v. Ford Motor Credit Corp (In re Spears), 223 B.R. 159 (Bankr. N.D. Ill. 1998) (FMCC did not violate automatic stay by refusing to return car to debtor).
4. Eaton v. River City Body Shop (In re Eaton), 220 B.R. 629 (Bankr. E.D. Ark. 1998) (car repair shop did not violate automatic stay by retaining possession of car after demand for turnover because, under Arkansas law, mechanic's lien was perfected by possession, and pursuant to § 546(b), debtor's right of recovery was subject to mechanic's right to retain possession).

## B. Relief From Stay on House

1. In re McPherson, 225 B.R. 203 (Bankr. D. Idaho 1998) (expensive house is not necessary to an effective reorganization).
2. In re Binder, 224 B.R. 483 (Bankr. D. Colo. 1998) (postpetition default in mortgage payments; home is not necessary where debtor has no equity, debtor presented no evidence that "the Debtor cannot obtain rental housing at a cost equal to or less than her current payments" and debtor unable to cure default through plan modification).
3. In re Donahue, 221 B.R. 105 (Bankr. D. Vt. 1998) ("there is an irrebuttable presumption that a chapter 13 debtor's home is necessary for an effective reorganization"), rev'd 232 B.R. 610 (D. Vt. 1999) (remanded for determination whether property was in fact debtor's primary residence).
4. In re White, 216 B.R. 232 (Bankr. S.D. Ohio 1997) ("A debtor's home is necessary to an effective reorganization only if the property is not fungible with other living arrangements meeting the debtor's minimum living arrangements."; debtor not permitted to retain \$450,000 home while paying unsecured creditors only 25%).

## C. Effect of Confirmation on Stay Relief

1. Diviney v. NationsBank of Texas (In re Diviney), 211 B.R. 951 (Bankr. N.D. Okla. 1997), aff'd 225 B.R. 762 (10th Cir. B.A.P. 1998) ("drop dead" provision in stay relief order was trumped by confirmation order; stay relief order entered before confirmation does not give bank right to repossess car after confirmation where neither plan nor confirmation order incorporated terms of stay relief order).
2. Chevy Chase Bank v. Locke (In re Locke), 227 B.R. 68 (E.D. Va. 1998) (creditor may not seek relief from stay on grounds that plan does not provide adequate protection where creditor did not object to confirmation).

#### D. Other § 362 Cases

1. Rowe v. Ocwen Federal Bank & Trust, 220 B.R. 591 (E.D. Tex. 1997) (fifth chapter 13 case filed within 180 days of dismissal with prejudice of fourth case was found to be in bad faith; therefore the fifth case was a nullity and never triggered the automatic stay; bankruptcy court annulled the stay ab initio and validated foreclosure sale).
2. In re Georgeff, 226 B.R. 852 (Bankr. S.D. Ohio 1998) (creditor willfully violated automatic stay by initiating garnishment while chapter 13 case was still pending; creditor admittedly was not certain whether order for conversion or dismissal had become effective).
3. In re Cox, 214 B.R. 635 (Bankr. N.D. Ala. 1997) (trustee filed motion to dismiss case for failure to make payments; before the hearing, creditor repossessed debtors' car; creditor's employee believed debtors' case had been dismissed; creditor found to have willfully violated automatic stay).
4. In re Sucre, 226 B.R. 340 (Bankr. S.D.N.Y. 1998) (creditor violated automatic stay by failing to stop garnishment upon notice of chapter 13 filing; creditor had argued that debtor shared in responsibility to contact the Sheriff, who was the collection officer, to stop garnishment).
5. In re McDaniels, 213 B.R. 197 (Bankr. M.D. Ga. 1997) (court sua sponte granted relief from stay to all creditors and overruled trustee's motion to dismiss).

#### E. Co-Debtor Stay

1. In re Schaffrath, 214 B.R. 153 (6th Cir. B.A.P. 1997) (relief from co-debtor stay is required where plan does not provide for payment of co-signed debt in full).
2. In re Janssen, 220 B.R. 639 (Bankr. N.D. Iowa 1998) (creditor not entitled to relief from co-debtor stay where debtor's plan proposes to pay claim in full but not post-petition interest).

### III. PROPERTY OF THE ESTATE

#### A. Causes of Action

1. American General Finance Inc. v. Tippins (In re Tippins), 221 B.R. 11 (Bankr. N.D. Ala. 1998) (chapter 13 debtor has standing to bring cause of action when it was scheduled as exempt and no one objected).
2. Olick v. Parker & Parsley Petroleum Co., 145 F.3d 513 (2d Cir. 1998) (chapter 13 debtor has standing to pursue cause of action).
3. Davis v. Victor Warren Properties, inc. (In re Davis), 216 B.R. 898 (Bankr. N.D. Ga. 1997) (trustee is proper party to prosecute a cause of action that is property of the estate unless the plan or confirmation order provide otherwise).

#### B. Exemptions

1. In re Gamble, 168 F.3d 442 (11th Cir. 1999) (exempt property is available for debtor's use after expiration of 30-day objection period).
2. In re Pendleton, 225 B.R. 425 (Bankr. E.D. Ark. 1998) (proceeds from settlement of personal injury suit constituted "disposable income" to be paid into plan despite the fact that debtor had claimed exemption).



#### IV. CHAPTER 13 PLAN ISSUES

##### A. Classification of Claims

###### 1. Cosigned Debts

- (a) In re Markham, 224 B.R. 599 (Bankr. W.D. Ky. 1998) (unfair discrimination to classify co-signed debt for less favorable treatment).
- (b) In re Chacon, 223 B.R. 917 (Bankr. W.D. Tex. 1998) (unfair discrimination to pay separately classified co-signed debts prior to paying other unsecured creditors).

###### 2. Student Loans

- (a) In re Mammel, 221 B.R. 238 (Bankr. N.D. Iowa 1998) (separate classification is unfair; provision in plan that student loans will be discharged upon completion of plan payments gives debtors no reason to pay anything to student loan creditors).
- (b) In re Turpen, 218 B.R. 908 (Bankr. N.D. Iowa 1998) (unfair classification to pay student loans in full while paying other unsecured debts less than 100%).
- (c) In re Featherston, 238 B.R. 377 (Bankr. S.D. Ohio 1999) (debtor must file adversary proceeding to determine dischargeability of student loans; provision in plan providing that collection costs are discharged upon completion of plan payments did not in fact discharge the debt).

### 3. Pension Loans

- (a) In re Buchferer, 216 B.R. 332 (Bankr. E.D.N.Y. 1997) (not unfair discrimination to pay loans from debtor's pension plan in full while paying 14% to unsecured creditors; pension fund has a secured claim).
- (b) In re Esquivel, 239 B.R. 146 (Bankr. E.D. Mich. 1999) (court does not reject debtor's attempts to distinguish the Sixth Circuit's holding in In re Harshbarger, 66 F.3d 775 (6th Cir. 1995); Harshbarger decision did not create a per se rule; court analyzed Harshbarger and Buchferer and ultimately concluded that plan providing for full payment of pension loan while paying unsecured creditors less than 100% is not confirmable).

## B. Cramdown - Residence

### 1. Claims Secured "Only By A Security Interest In Real Property That Is the Debtor's Principal Residence" Cannot Be Modified – § 1322(b)(2):

- (a) In re Donahue, 221 B.R. 105 (Bankr. D. Vt. 1998) (claim originally secured by home and 50 acres; before bankruptcy, debtor divided acreage into 10-acre lots and sold one lot; at commencement of case, debtor had home and 10-acre lot as residence and 3 lots for commercial development; loan could be modified because at time of petition loan was secured by property other than principal residence), rev'd on other grounds, 232 B.R. 610 (D. Vt. 1999).
- (b) In re Howard, 220 B.R. 716 (Bankr. S.D. Ga. 1998) (creditor took mortgage in 103-acre tract and smaller tract that contained debtor's residence; prior to bankruptcy creditor foreclosed on 103-acre tract; when petition was filed mortgage documents still referred to the additional collateral even though the only collateral remaining was debtor's residence; mortgage could be modified).
- (c) In re Smart, 214 B.R. 63 (Bankr. D. Conn. 1997) (determination of whether mortgage holder's rights can be modified is based on circumstances at the time of the transaction, "not the serendipitous or manipulated facts existing on the date of the filing of the petition."; house was debtor's residence at time of mortgage but was leased to unrelated third parties at time of petition; modification not permitted).

2. Short-term, Matured, or Balloon-Payment Obligations Which Can Be Modified – § 1322(c)(2)

- (a) First Union Mortgage Corp. v. Eubanks (In re Eubanks), 219 B.R. 468 (6th Cir. B.A.P. 1998) (permitting modification of undersecured “short term” second mortgage in debtors’ principal residence) (dissent by Judge Stosberg: 1322(c)(2) was not enacted to overrule Nobleman; agrees with 4th Circuit in Witt).
- (b) In re Nepil, 206 B.R. 72 (Bankr. D.N.J. 1997) (under § 1322(c)(2), debtor may pay in full during the life of the plan a mortgage that was accelerated and reduced to foreclosure judgment prepetition; “As a practical matter this Court can discern no difference among a fully matured mortgage debt, a mortgage on which the balloon payment is due, and a foreclosure judgment.”; but foreclosure judgment must be paid in full during life of plan).
- (c) In re Glenn, 1999 WL 68570 (6th Cir. 1999) (unpublished disposition) (confirmed plan provided for mortgage to be satisfied by payments under the plan for 60 months with a balloon payment due at the end of the plan; original mortgage called for a balloon payment at end of 5 years; debtors filed bankruptcy a year and a half into mortgage term).
- (d) In re Rowe, 239 B.R. 44 (Bankr. D. N.J. 1999) (“last payment due” means due under the original note, not as accelerated in foreclosure; debtor’s remedy in chapter 13 is to reinstate the mortgage, cure the arrearages through the plan and resume payments on the mortgage outside the plan).
- (e) In re Reeves, 221 B.R. 756 (Bankr. C.D. Ill. 1998) (debtor may bifurcate and cram down note that ballooned and became payable before bankruptcy).

- (f) In re Witt, 113 F.3d 508 (4th Cir. 1997) (interpreting § 1322(c)(2) as permitting modification of payments, not modification of claim; "Thus, § 1322(c)(2) was only intended to allow payments to be stretched out over time; the debtor is still required to pay the 'full amount of the allowed secured claim.'").
- (g) In re Dandridge, 221 B.R. 741 (Bankr. W.D. Tenn. 1998) (fact that note had a call provision did not permit modification under § 1322(c)(2); call provision is distinguishable from balloon provision; court's conclusion may have been different if call had been exercised before bankruptcy).
- (h) In re Petrella, 230 B.R. 829 (Bankr. N.D. Ohio 1999) (creditor holding first and second mortgage on debtors' residence objected to plan on grounds that it impermissibly modified creditor's claim; court held creditor failed to satisfy its burden of proof on its objection because it did not provide evidence of when last payment on second mortgage would become due; "it is incumbent upon [the creditor] to show that the provisions of § 1322(c)(2) are not applicable."; second mortgage could be modified).

### C. Cure Defaults

1. In re Bumgarner, 225 B.R. 327 (Bankr. D.S.C. 1998) (mortgage did not specifically authorize interest on unpaid arrearages; therefore, chapter 13 plan did not need to provide for interest on arrearages in order to cure mortgage default).
2. In re Morgan, 225 B.R. 309 (Bankr. E.D. Pa. 1998) (mortgage holder was not entitled to receive interest on arrearages to the extent the claim was undersecured).
3. In re Reed, 226 B.R. 1 (Bankr. W.D. Ky. 1998) (six months was maximum permissible period of time in which debtors could cure their automobile lease arrearage).

### D. Surrender of Property

1. Williams v. Tower Loan of Mississippi, Inc. (In re Williams), 168 F.3d 845 (5th Cir. 1999) (debtor cannot surrender part of collateral in partial satisfaction of non-purchase money lien and pay balance of claim for retained collateral; debtor proposed to surrender law books, one TV, and gold chain, and retain a camera, saxophone, video cassette recorder, and one TV).
2. In re Donahue, 221 B.R. 195 (Bankr. D. Vt. 1998) (debtor may surrender three 10-acre lots and retain the fourth 10-acre lot; mortgage originally was secured by one 50-acre tract; prior to bankruptcy, debtor divided property into five tracts and sold one lot), rev'd on other grounds, 232 B.R. 610 (D. Vt. 1999).

E. Post-Confirmation Modification – § 1329(a)(1)

1. Chrysler Fin. Corp. v. Nolan, 234 B.R. 390 (M.D. Tenn. 1999) (debtor may not surrender car and reclassify deficiency claim as unsecured; full amount of the secured claim as of the effective date of the plan must be paid).
2. In re Dunlap, 215 B.R. 867 (Bankr. E.D. Ark. 1997) (debtor cannot surrender car after confirmation and treat deficiency as unsecured claim).
3. In re Waller, 224 B.R. 876 (Bankr. W.D. Tenn. 1998) (after creditor obtained relief from stay post-confirmation to repossess car, debtor could modify plan to reclassify deficiency balance as unsecured claim; “any plan payments on the bank’s secured claim that accrued before [the stay was terminated] must be paid as a secured claim.”).

## V. CONFIRMATION ISSUES

### A. Disposable Income

1. In re Burgie, 239 B.R. 406 (9th Cir. B.A.P. 1999) (proceeds that debtors received five days after confirmation from sale of homestead did not constitute disposable income; postpetition disposable income does not include prepetition property or its proceeds; "The test is whether the asset in question is an anticipated stream of payments.").
2. In re Pendleton, 225 B.R. 425 (Bankr. E.D. Ark. 1998) (proceeds from settlement of personal injury suit constituted "disposable income" to be paid into plan despite the fact that debtor had claimed exemption).

### B. Binding Effect

1. In re Pardee, 1999 WL 965651 (9th Cir. 1999) (plan specifically provided that postpetition interest on student loan debt would be discharged; creditor did not object to confirmation or appeal order confirming plan; creditor waived its right to assert postconfirmation collateral attack against plan on basis that interest discharge provision violated Bankruptcy Code; plan had res judicata effect).
2. In re Andersen, 179 F.3d 1253 (10th Cir. 1999) (plan specified that confirmation would constitute finding that payment of student loans beyond that provided for by plan would impose undue hardship upon debtor, and that student loans would be dischargeable; debtor did not initiate adversary proceeding to prove undue hardship; lender did not object to plan or appeal order confirming plan; plan is res judicata; confirmed plan is not rendered void merely because a certain provision of the plan may be inconsistent with, or even contrary to, the Bankruptcy Code).



3. In re Holmes, 225 B.R. 789 (Bankr. D. Colo. 1998) (secured creditor's claim may be valued and/or modified in chapter 13 plan through the confirmation process, and no formal objection claim is required; debtors' motion to confirm provided adequate notice and due process sufficient to inform secured creditor that amount of its claim would be determined at time of confirmation hearing).
4. In re Scott, 229 B.R. 811 (Bankr. E.D. Okla. 1999) (for order confirming chapter 13 plan to be given res judicata effect, and for plan to bind oversecured mortgagee to treatment provided in plan, mortgagee had to be given notice that plan was reducing its claim, and in absence of any notice or motion filed by debtors, or of anything in plan to put mortgagee on notice that plan was reducing its claim, res judicata did not apply).
5. Marlow v. Sweet Antiques (In re Marlow), 216 B.R. 975 (Bankr. N.D. Ala. 1998) (only rights that may be asserted by party after confirmation are those provided for in plan; res judicata barred debtor's postconfirmation adversary proceeding against judgment creditor where debtor had neither filed timely objection to judgment creditor's proof of claim nor reserved cause of action in confirmation order).
6. In re Thomas, 222 B.R. 524 (Bankr. E.D. Va. 1998) (notice in plan of value of secured claim and that liens would be released upon payment of value set forth in plan provided creditor with sufficient notice; plan established amount of creditor's secured claim).

C. Effect of Confirmation on Stay Relief

1. Chevy Chase Bank v. Locke (In re Locke), 227 B.R. 68 (E.D. Va. 1998) (creditor may not seek relief from stay on grounds that plan does not provide adequate protection where creditor did not object to confirmation).
2. Diviney v. NationsBank of Texas (In re Diviney), 211 B.R. 951 (Bankr. N.D. Okla. 1997), aff'd 225 B.R. 762 (10th Cir. B.A.P. 1998) ("drop dead" provision in stay relief order was trumped by confirmation order; stay relief order entered before confirmation does not give bank right to repossess car after confirmation where neither plan nor confirmation order incorporated terms of stay relief order).

D. Standing to Object to Confirmation

1. The Court Sua Sponte

- (a) In re Walsh, 224 B.R. 231 (Bankr. M.D. Ga. 1998) (court may raise objection to confirmation based on disposable income test sua sponte even though neither trustee nor unsecured creditor objected; good faith factors overlap disposable income test, and § 1325(b)(1) does not preclude court from considering good faith).
- (b) In re MacDonald, 222 B.R. 69 (Bankr. E.D. Pa. 1998) (court may not raise objection to confirmation based on disposable income test; pursuant to § 1325(b)(1)(B), objection may be raised only by trustee or unsecured creditor).
- (c) In re Mammèl, 221 B.R. 238 (Bankr. N.D. Iowa 1998) (court retains "independent right and duty to review proposed Chapter 13 plans for compliance with the Code" even where trustee withdraws objection and no creditor objects to confirmation).

## 2. Creditors

- (a) In re Morgan, 225 B.R. 290 (Bankr. E.D.N.Y. 1998) (corporate servicing agent for mortgage lacks standing to object to confirmation and engages in the unauthorized practice of law by doing so).
- (b) In re Turpen, 218 B.R. 908 (Bankr. N.D. Iowa 1998) (creditor is not required to file proof of claim in order to have standing to object to confirmation, especially where confirmation hearing is held before bar date; however, creditor must be the holder of an allowed unsecured claim in order to object based on disposable income test per § 1325(b)(1)(B)).
- (c) In re Holmes, 225 B.R. 789 (Bankr. D. Colo. 1998) (creditor has affirmative duty to object to confirmation when it is put on notice in debtor's motion to confirm plan that plan proposed to pay creditor less than creditor's proof of claim).

## E. Lien Avoidance via Confirmation; Release of Liens

1. In re Thompson, 224 B.R. 360 (Bankr. N.D. Tex. 1998) debtors could not obtain a release of secured creditors' liens until debtors successfully completed their confirmed plans and received discharge.
2. In re McPherson, 230 B.R. 99 (Bankr. E.D. Ky. 1999) ("in order to protect the creditor from premature lien termination, and insure that the debtor is not held hostage beyond the time he/she has performed according to the confirmed plan, . . . the better approach is to require that a lien be released upon successful completion of the Chapter 13 plan, but before a discharge is entered.").

3. Keene v. Charles (In re Keene), 222 B.R. 511 (E.D. Va. 1998) (if plan contemplates valuing secured creditor's collateral, then secured creditor must be given notice that valuation hearing will be held; mere notice that bankruptcy court will hold confirmation hearing on proposed plan, in absence of notice specifically directed at security valuation process, will not suffice; plan stated: "The order confirming this Plan shall be deemed to avoid the lien and shall be a judicial determination of the property's value" and further provided that lien shall be released upon confirmation of plan; debtor was required to file an adversary proceeding or a motion requesting valuation).
4. In re Harnish, 224 B.R. 91 (Bankr. N.D. Iowa 1998) (a lien not preserved in a Chapter 13 plan is extinguished at confirmation, if the creditor has filed a proof of a secured claim and is scheduled as an unsecured creditor).
5. In re Robertson, 232 B.R. 846 (Bankr. D. Md. 1999) (claim of creditor holding unperfected lien would be allowed as unsecured even though chapter 13 trustee had not filed an adversary proceeding to avoid the lien).
6. In re Therneau, 214 B.R. 782 (Bankr. E.D.N.C. 1997) ("As a general rule liens pass through bankruptcy unaffected unless there is affirmative avoidance action taken. Sometimes that action must be an adversary proceeding, but in some circumstances . . . the lien may be challenged by an objection. Liens may also be modified through the valuation process, which in this district involves notifying the secured creditor of the allowed amount of the secured claim through the confirmation order and giving the creditor an opportunity to object.").

## VI. DISMISSAL/CONVERSION

### A. Debtor's "Absolute" Right to Dismiss Chapter 13 Case

1. In re Barbieri, 226 B.R. 531 (E.D.N.Y. 1998) (court has discretion to refuse to dismiss case at debtor's request and instead to order conversion where there is evidence of bad faith).
2. Clearstory & Co. v. Blevins, 225 B.R. 591 (D. Md. 1998) (debtor has absolute right to dismiss case even though creditor had filed motion to convert and there were allegations of bad faith).
3. In re Whitmore, 225 B.R. 199 (Bankr. D. Idaho 1998) (debtors' motion to dismiss should be granted even though trustee previously filed motion to dismiss for failure to make payments; as a result, debtors were able to immediately file second case, which was not dismissed under § 109(g)(1)).

### B. Relief From Stay as Alternative to Dismissal

In re McDaniels, 213 B.R. 197 (Bankr. M.D. Gal. 1997) (trustee filed motion to dismiss case for failure to make payments; court sua sponte granted relief from stay as to all creditors and overruled motion to dismiss on grounds that if motion to dismiss were granted, debtor may refile before mortgage holder completes foreclosure sale).

## UNITED STATES CODE

## Title 11. Bankruptcy

Chapter 13. Adjustment of Debts of an Individual With Regular Income

## Subchapter II. The Plan

## SECTION 1321 (11 U.S.C. § 1321)

**§ 1321. Filing of plan.** The debtor shall file a plan.

**Bankruptcy Rule Reference:** 3015

## SECTION 1322 (11 U.S.C. § 1322)

**§ 1322. Contents of plan.**

(a) The plan shall—

(1) provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and

(3) if the plan classifies claims, provide the same treatment for each claim within a particular class.

(b) Subject to subsections (a) and (c) of this section, the plan may—

(1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated, however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;

(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of

**§ 1322**

**BANKRUPTCY CODE**

holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

(3) provide for the curing or waiving of any default;

(4) provide for payments on any unsecured claim to be made concurrently with payments on any secured claim or any other unsecured claim;

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

(6) provide for the payment of all or any part of any claim allowed under section 1305 of this title;

(7) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;

(8) provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;

(9) provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and

(10) include any other appropriate provision not inconsistent with this title.

*(c) Notwithstanding subsection (b)(2) and applicable nonbankruptcy law—*

*(1) a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured under paragraph (3) or (5) of subsection (b) until such residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law; and*

*(2) in a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal*

ADJUSTMENT OF DEBTS—INDIVIDUAL § 1324

*residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title.*

(c) (d) The plan may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years.

(e) *Notwithstanding subsection (b)(2) of this section and sections 506(b) and 1325(a)(5) of this title, if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.*

**Bankruptcy Rule References:** 3013 and 6006

**SECTION 1323 (11 U.S.C. § 1323)**

**§ 1323. Modification of plan before confirmation.**

(a) The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1322 of this title.

(b) After the debtor files a modification under this section, the plan as modified becomes the plan.

(c) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection.

**Bankruptcy Rule Reference:** 3015

**SECTION 1324 (11 U.S.C. § 1324)**

**§ 1324. Confirmation hearing.** After notice, the court shall hold a hearing on confirmation of the plan. A party in interest may object to confirmation of the plan.



**§ 1325**

**BANKRUPTCY CODE**

**Bankruptcy Rule Reference: 3015**

**SECTION 1325 (11 U.S.C. § 1325)**

**§ 1325. Confirmation of plan.**

(a) Except as provided in subsection (b), the court shall confirm a plan if—

(1) the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

(2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

(3) the plan has been proposed in good faith and not by any means forbidden by law;

(4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;

(5) with respect to each allowed secured claim provided for by the plan—

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and

(6) the debtor will be able to make all payments under the plan and to comply with the plan.

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—

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(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

(2) For purposes of this subsection, "disposable income" means income which is received by the debtor and which is not reasonably necessary to be expended—

(A) for the maintenance or support of the debtor or a dependent of the debtor, including charitable contributions (that meet the definition of "charitable contribution" under section 548(d)(3)) to a qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)) in an amount not to exceed 15 percent of the gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

(c) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee.

**Bankruptcy Rule Reference: 3015**

**SECTION 1326 (11 U.S.C. § 1326)**

**§ 1326. Payments.**

(a)(1) Unless the court orders otherwise, the debtor shall commence making the payments proposed by a plan within 30 days after the plan is filed.

(2) A payment made under this subsection shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with

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**BANKRUPTCY CODE**

the plan, *as soon as practicable*. If a plan is not confirmed, the trustee shall return any such payment to the debtor, after deducting any unpaid claim allowed under section 503(b) of this title.

(b) Before or at the time of each payment to creditors under the plan, there shall be paid—

(1) any unpaid claim of the kind specified in section 507(a)(1) of this title; and

(2) if a standing trustee appointed under section 586(b) of title 28 is serving in the case, the percentage fee fixed for such standing trustee under section 586(e)(1)(B) of title 28.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

**Bankruptcy Rule Reference: 3010**

**SECTION 1327 (11 U.S.C. § 1327)**

**§ 1327. Effect of confirmation.**

(a) The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

**Bankruptcy Rule Reference: 3015**

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SECTION 1328 (11 U.S.C. § 1328)

**§ 1328. Discharge.**

(a) As soon as practicable after completion by the debtor of all payments under the plan, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt—

- (1) provided for under section 1322(b)(5) of this title;
- (2) of the kind specified in paragraph ~~(5) or (6)~~ (5), (8), or (9) of section 523(a) or 523(a)(9) of this title; or [sic]
- (3) for restitution, or a *criminal fine*, included in a sentence on the debtor's conviction of a crime.

(b) At any time after the confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if—

- (1) the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
- (2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and
- (3) modification of the plan under section 1329 of this title is not practicable.

(c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt—

- (1) provided for under section 1322(b)(5) of this title;
- or
- (2) of a kind specified in section 523(a) of this title.

**§ 1329**

**BANKRUPTCY CODE**

(d) Notwithstanding any other provision of this section, a discharge granted under this section does not discharge the debtor from any debt based on an allowed claim filed under section 1305(a)(2) of this title if prior approval by the trustee of the debtor's incurring such debt was practicable and was not obtained.

(e) On request of a party in interest before one year after a discharge under this section is granted, and after notice and a hearing, the court may revoke such discharge only if—

- (1) such discharge was obtained by the debtor through fraud; and
- (2) the requesting party did not know of such fraud until after such discharge was granted.

**Bankruptcy Rule Reference: 4007**

**SECTION 1329 (11 U.S.C. § 1329)**

**§ 1329. Modification of plan after confirmation.**

(a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, upon request of the debtor, the trustee, or the holder of an allowed unsecured claim, to—

- (1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
- (2) extend or reduce the time for such payments; or
- (3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan.

(b)(1) Sections 1322(a), 1322(b), and 1323(c) of this title and the requirements of section 1325(a) of this title apply to any modification under subsection (a) of this section.

(2) The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

(c) A plan modified under this section may not provide for payments over a period that expires after three years

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after the time that the first payment under the original confirmed plan was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.

**Bankruptcy Rule Reference:** 3015

**SECTION 1330 (11 U.S.C. § 1330)**

**§ 1330. Revocation of an order of confirmation.**

(a) On request of a party in interest at any time within 180 days after the date of the entry of an order of confirmation under section 1325 of this title, and after notice and a hearing, the court may revoke such order if such order was procured by fraud.

(b) If the court revokes an order of confirmation under subsection (a) of this section, the court shall dispose of the case under section 1307 of this title, unless, within the time fixed by the court, the debtor proposes and the court confirms a modification of the plan under section 1329 of this title.

**Bankruptcy Rule Reference:** 7001



**POTPOURRI OF RECENT IMPORTANT CASES**

**Lawrence P. King**  
**New York University School of Law**  
**New York, New York**  
**and**  
**Counsel, Wachtell, Lipton, Rosen & Katz**  
**New York, New York**



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## POTPOURRI OF RECENT IMPORTANT CASES

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## POTPOURRI OF RECENT IMPORTANT CASES

Lawrence P. King  
Charles Seligson Professor of Law  
New York University School of Law  
Counsel, Wachtell, Lipton, Rosen & Katz  
New York City

### I. Chapter 11 Plan Hits Supreme Court and Sinks

- A. *Bank of America v. 203 North LaSalle Street Partnership*, \_\_ U.S. \_\_, 119 S.Ct. 1411, \_\_ L.Ed.2d \_\_ (1999). The Court did and did not resolve the issue whether the new value “exception” or “corollary” to the absolute priority rule can be utilized to cram down a chapter 11 plan under § 1129(b)(2) of the Code. In this case, the partners would have been allowed to retain the asset of the partnership by contributing new money under the debtor’s plan proposed during its period of exclusivity.
- B. The Court seemed to indicate that the contribution of new value may, in some circumstances, permit an existing underwater class to retain an equity interest

even if a class of creditors does not receive full payment. However, these were not the circumstances.

- C. In interpreting § 1129(b)(2)(B)(ii) which provides that a junior class may not receive or retain any property “on account of such junior claim” if a senior class is not paid in full, the Court gave “on account of” its plain meaning, i.e., “because of”. In this case, it was because of the fact that the class consisted of equity (partners) that they were allowed to contribute money and retain their interests. This the Code does not permit.
- D. On the other hand, what the Code permits is a “truly full value transaction” in cash or money’s worth. This would pose no “threat to the bankruptcy estate.”
- E. Since no one else was permitted to “compete for the equity or to propose a competing reorganization plan”, the plan was doomed.
- F. Furthermore, the exclusivity factor barring any other party from proposing a plan, must be considered property of value to the equity holders because it is on account of their status that only they can purchase the property. Since this property is also “on account of,” it causes the plan to run afoul of the cramdown provisions.

**G. Conclusion: The plan sinks.**

1. Possibly, the Court would approve a debtor's plan proposed during the exclusivity period that provided for an auction.
2. Possibly, the court would approve a debtor's plan that provided only for the equity holders to retain the interest if exclusivity has been terminated and other parties in interest had an opportunity to propose a plan but did not do so.
3. It is unlikely that the Court, in a future case, will deny totally the existence of the new value exception/corollary.

**II. Shoot Out between Senior and Subordinated**

- A.** The Court of Appeals for the Eleventh Circuit has held that § 510(a) abrogates a relatively long standing judicially constructed rule known as the "rule of explicitness" and resort to applicable nonbankruptcy law is required. *Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998).
1. The "rule", concerning senior debt's entitlement to postpetition interest from any distribution that would otherwise go to subordinated debt, required the subordination agreement to provide explicitly that senior

debt would be entitled to such postpetition interest in the event of a bankruptcy distribution. General language would not suffice to put the subordinated creditors on notice of their rights or lack thereof, in a bankruptcy case.

2. The Eleventh Circuit held that § 510(a) displaced the rule by providing that the enforceability of a subordination agreement is dependent on applicable nonbankruptcy law. Accordingly, whether or not senior debt was entitled to postpetition interest in advance of any payment to subordinated debt was controlled by nonbankruptcy law, in this case the law of New York.

- B.** The Eleventh Circuit certified the issue of entitlement to postpetition interest to the New York Court of Appeals, which held that under New York law, the rule of explicitness continued in full force. *Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.)*, 93 N.Y. 2d 178, \_\_ N.E.2d \_\_, \_\_ N.Y.S.2d \_\_ (1999). Specific, clear language is required in any subordination agreement to inform a junior creditor of the possibility of being charged with postpetition interest on senior debt. Accordingly, the Court of Appeals for the Eleventh Circuit affirmed the district court's ruling that the senior debt was not entitled to the postpetition interest. *In re Southeast Banking Corp.*, 179 F.3d 1307 (11<sup>th</sup> Cir. 1999).

C. **Conclusion:** The out-gunned juniors win again. While the decisions ended up as if there were no § 510(a), what is necessary today is to research relevant state law and draft the subordination agreement in accordance with that law and the parties' intent. As to outstanding agreements, look closely at the language if a bankruptcy case is commenced or begins to appear likely. Presumably, until such time, involved counsel, on either side, will not recognize the existence of a potential problem.

### III. Environmental Claim Entitled to Administrative Priority.

A. Texas law required the owner to plug wells that were unproductive for one year. Wells became inoperative during the chapter 11 case and, thus, the obligation to plug them arose postpetition. The chapter 11 trustee and the State agreed that the State would do the plugging and charge the chapter 11 estate. The case was converted to chapter 7 and the chapter 7 trustee argued that plugging the wells was of no benefit to the estate and, therefore, the cost should not be an administrative expense under § 503. The court disagreed. *State of Texas v. Lowe (In re H.L.S. Energy Co., Inc.)*, 151 F.3d 434 (5<sup>th</sup> Cir. 1998), citing and applying *Reading Co. v. Brown*, 391 U.S. 471, 20 L.Ed.2d 751, 88 S.Ct. 1759 (1968). Under § 503(b)(1)(A), benefit to the estate is inextricably interwoven with that which is a necessary expense. Here the combination of state and federal law certainly made it a necessary expense because the plugging was



required by state law and 28 U.S.C. 959(b) requires a bankruptcy trustee to comply with state law.

- B. In *Pennsylvania Department of Environmental Resources v. Tri-State Clinical Laboratories, Inc.*, 178 F. 3d 685 (3d Cir. 1999), the debtor, a clinical laboratory, commenced a case under chapter 11. The case was subsequently converted to chapter 7. A few months after the chapter 11 filing, municipal workers emptying a dumpster were sprayed with blood the debtor had illegally placed in the dumpster. The debtor was charged with two counts of violating the Pennsylvania Solid Waste Management Act. The first count charged that the debtor had illegally stored the blood prepetition. The second count charged that the debtor illegally dumped the blood postpetition. The debtor was convicted on both counts and assessed fines for both counts (\$10,000 and \$20,000 respectively).

The Pennsylvania Department of Environmental Resources ("DER") filed proofs of claim asserting a \$10,000 unsecured claim based on the prepetition conduct and a \$20,000 administrative expense claim based on the postpetition conduct. The chapter 7 trustee objected to the treatment of the \$20,000 claim as an administrative expense. The bankruptcy court found that the \$20,000 claim was not entitled to priority as an administrative expense, and the district court affirmed. The court of appeals held:

1. According to § 503(b)(1)(A), for a claim to be given priority as an administrative expense it must be (1) a “cost” or “expense” that is (2) “actual” and “necessary” for (3) “preserving the estate”. The Supreme Court, in *Reading Co. v. Brown*, 391 U.S. 471, 88 S.Ct. 1759, concluded that “the words ‘preserving the estate’ include the larger objective, common to arrangements, of operating the debtor’s business with a view to rehabilitating it.” In addition it held that “ ‘usual and necessary cost’ should include costs ordinarily incident to operation of a business, and not be limited to costs without which rehabilitation would be impossible.”
2. The language of § 503(b), read as a whole, suggests a quid pro quo pursuant to which the estate accrues a debt in exchange for some consideration necessary to the operation or rehabilitation of the estate.
3. The court distinguished the current case from the *Reading* case, in which the Supreme Court held that damages from a fire to a property adjacent to the bankruptcy estate’s property, that was caused by negligence of the receiver, was entitled to priority as an administrative expense under Section 64a(1) of the Bankruptcy Act. In *Reading*, the Supreme Court’s holding was motivated by considerations of fairness and practicality. The Court believed that those who continue to transact business with the

debtor during the Chapter 11 case [sic], and who suffer financially as a result, are entitled to priority over other creditors who have not affirmatively assumed such risk. Fairness dictates that those injured by the operation of a business by a receiver acting within the scope of authority should be compensated for the injury.

4. The court held that payment of the criminal fine would not compensate for damages resulting from Tri-State's conduct. It would merely cause Tri-State to satisfy its obligations to the state out of the pockets of its creditors. The Third Circuit refused to equate criminal fines and the conduct they attempt to punish to costs of operating the debtor's business and preserving the estate. The purpose of the criminal fines was not related to compensation or proper business operation but rather to "deterrence, retribution, and punishment".
5. Section 503(b)(1)(C) provides that fines and penalties related to taxes incurred by the estate are to be treated as administrative expenses. The inclusion of tax fines and penalties in § 503(b) cannot, however, be expanded to include other fines and penalties.

C. Since there was enough money in the estate to pay all chapter 7 administrative expenses, the court did not have to determine whether the cost of plugging would be subordinated to the chapter 7 expenses.

**IV. Only the Trustee May Surcharge under § 506(c).**

A. *In re Hen House Interstate, Inc.*, 177 F.3d 719 (8<sup>th</sup> Cir. 1999) (*en banc*), cert. granted sub nom. *Hartford Underwriters Ins. Co. v. Magna Bank N.A.*, 68 U.S.L.W. 3310 (1999). Chapter 11 was unsuccessful and resulted in conversion to chapter 7, leaving an insurance company with unpaid premiums for workers' compensation insurance. All the debtor's assets were encumbered by bank's security interest. In the chapter 11 case, the cash collateral order provided, with the bank's agreement, that the insurance company would be paid. In the chapter 7 case, the insurance company sought to surcharge the collateral with this claim and the lower courts agreed, under a prior Eighth Circuit case. On appeal, the Eighth Circuit affirmed but with two judges suggesting an en banc hearing to overrule the earlier precedent. In a split decision, the court, en banc, overruled and held that only the trustee may seek to surcharge a creditor's collateral for expenses that were of benefit to the creditor.

- B. Four judges, in a strong dissent, would have permitted the insurance company to recover under § 506, basically on the grounds that the section does not say that only the trustee may recover and, in a case such as this, a trustee has no incentive to bring an action and there is no reason to permit the secured creditor a windfall. The dissent stressed that four circuits have held contrary to the majority and *Collier* also expresses the view that persons other than the trustee should be able to bring a surcharge action. 4 *Collier on Bankruptcy* ¶ 506.05[8] at 506-142-43 (15th ed. rev.)

V. **Circumventing (in part) Bankruptcy Remote Provisions.**

- A. “Fashion has a role not only in the garment industry but in the legal one as well. One of the newest fashions in commercial real estate financing is the so-called “mortgage backed securitization” coupled with the presence of corporate governance provisions known as “bankruptcy remote provisions” designed to make bankruptcy unavailable to a defaulting borrower without the affirmative consent of the mortgagee’s designee on the borrower’s board of directors.” *In re Kingston Square Associates*, 214 B.R. 713, 714 (Bankr. S.D.N.Y. 1997)(per Brozman, C.J.).
- B. On the eve of foreclosure, involuntary chapter 11 petitions were filed against single asset real estate debtors, allegedly as result of collusion between debtors

and petitioning creditors. Such creditors were sought out by debtors and consisted of one trade creditor each with rest being professionals, and the litigation expenses would be borne by others. Proof existed that such collusion did not warrant dismissal, bad faith did not exist, and it was to stay foreclosure in the presence of corporate provisions barring filing of voluntary petition without unanimous consent of all directors, one of whom was the mortgagee's designee.

- C. Interestingly, the court did not reach the question as to whether the bylaw provision was void as against public policy (antibankruptcy). Nor was there discussion, presumably no raised issue, regarding lender liability for mortgagee's having a director on the board.
- D. The future of bankruptcy remote provisions is still up in the air. In this case, the involuntary petition was used to circumvent them.

## **VI. Break-Up Fees in Trouble**

Debtor and bidder entered into purchase agreements for all of debtor's assets which was conditioned on court approval of break-up fee and break-up expenses. Court refused to approve and in new bidding, consent order was entered providing that bidder reserved right to seek fee and expenses. New bidder was successful and first bidder applied for fees and expenses. Bankruptcy and district courts denied request. Court of appeals

affirmed. Standard to determine propriety of such fees was under Code's administrative expense provisions and not a general common law developed for break-up fees. Here the facts showed that such fees were not necessary to preserve value of the estate and did not benefit it.

*In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999).

## **VII. Preferences**

### **A. Debt Restructuring**

In *In re Kaypro*, 230 B.R. 400 (9<sup>th</sup> Cir. B.A.P. 1999), the court held that payments pursuant to a debt restructuring are not, as a matter of law, outside of the ordinary course of business. Under the facts of this proceeding, however, the § 547(c)(2) exception was not available to the transferee.

### **B. Valuation of Collateral**

Payments on a fully secured claim are not preferential because § 547(c)(5) requirement will not be met. Payments on an undersecured claim are voidable because they are applied to the unsecured portion of the claim. To determine whether the claim is fully secured, the collateral should be valued as of the transfer date and not as of the petition date.

*In re Telesphere Communications, Inc.*, 229 B.R. 173 (Bankr. N.D. Ill. 1999).

C. A Misread of the Preference Section: "Substantially Contemporaneous"

1. *In re Dorholt, Inc.*, (B.A.P., 8<sup>th</sup> Cir. 1999), the BAP held that perfection of a security interest by the filing of a financing statement 16 days after the security agreement became effective was substantially contemporaneous with the creation of the security interest. In effect, the holding reads out of § 547 the provisions in subsection (e) that determine when a transfer is made and which provide a ten-day grace period for perfection of a security interest. The court found that the late filing was, in fact, substantially contemporaneous, and it was intended to be substantially contemporaneous, therefore, the exception in subsection (c)(1) controlled.
2. The decision was 2-1. The dissent would have held that the ten-day period of § 547(e) controlled rather than the exception in subsection (c)(1).
3. The dissent was correct and the majority opinion and holding were a misread of § 547. If the majority is correct, any time a secured creditor belatedly perfects the security interest it would argue to this majority that, of course, the perfection was meant to be substantially contemporaneous with the execution of the security agreement and it



was, in fact, substantially contemporaneous. Even without § 547(e), it seems absurd to conclude that a delay of 16 days is substantially contemporaneous. How about 20 days, 18 days, 25 or 50 days?

**D. The Relation Between § 547(c)(3)(B) and State Law**

In *Fidelity Financial Services, Inc. v. Fink*, 522 U.S. 211 (1998), a purchaser of a new car gave Fidelity Financial Services, Inc. a promissory note for the purchase price, secured by the car. Twenty-one days later, Fidelity mailed the application necessary to perfect its security interest under Missouri law. The purchaser later filed a chapter 7 petition, and the trustee moved to set aside Fidelity's security interest on the ground that the lien was a voidable preference under § 547(b).

Section 547(c)(3)(B) provides a grace period for perfecting a purchase money security interest of 20 days after the debtor receives possession of the property. The trustee argued that the exception limits the grace period to 20 days.

Fidelity responded that under Missouri law, a motor vehicle lien is perfected on the date of its creation (in this case, within the 20-day period), if the creditor files the necessary documents within 30 days after the debtor takes possession.

The bankruptcy court set aside the lien as a voidable preference, holding that state law could not extend § 547(c)(3)(B)'s 20-day perfection period. The district court affirmed, as did the court of appeals. The Supreme Court affirmed, holding that:

1. A transfer of a security interest is made under § 547(c)(3)(B) on the date that the secured party has completed the steps necessary to perfect its interest. A creditor may invoke the enabling loan exception only by satisfying state law perfection requirements within the 20-day period provided by the federal statute.
  
2. Section 547(e)(1)(B) provides that "a transfer of ... property ... is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." This definition implies that a transfer is perfected only when the secured party has done all the acts required to perfect its interest, not at the moment as of which state law may retroactively deem that perfection effective. The statutory text, structure, and history lead to the understanding that a creditor may invoke the enabling loan exception only by acting to perfect its security interest within 20 days after the debtor takes possession of its property.

## **VIII. Executory Contracts and Leases**

### **A. Administrative Rent claim**

Rejection of a lease after assumption creates a future rent claim resulting from the breach that is entitled to administrative expense priority. *In re Baldwin Rental Centers*, 228 B.R. 504 (Bankr. S.D. Ga. 1998), citing § 365(g)(2) and *Nostas Assocs. V. Costich (In re*

*Klein Sleep Prods., Inc.*), 78 F.3d 18 (2d Cir. 1996). But the court went on, in dicta, to hypothesize that if the plain meaning rule would produce an absurd result, it need not be followed and absurdity would exist if its result would prevent the possibility of reorganization or so deplete the estate so "as to wipe out all general unsecured claims." Such was not the case here. But why are these results absurd? Whether or not reorganization should be easy, difficult or impossible is a legislative determination.

**B. Nonassignability**

1. When patent law renders a nonexclusive license nonassignable absent consent of licensor, § 365(c)(1) bars a debtor in possession from assuming the license, even if it were not to assign it. *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9<sup>th</sup> Cir. 1999). But see VIII.B.2., infra.
2. In *Institute Pasteur v. Cambridge Biotech Corp.*, 104 F. 3d 489 (1st Cir. 1997), a manufacturer of medical diagnostic tests (CBC) filed a chapter 11 petition and continued to operate its testing business as debtor in possession. Its reorganization plan proposed the assumption of two cross-licenses with a research foundation (Pasteur) that owned various patented medical diagnosing procedures. According to the original agreements, each party acquired a nonexclusive perpetual license to use

some of the patented technology licensed by the other. Each cross-license broadly prohibited the licensee from assigning or sublicensing to others. In addition, the debtor's plan proposed the sale of all the debtor's stock to a subsidiary of a corporation that is Pasteur's direct competitor in international biotechnology sales.

Pasteur objected to the plan, relying on § 365(c)(1), contending that the proposed sale of CBC's stock to its competitor amounted to CBC's assumption of the cross-licenses and their assignment to a third party in contravention of the presumption of nonassignability under the federal common law of patents, as well as the explicit nonassignability provision contained in the cross-licenses.

The court of appeals held:

- a. Subsections 365(c) and (e) contemplate a case-by-case inquiry into whether the nondebtor party was actually being forced to accept performance under its executory contract from someone other than the debtor with whom it originally contracted.
  - (1) When the particular transaction envisions that the debtor in possession would assume and continue to perform under an executory contract, the bankruptcy court cannot

simply presume as a matter of law that the debtor in possession is a legal entity materially distinct from the prepetition debtor with whom the nondebtor party (Pasteur) contracted. Rather, sensitive to the rights of the nondebtor party, the bankruptcy court must focus on the performance actually to be rendered by the debtor in possession with a view to ensuring that the nondebtor party will receive the full benefit of its bargain.

- (2) Stock sales are not mergers whereby outright title and ownership of the licensee-corporation's assets (including its patent licenses) pass to the acquiring corporation. Rather, as a corporation, CBC is a legal entity distinct from its shareholders. Absent compelling grounds for disregarding its corporate form, therefore, CBC's separate legal identity, and its ownership of the patent cross-licenses, survive without interruption notwithstanding repeated and even drastic changes in its ownership. The cross-licenses contain no provision either limiting or terminating CBC's rights in the event its stock ownership were to change hands. As CBC remained in all material

respects the legal entity with which Pasteur freely contracted, Pasteur has not made the required individualized showing that it is or will be deprived of the full benefit of its bargain.

**C. Impact of Postpetition and Prepetition Defaults on Debtor's Entitlement to Exercise Lease Renewal Option**

In *Coleman Oil Company, Inc. v. The Circle K Corporation (In re Circle K Corp)*, 127 F. 3d 904 (9<sup>th</sup> Cir. 1997), *cert. denied*, 140 L. Ed. 3d 176 (1998), the court of appeals dealt with the question whether a lessee debtor, prior to deciding whether to assume or reject nonresidential leases, may exercise an option to renew the leases even though the debtor is in default and the leases specify that they may not be renewed if in default.

The lessor leased six gasoline stations for ten years, with options to renew for two additional five-year terms, if not in default. The lessee-debtors (two subsidiaries of the Circle K Corporation) renewed the lease and subsequently filed a chapter 11 petition. The debtors sought and received an extension of time within which to assume or reject the leases. The first five-year extension of the leases was due to expire prior to the time when the debtors were required to accept or reject the leases. The debtors exercised their option to extend the leases for a second five-year term, even though prepetition defaults in at least some of the leases had not been cured and in disregard of the lease default provision.

The bankruptcy court and the Bankruptcy Appellate Panel concluded that the leases may be renewed despite the uncured defaults. The court of appeals affirmed, holding:

1. The nature and extent of the defaults is immaterial because the bankruptcy court had the power to permit the debtors to extend the leases without first curing the defaults.
2. The purpose behind § 365 is to balance the state law contract right of the creditor to receive the benefit of its bargain with the federal law equitable right of the debtor to have an opportunity to reorganize. Section 365, in conjunction with the automatic stay of § 362, suspends, once the petition is filed, the termination of a lease that is in default. It extends the debtor lessee's opportunity to cure any defaults until the debtor has the chance to decide whether to assume the lease. The lessor will then get the benefit of its bargain upon assumption, when the debtor lessee must cure the defaults. If the bankruptcy court could not allow a debtor lessee to renew a lease without first curing defaults, § 365's basic purpose would be frustrated. The debtor would be denied the benefit of § 365's "suspension of time" in order to determine whether to assume or reject the lease. For example, if a debtor cured defaults in order to exercise an option to renew, and then later decided to reject the lease, the debtor would have given a preference to the lessor who would

otherwise hold a prepetition claim for pre-petition defaults. On the other hand, if a debtor did not cure defaults and could not renew, the lease would expire and the debtor would have lost the opportunity to choose whether to assume or reject.

3. A future election under § 365 to assume or reject a lease will be rendered largely illusory if prepetition defaults must be cured in order to keep the lease alive for the election.
4. No explanation is given in the opinion as to how a renewal can be accomplished without an assumption. Exercise of a renewal provision is part of the lease and black letter law has often stated an executory contract must be totally assumed or not assumed at all. And cure must precede assumption. § 365(b)(1).
5. In *Cannery Row Co. v. Leisure Corp. (In re Leisure Corp.)*, 234 B.R. 916 (B.A.P. 9<sup>th</sup> Cir. 1999), the debtor leased its business premises from the appellant. The lease included five successive one-year options of renewal. Shortly after exercising its first option of renewal, the debtor filed a chapter 11 petition. The debtor's time to assume or reject the lease was extended indefinitely by the bankruptcy court. The debtor tried to exercise its second lease option of renewal but the lessor claimed



the debtor could not exercise the option due to pre and postpetition defaults under the lease. The lessor filed a motion for relief from the stay and for adequate protection. The bankruptcy court denied relief from the automatic stay and allowed the debtor to extend payment of its postpetition lease obligations. The lessor filed a second motion for relief from the automatic stay. The debtor asserted that the holding in *Circle K* permitted it to exercise the option without first curing its defaults. The bankruptcy court held that, as a matter of law according to the holding in *Circle K*, the debtor had the right to renew the lease irrespective of any prepetition or postpetition defaults in payment. Accordingly, the bankruptcy court determined that the debtor had validly exercised the option to renew the lease, and it denied the lessor's motion for relief from the automatic stay.

The Bankruptcy Appellate Panel vacated and remanded the bankruptcy court's order, holding:

- a. "[T]he purpose behind § 365 is to balance the state law contract right of the creditor to receive the benefit of his bargain with the federal law equitable right of the debtor to have an opportunity to reorganize," quoting *Circle K*.

- b. The B.A.P. focused on the fact that the alleged defaults in payment were primarily defaults in postpetition payments rather than in prepetition payments, as was the case in *Circle K*. Postpetition defaults, unlike prepetition defaults, violate the "timely performance" requirement of § 365(d)(3).
- c. Although § 365(d)(3) requires a debtor to perform timely the obligations under a lease until the lease is assumed or rejected, § 365(d)(3) neglects to prescribe the consequence of noncompliance. Thus, there was only one issue to address: may a debtor who had defaulted on a lease postpetition in violation of § 365(d)(3) nevertheless exercise a renewal option in order to preserve its right to assume the lease, even though the lease prohibited renewal if there were outstanding defaults?
- d. *Circle K* does not compel a bankruptcy court to allow renewal when there is a postpetition default and § 365(d)(3) does not absolutely prohibit renewal in the same circumstances. Postpetition defaults should be a factor for the court to consider in deciding whether a debtor may renew a lease.

- e. In determining whether the renewal of a lease is effective, the bankruptcy court should consider any postpetition defaults and their causes along with the purposes of § 365 of preserving the debtor's opportunity to reorganize, while also protecting the landlord's right to current payment for current services.
  
- f. In this case the bankruptcy court erred in concluding as a matter of law that the debtor could renew the lease despite alleged postpetition defaults. If the bankruptcy court finds that there were postpetition defaults at the time of renewal, the court must exercise its discretion in deciding whether the scope of the default, the cause of default, any subsequent cure of the default, and the significance of the lease to the reorganization are sufficient to outweigh the policy of § 365(d)(3) that the landlord has a right to timely payment postpetition.

**IX. No Damage Requirement Under § 523(a)**

In *Wolf v. Campbell (In re Campbell)*, 159 F.3d 963 (6th Cir. 1998), the court of appeals dealt with the issue whether a fraudulently obtained new promise to forbear on an unpaid, non-fraudulent, dischargeable old indebtedness should render the new extension of

credit nondischargeable, even though the creditor may in fact be in no worse of an economic condition as a result of the fraudulent refinancing.

Gary Campbell, an individual debtor and sole shareholder of a debtor corporation, failed to make payments to certain creditors under a promissory note for \$500,000. In order to obtain the creditors' forbearance from collecting on the defaulted note, the debtor gave the creditors false financial documents showing inflated inventory and account receivable values. On the basis of the false documents, the debtor and the creditors negotiated new repayment terms, and the creditors conditionally agreed to forbear. When the debtor failed to make the interest payment due, the creditors filed a suit to collect the amount still due on the original promissory note. The debtor and his wholly owned company subsequently commenced bankruptcy cases, thereby staying the creditors' suit.

The bankruptcy court held that the debt was dischargeable because the creditors failed to show that they had suffered any damages since the debtor was already insolvent when the creditors extended the debt. The district court reversed, holding that the "damages" requirement imposed by the bankruptcy court had no basis in the language of the statute.

The court of appeals held:

- a. An enforceable promise, as in this case, clearly creates a sufficient "extension of credit" or "refinancing" to come within the coverage of § 523(a). The waiver of default and the

agreement to forbear by the creditors in exchange for Campbell's modified promise to pay formed a deal sufficient to be called a new "extension of credit". This extension of credit was obtained by fraud.

- b. A contractual "refinancing" or "extension of credit" is sufficient without showing further damage. A creditor need not show that the loan could have been collected prior to the commencement of a case under the Bankruptcy Code but for the new extension of credit.
- c. The court found that the entire amount of the debt was obtained by the debtor's intentional use of a false statement in writing regarding his company's financial condition, and the entire amount was nondischargeable.
- d. The court noted that holding otherwise would create a perverse incentive for insolvent debtors to lie to creditors to get them to forbear collection of past due indebtedness.
- e. Note: With the decision in this case, the Sixth Circuit joined the First, Fifth, Seventh, and Tenth Circuits, which have found that there is no requirement that a creditor must show actual damage

proximately resulting from reliance on false financial statements before a debt may be declared nondischargeable.

**X. The Applicability of the "Mareva" Injunction**

In *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 119 S. Ct. 1961 (1999), a Mexican holding company (GMD), issued \$250 million of unsecured, guaranteed notes, which ranked pari passu in priority of payment with all of GMD's other unsecured and unsubordinated debt. Four subsidiaries of GMD guaranteed the notes. Respondents, investment funds, purchased approximately \$75 million of the notes. GMD was involved in a toll road construction program sponsored by the Government of Mexico that resulted in severe losses. GMD did not get paid for its part in the project. In response to these problems the Mexican Government announced a Rescue Program, under which it would issue guaranteed notes (Toll Road Notes) to the concessionaires of the program (subsidiaries of GMD), in exchange for their ceding to the Government ownership of the toll roads. GMD expected to receive approximately \$309 million of Toll Road Notes under the program. In addition to the notes, GMD owed other debts of about \$450 million.

GMD filed a 20-F Form with the Securities and Exchange Commission stating that its current liabilities exceeded its current assets and that there was "substantial doubt" whether it could continue as a going concern. As a result of these financial problems, neither GMD nor its subsidiaries (who had guaranteed payment) made the interest payment on the

notes. GMD attempted to negotiate a restructuring of its debt with its creditors. Eventually, GMD publicly announced that it would place in trust its right to receive \$17 million of Toll Road Notes, to cover employee compensation payments, and that it had transferred its right to receive \$100 million of Toll Road Notes to the Mexican Government (apparently to pay back taxes). GMD also negotiated with the holders of the notes (including respondents) to restructure that debt, but these negotiations had failed. In December 1997, respondents accelerated the principal amount of their notes and filed suit for the amount due in the United States District Court for the Southern District of New York. The complaint alleged that "GMD is at risk of insolvency, if not insolvent already," that GMD was dissipating its most significant asset, the Toll Road Notes, and was preferring its Mexican creditors by its planned allocation of Toll Road Notes to the payment of their claims, and by its transfer to them of Toll Road Receivables; and that these actions would "frustrate any judgment" respondents could obtain. Respondents sought breach of contract damages of \$80.9 million, and requested a preliminary injunction, restraining GMD from transferring the Toll Road Notes or Receivables. On that same day, the district court entered a temporary restraining order, as requested. Later on, the district court entered an order in which it accepted all of the respondents claims and preliminarily enjoined GMD "from dissipating, disbursing, transferring, conveying, encumbering or otherwise distributing or affecting any petitioner's right to, interest in, title to or right to receive or retain, any of the Toll Road Notes. The court

ordered respondents to post a \$50,000 bond. The Second Circuit affirmed. The Supreme Court granted certiorari.

The Supreme Court ruled:

1. The essence of the "Mareva" injunction, known in commonwealth countries, in the words of Lord Denning, is "[I]f it appears that the debt is due and owing--and there is a danger that the debtor may dispose of his assets so as to defeat it before judgment--the Court has jurisdiction in a proper case to grant an interlocutory judgment so as to prevent him [sic] disposing of those assets." 2 Lloyd's Rep., at 510.
2. Federal courts cannot issue the U.S. equivalent of a "Mareva" injunction.
3. The United States, as amicus curiae, contended that the preliminary injunction was analogous to the relief obtained in an equitable action known as a creditor's bill, which was used to permit a judgment creditor to discover the debtor's assets, to reach equitable interests not subject to execution at law, and to set aside fraudulent conveyances. The Court held that it was well established that as a general rule, a creditor's bill may be brought only by a creditor who had already obtained a judgment establishing the debt. Therefore, a judgment for the debt was necessary



before a court of equity would interfere with the debtor's use of its property.

4. The Court described the "Mareva" injunction and its influence on English law since 1975, the year that it was introduced in England. Nevertheless, the Court stated that it is indisputable that the English courts of equity did not actually exercise this power until 1975, and that federal courts in this country have traditionally applied the principle that courts of equity will not, as a general matter, interfere with the debtor's disposition of its property at the instance of a non-judgment creditor. The Court concluded that it is incompatible with its traditionally cautious approach to equitable powers, which leaves any substantial expansion of past practice to Congress, to decree the elimination of this significant protection for debtors.
5. The district court had no authority to issue a preliminary injunction preventing GMD from disposing of its assets pending adjudication of respondents' contract claim for money damages.

#### **XI. Sheriff's Sale and the Automatic Stay**

In *Taylor v. Slick*, 178 F.3d 698 (3d Cir. 1999), after a default judgment was entered on a mortgage note and a sheriff's sale was scheduled for the property securing the

mortgage note, the debtor commenced a case under chapter 11. The executor of the mortgagee's estate sought relief from the automatic stay in the bankruptcy court in order to continue with the sheriff's sale of the property. The debtor did not respond or attend the hearing before the bankruptcy court, and the court granted relief from the stay. The sale took place as scheduled, the executor was the high bidder for the property, and the sheriff's deed of the property was executed and recorded. The debtor's chapter 11 petition was subsequently dismissed on procedural grounds. The debtor later filed an adversary complaint in the bankruptcy court and contended, among other things, that the continuance of the sheriff's sale after the debtor had filed a chapter 11 petition violated § 362(a) and, therefore, voided the sale of the property. The bankruptcy court granted the executor's motion to dismiss the adversary complaint on the ground that there had been no violation of the automatic stay. The district court dismissed the debtor's appeal.

The Court of Appeals for the Third Circuit concentrated on the purpose of the automatic stay and whether a continuation of a sheriff's sale serves to maintain the status quo between the debtor and creditors or whether it constitutes 'a judicial, administrative, or other action or proceeding' prohibited by § 362(a)(1). The court concluded that:

1. The continuation of a sheriff's sale connotes the postponement of a proceeding and effectuates the purposes of § 362(a)(1) by preserving the status quo until the bankruptcy process is completed or until the creditor obtains relief from the automatic stay.

2. So long as the chapter 11 petition is pending before the bankruptcy court, a creditor must apply for and obtain relief from the stay before it can proceed with the sale. The creditor properly applied for and obtained relief from the automatic stay before it proceeded with the sale of the property. Upon receiving relief from the stay, the creditor was permitted to proceed with the sheriff's sale so long as appropriate notice requirements had been met.

## **XII. Ancillary Relief Under § 304**

*In In re Board of Directors of Hopewell International Insurance Ltd.*, 238 B.R. 25 (Bankr. S.D.N.Y. 1999), Hopewell International Insurance Ltd., a Bermuda reinsurance company (Hopewell), adopted a scheme of arrangement between the company and its creditors, similar to a prepackaged chapter 11 plan. The scheme was unanimously approved by the creditors and sanctioned by a Bermuda court under Bermuda law. Subsequently, one of the creditors (Gold Medal) informed Hopewell that it intended to sue it in Minnesota and to attach any Hopewell assets in the United States in satisfaction of an insurance contract claim. Since such actions would violate the dispute resolution process contained in Hopewell's scheme of arrangement, the Bermuda court enjoined Gold Medal from violating the scheme. Immediately thereafter, Hopewell's board of directors filed a petition in New York to commence an ancillary case to enforce the Bermuda injunction and to issue a nationwide injunction enforcing

the terms of the scheme against all creditors in order to preserve Hopewell's assets in the U.S. for the benefit of all creditors.

Gold Medal and its insured, General Mills, opposed the granting of a nationwide injunction, raising numerous objections to the relief sought by Hopewell:

1. They argued that the scheme of arrangement was not a "foreign proceeding" for purposes of Bankruptcy Code § 304 because it was a "stand-alone scheme" that was not under court supervision. The bankruptcy court held that the scheme satisfied the Code's definition of a foreign proceeding, "a foreign judicial or administrative process whose end it is to liquidate the foreign estate, adjust its debts or effectuate its reorganization."
2. Gold Medal and General Mills asserted that Hopewell's scheme was no longer a foreign proceeding because the Bermuda court's file was closed after the scheme was sanctioned. The bankruptcy court held that since that significant judicial involvement continued, and the proceeding was pending until one of the goals of a foreign proceeding has been accomplished, regardless of whether the case is technically open or shut, Hopewell was the subject of a foreign proceeding.

3. Gold Medal and General Mills argued that Hopewell's board of directors was not eligible to be a "foreign representative" that could file a petition under § 304 because it had not been appointed by the Bermuda court to oversee the scheme. The bankruptcy court dismissed this argument on the ground that the statute does not require that the foreign representative be court appointed. Moreover, it observed that since the Bermuda court had sanctioned the scheme, which provided for the company to implement it, the board of directors, as the company's management, constituted the duly selected representative of the estate.
4. Gold Medal and General Mills argued that Hopewell's scheme treated it unfairly in several respects. The court rejected these arguments. It stated that because Gold Medal had not established that fraud occurred or that the scheme proceeding was procedurally unfair, the scheme had the same binding effect as a confirmed plan under the Bankruptcy Code and was immune from collateral attack.
5. Gold Medal and General Mills also argued that they would be prejudiced and inconvenienced by having to arbitrate their reinsurance claim in Bermuda under Bermuda law. The court held that Gold Medal had consented to the change in governing law when it voted to accept the scheme, which superseded its prior rights just as a chapter 11 plan may

modify preexisting rights. Moreover, the court found that the arbitration would not be offensive, as it would be conducted in accordance with the International Conciliation and Arbitration Act of 1993, which adopted the model law promulgated by UNCITRAL.

6. Finally, the court considered the question of comity. It observed that the scheme's arbitration procedures were established to centralize the claims resolution process and to enhance uniformity in treatment of all creditors. To allow Gold Medal to sidestep that procedure and attach assets in the United States would undermine the administration of the estate for the benefit of all creditors. Accordingly, the court concluded that the sanctioned scheme and the Bermuda injunction were entitled to comity to ensure a fair, economical, and expeditious administration of Hopewell's estate.

### **XIII. The Right to Jury Trial in a Nondischargeability Action**

Within two days, two bankruptcy courts, one in New York and one in Tennessee, dealt with exactly the same issue but reached exactly opposite conclusions.

In *In Re Weinstein*, 237 B.R 567 (Bankr. E.D.N.Y. 1999), decided on 8/18/99, the plaintiff filed a complaint for a determination of nondischargeability under § 523(a)(2)(A)

and (B) for a debt incurred as a result of fraud. The plaintiff made a timely demand for a jury trial and moved to withdraw the reference from the bankruptcy court.

The bankruptcy court held: In a § 523(a)(2) proceeding, there can be a state or federal jury trial on the existence of fraud or deceit, and if and only if there is a judgment against the debtor, the bankruptcy court will determine the issue of nondischargeability.

In *In Re Bandy*, 237 B.R. 661 (Bankr. E.D.Tenn. 1999), decided on 8/19/99, creditors filed complaints against two separate chapter 7 debtors (both “no asset” cases), claiming that debtors convinced them to buy a Jeep by intentionally misrepresenting its condition. The complaints asked for damages and a determination that the debt was nondischargeable. The creditors requested a jury trial, and the defendants objected.

The bankruptcy court held: There is no right to a jury trial in dischargeability proceedings, even on the liability issues. All proceedings that deal with whether the debtor is entitled to a discharge are equitable proceedings, including a proceeding to determine the dischargeability of a particular debt.

**SINGLE ASSET AND SMALL BUSINESS**

**CHAPTER 11 CASES**

**Charles P. Normandin  
Of Counsel, Ropes & Gray  
Boston, Massachusetts**



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# SINGLE ASSET AND SMALL BUSINESS CHAPTER 11 CASES

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**SINGLE ASSET AND SMALL BUSINESS  
CHAPTER 11 CASES**

**Charles P. Normandin  
Of Counsel, Ropes & Gray  
Boston, Massachusetts**

**I. INTRODUCTION**

The Bankruptcy Code contains special provisions dealing with single asset real estate cases and with small business Chapter 11 cases. These provisions were inserted by the Bankruptcy Reform Act of 1994.<sup>1</sup> Both single asset real estate cases and small business Chapter 11 cases were perceived as being only rarely successful due to the lack of resources available to the debtors in these cases and to the procedural complexity, delay, and expense involved in consummating a reorganization under Chapter 11. The general intention of the provisions was to provide a fast, up-or-out track for single asset real estate cases and an simplified, expedited procedure for small business Chapter 11 cases, eliminating complexity and delay and insuring that the cases would be consummated quickly, whether successfully or unsuccessfully. To date, the amendments have not generated a large number of published judicial opinions. This may be due to the relatively short period of time which has elapsed since their enactment, and to the fact that the debtors involved in these cases rarely have the resources with which to fight a prolonged legal battle.

**II. SINGLE ASSET REAL ESTATE CASES**

The provisions dealing with single asset real estate cases reflect the view, held by many lenders and their counsel and by some judges, that many such cases are desperate last ditch efforts by a debtor to retain possession of heavily over-encumbered real estate at the expense of the debtor's secured creditors. These cases are viewed by some as an inappropriate use of bankruptcy law to resolve what is essentially a two-party dispute. Reorganization of a single asset real estate debtor generally has relatively little impact on parties other than the debtor and secured creditors, since the debtor usually has few employees and owes only modest amounts of unsecured trade debt. Also, the probability of a successful reorganization in many of these cases is remote. The Bankruptcy Code's provisions dealing with single asset real estate cases are relatively simple. They consist of a definition and an additional ground for a secured creditor's obtaining relief from the automatic stay. The definition is set forth at 11 U.S.C. §101(51B). The provision for obtaining relief from the automatic stay is 11 U.S.C. §362(d)(3).

**A. Definition** - The definition is of "single asset real estate," but it contains elements relating to the debtor owning the property as well as elements relating to the property itself. The definition can conveniently be broken down into four criteria that must be satisfied if real property is to be considered "single asset real estate."

**1. Single Property or Project** - The real property must consist of a single property or project, other than residential real property with fewer than four residential units. Whether something is "real property" will not often generate controversy. Nor will whether residential property contains fewer than four units. The debtor must own the real property directly, and not indirectly, such as through the debtor's ownership of the general partner's interest in a partnership which has direct ownership of the property. Whether the real estate is a single property will ordinarily be determinable by reference to deeds and land records. If more than one property or parcel of real estate is involved, determining whether they constitute a single project may be somewhat more difficult. Parcels on which the debtor intends to construct separate semi-detached houses to be sold to separate buyers have been held to constitute a single project and single asset real estate.<sup>2</sup> Even if the parcels are not all adjacent, or are not all intended for the same use, they may constitute a single project if the debtor and secured creditor treat them as such; for example, by financing them on a project-wide basis. However, the mere fact of common ownership, or that

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<sup>1</sup> Pub. L. No. 103-394, 108 Stat. 4106.

<sup>2</sup> In re Philmont Development Co., 181 B.R. 220 (Bankr. E.D. Pa. 1995).

the properties adjoin one another, does not suffice to constitute a single project. They must be linked together in some fashion in a common scheme or plan involving their use.<sup>3</sup>

**2. Generating All of Debtor's Gross Income** - The real property must generate substantially all of the debtor's gross income. The gross income test should be simple to apply in most cases. Use of a net income test would have introduced accounting issues and complexities, necessitating hearings and a judicial resolution of whether this element of the definition was met. The meaning of "substantially all" may be disputed, but a determination of that issue will not long occupy a bankruptcy judge.

**a. Raw Land** - The requirement that the real property generate substantially all of the debtor's gross income gives rise to the question whether raw, unimproved land not generating any income can be single asset real estate. Raw land can fall within the definition, notwithstanding the awkwardness of the statutory language.<sup>4</sup> Many of the cases decided prior to the Bankruptcy Reform Act of 1994 treated raw land as single asset real estate, and that this settled case law should be given weight in determining Congress' intent in enacting the definition. Interpreting the statute to exclude raw land would not serve the purpose of the statutory scheme of expediting cases.

**3. No Other Business** - The debtor must be conducting no substantial business on the property other than the business of operating the property and activities incidental thereto. Distinguishing the business of operating the property and activities incidental thereto from a business conducted on the property but distinct from its operation may involve some difficulty. Some cases will be clear. For instance, an apartment complex from which the debtor derives rental income will be single asset real estate even though the debtor also collects some revenue from coin-operated laundry facilities located in the complex. The laundry facilities and revenue derived therefrom are incidental to the operation of the apartment complex. At the other end of the spectrum, if the owner of a strip mall rents a number of retail stores to third parties, but itself occupies and operates a retail store in the mall, the definition of single asset real estate is probably not met. The retail store is a business separate from and not merely incidental to operation of the mall. The difficult cases are those in which the debtor is conducting an activity on the property which goes beyond the type of activity generally associated with being a landlord, but which is also somewhat related to this particular property. A marina has been held not to be single asset real estate, because it involved more than the simple rental of moorings for boats.<sup>5</sup> The marina stored, repaired, and winterized boats. It provided showers, a pool, and other services and activities to boaters. It also sold gas and operated concessions on the property. All of these activities went beyond those incidental to operating the real property and constituted a separate business. Other types of activities which give rise to similar questions include hotels<sup>6</sup>, golf courses<sup>7</sup>, and parking facilities.

Other definition issues may arise where there are affiliated debtors. There is no statutory basis for combining the secured debts of two affiliated debtors where the combination would cause the aggregate secured debt to exceed \$4,000,000. In some cases, one debtor may own the real property, but conduct no unrelated business thereon, while an affiliated debtor conducts a separate business on the real estate. Again, there is no statutory basis for considering the business activities of the two affiliated debtors together in determining whether either of the debtors is a single asset real estate debtor.

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<sup>3</sup> In re The McGreals, a partnership, 201 B.R. 736 (Bankr. E.D. Pa. 1996).

<sup>4</sup> In re Oceanside Mission Associates, 192 B.R. 232, 234-236 (Bankr. S.D. Cal. 1996).

<sup>5</sup> In re Kkemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995).

<sup>6</sup> Centofante v. CBJ Development, Inc. (In re CBJ Development, Inc.), 202 B.R. 467 (9th Cir. B.A.P. 1996)(owner-operator of hotel not single asset real estate debtor).

<sup>7</sup> In re Larry Goodwin Golf, Inc. 219 B.R. 391 (Bankr. M.D.N.C. 1997)(golf course not single asset real estate).

**4. Limit on Secured Debts** - The debtor must have aggregate noncontingent, liquidated secured debts of no more than \$4,000,000. Noncontingent debts are debts where the debtor's liability is not dependent on the occurrence or nonoccurrence of a future event. Liquidated debts are debts the amount of which is fixed by an instrument or contract or can readily be determined from the instrument or contract by calculation. A debt may be noncontingent and liquidated even if it is disputed. Most mortgage debts will be noncontingent and liquidated.

**a. Calculating Amount of Secured Debts** - Whether the debtor's aggregate secured debts exceed \$4,000,000 will depend on how the amount is calculated. Should the entire amount owed to the secured creditor be included, without regard to the value of the real property which serves as collateral? Or, does the value of the collateral limit the secured debt owed to the creditor, without any balance in excess of the collateral's value being treated as unsecured debt? Courts have split on this issue.<sup>8</sup>

On the one hand, the statutory goal is to provide for expedited and relatively inexpensive resolution of single asset real estate cases. An interpretation of section 101(51B) that requires determination of the collateral's value would be inconsistent with the goal, and would encourage costly valuation disputes in a case which may simply go away quietly in 90 days. Also, the debtor should be able to determine at the outset of the case, without valuation hearings, whether or not compliance with section 362(d)(3), discussed below, will be required.

On the other hand, 11 U.S.C. 506(a) applies generally to determine the amount of a secured claim, and provides that a claim is secured only to the extent of the value of the creditor's interest in the collateral. Interpreting "secured debts" in section 101(51B) in this manner would be consistent with this general usage. Note that bifurcation of the debt into secured and unsecured components may present strategic problems for both the debtor and the secured creditors. In attempting to escape from being treated as a single asset real estate debtor, the debtor will want to argue that the property, and thus, the secured debt, has a high value, over \$4,000,000. However, when the time comes to determine the amount of the secured claim for plan purposes, the debtor may wish to argue for a lower value. The secured creditor may face a similar problem in reverse.

**B. Additional Ground for Relief from Stay** - Section 362(d)(3) creates an additional ground<sup>9</sup> for relief from the automatic stay, applicable only in single asset real estate cases. It provides that the court should grant relief from stay with an act against single asset real estate<sup>10</sup> by a creditor whose claim is secured by the real estate unless the debtor has satisfied one of two conditions within ninety (90) days from entry of the order for relief. The 90-day period may be extended by the court for cause by order entered within the period. The two conditions are that the debtor either (i) have filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or (ii) have commenced monthly payments to each creditor whose claim is secured by the real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate. The two alternative conditions are discussed below, in reverse order.

**1. Monthly Payments on Secured Debts** - Satisfying this condition may raise a number of questions and issues:

<sup>8</sup> Compare *In re Oceanside Mission Associates*, 192 B.R. 232, 238 (Bankr. S.D. Cal. 1996) with *In re Pesignorkay, Inc.*, 204 B.R. 676, 683 (Bankr. E.D. Pa. 1997).

<sup>9</sup> Secured creditors may, and often do, simultaneously seek relief from the stay on the ground of lack of adequate protection or other cause. 11 U.S.C. §362(3)(1). The cause alleged often is that the Chapter 11 filing was made in bad faith. Seeking relief under section 362(d)(2) is less attractive, because, at least in the early stage of a Chapter 11 case, a single asset real estate debtor will be able to argue that the property is necessary to an effective reorganization.

<sup>10</sup> The relief from stay does not extend to acts against the debtor, only to acts against the real estate.

a. **On Which Debts Must Payments Be Made?** On a quick reading, the statute appears to require that payments be made to each creditor holding a mortgage on the real estate. This is not so, however, because the amount of the required payment is based on the value of the secured creditor's interest in the real estate. Accordingly, a creditor whose mortgage is entirely under water will not be entitled to payment. A creditor holding a matured statutory lien, such as a lien for real estate taxes due and owing, is entitled to payment. However, such creditors are not usually aggressive in seeking relief from stay under section 363(d)(3).

b. **Payments Not Necessarily Interest** - The monthly payments to secured creditors are not necessarily interest, although the amount of the payments is equal to interest. Characterizing the payments as interest would be inconsistent with the Supreme Court's holding in *Timbers*<sup>11</sup> that adequate protection does not entitle a partially secured creditor to interest, or lost opportunity costs during the period prior to confirmation of a plan of reorganization. Section 362(d)(3) specifies only how the amount of the payments is determined. How the payments will ultimately be characterized is left to a later phase of the Chapter 11 case, usually at plan confirmation. See paragraph h below.

c. **Fair Market Rate** - The amount of any required payment is determined using a current fair market rate. This is not necessarily the contract rate, although some mortgagees will so argue. How is the rate to be ascertained by the debtor? The current fair market interest rate for a mortgage loan will vary depending on the loan's maturity, its credit quality, the type of real estate involved, and other factors. The average rate currently charged for various types of mortgage loans may be found in various financial publications, or by talking to a number of local lenders. While a dispute as to the rate may ultimately have to be resolved by the court, the debtor should usually make payment in an amount determined using a rate which it believes appropriate, and leave it to the creditor to seek a judicial determination if it is unsatisfied. Most judges are prepared to cut the debtor some slack on this issue.

d. **Based on Value of Collateral** - The monthly payments are to be calculated based on the value of the creditor's interest in the real estate. Section 506(a) applies here, requiring that the secured creditor's claim be bifurcated into secured and unsecured components. If the parties are unable to agree on the value of the secured claim, it will be determined by the court.<sup>12</sup> Again, the debtor should usually make payment in an amount based on what it believes is the proper value of the secured claim, leaving it to the secured creditor to seek a judicial determination if it is unsatisfied.

e. **Do Payments Require Prior Court Approval?** - The monthly payments referred to in section 362(d)(3)(B) are being made with respect to prepetition debt, and almost certainly from the proceeds of cash collateral. Accordingly, the debtor may require prior court approval to make the payments.<sup>13</sup> A secured creditor will usually not oppose such approval, since it will be receiving the payments.

f. **Relation to Adequate Protection Payments** - A secured creditor may be entitled to adequate protection payments to compensate it for diminution in the value of its collateral. Or, the debtor may be required to pay real estate taxes, and to keep the property insured, as a form of adequate protection. Adequate protection payments are independent of, and cannot be counted against, any payments required under section 362(d)(3)(B).<sup>14</sup>

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11 United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd. 484 U.S. 365 (1988).

12 Fed. R. Bankr. P. 3012.

13 11 U.S.C. §363(c).

14 In re LDN Corp., 191 B.R. 320 (Bankr. E.D. Va. 1996).

**g. Rents** - As substantially all of a single asset real estate debtor's gross income must be derived from real estate, and the debtor may not conduct any business on the real estate other than its operation and activities incidental thereto, the source of the monthly payments required by section 362(d)(3)(B) will almost always be rents or other revenues derived from the real estate itself. A secured creditor holding a mortgage on the real estate usually also will hold an assignment of rents and other revenues. Assuming that this assignment of rents and profits is valid and perfected under local law, 11 U.S.C. §552(b) provides that the creditor will have a security interest in postpetition rents and other revenues, except to the extent that the court orders otherwise based on the equities of the case.<sup>15</sup> Is the security interest in rents merely ancillary to the mortgage, or do the rents constitute collateral separate and independent from the real estate itself? This is not merely an intellectual question. If the rent does constitute cash collateral separate and independent from the real estate, what basis is there for allowing the debtors to use the rent in order to make the payments on the mortgage required by section 362(d)(3)(B)?

Would not using the rent for that purpose deprive the secured creditor of its cash collateral without adequate protection? If, on the other hand, the assignment of rents is regarded as ancillary to the mortgage, payment of the rents to the secured creditor may satisfy section 362(d)(3)(B) and, depending on the facts, the rents paid over may also count in partial satisfaction of the secured creditor's claim.

**h. Characterization of Payments** - At plan confirmation (or some other advanced stage in the Chapter 11 case), it will become necessary to decide how payments which have been made under section 362(d)(3)(B) should be characterized and applied. If the secured creditor's claim is fully secured, the payments will usually be characterized as having been paid as interest on that claim. If the claim was only partially secured, the issue is more difficult. Section 362(d)(3)(B) does not require that the payments be treated as interest, but tends to support such treatment. Section 506(b) and *Timbers*, on the other hand, tend to support characterizing the payments as principal repayments, reducing the amount of the creditor's secured claim which must be dealt with under the plan of reorganization. Courts are split on the issue.<sup>16</sup> The matter is further complicated by the fact that the value of the real estate, and hence the amount of the secured claim, may have changed between the date on which the §362(d)(3)(B) payments were determined and the date of plan confirmation.

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<sup>15</sup> "Based on the equities of the case" is an elastic standard and gives the bankruptcy judge considerable discretion as to how much of the rents a debtor should be required to turn over to the secured creditor. Most bankruptcy judges permit the debtor to use rents to pay postpetition real estate taxes, insurance premiums and other direct costs of maintaining and operating the mortgaged property. This is justified on the ground that unless the property is properly maintained and operated, it is unlikely to continue generating rents for long. The practice also accords with that followed in many states in mortgage receivership cases brought under state law. Some secured creditors argue that they are entitled to the gross rents, without deduction for maintenance and operating costs, but most of them do not appear to have their heart in it.

<sup>16</sup> Compare *In re Flagler-at-First Associates, Ltd.*, 114 B.R. 297 (Bankr. S.D. Fla. 1990), *In re Landing Associates, Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990), and *In re Birdneck Apartment Associates II, L.P.*, 156 B.R. 499 (Bankr. E.D. Va. 1993), with *In re Reddington/Sunarrow L.P.*, 119 B.R. 809 (Bankr. D.N.M. 1990), *In re IPC Atlanta L.P.*, 142 B.R. 547 (Bankr. N.D. Ga. 1992), and *Mutual Life Ins. Co. v. Paradise Springs Associates (In re Paradise Springs Associates)*, 165 B.R. 913 (Bankr. D. Ariz. 1994). These cases involve the application and characterization of adequate protection payments, rather than payments made under section 362(d)(3)(B), but the issues and arguments are similar as to both types of payments. The cases involving adequate protection payments sometimes characterize the issue as being whether the payments should be applied to the creditor's secured claim or its unsecured claim. Where payments are made under section 362(d)(3)(B), they clearly are to be applied to a partially secured creditor's secured claim, not its unsecured claim. The question is whether they are to be applied to the secured claim as a payment of principal, reducing the amount of the secured claim to be dealt with under the plan, or of interest. The issues discussed in the cases involving adequate protection payments, however, are substantially similar to those which arise in cases involving section 362(d)(3)(B) payments.



**i. Fundamental Problem as to Monthly Payments** - The questions and issues discussed above are important in a case where the debtor contemplates making monthly payments to satisfy section 362(d)(3)(B). It is seldom, however, that the debtor is in a position to realistically contemplate making such payments. Substantially all of the debtor's gross income will derive from the property. This income must suffice to meet all operating expenses, including insurance premiums and real estate taxes. It must also be sufficient to make the payments required by section 362(d)(3)(B), and to provide adequate protection for any diminution in value of the property. If the real estate threw off enough income to meet these needs, it is unlikely that the debtor would be in Chapter 11. Where the single asset real estate is raw land, there will be little or no income generated, and satisfying §362(d)(3)(B) will be virtually impossible. Where the single asset real estate is a developed property and is generating income, it is possible, but still unlikely, that the income will be sufficient. In short, avoiding expedited relief from the automatic stay through compliance with section 362(d)(3)(B) is usually not economically practical.

In some cases where the income generated from the real estate is insufficient, there may be other possible sources, such as payment from funds provided by an affiliate of the debtor (or other third party). However, even in such cases, the affiliate (or other third party) will usually prefer not to commit the funds early in the case, at a time when it is unclear whether a plan of reorganization will be confirmed. The preferable course will usually be for the debtor to file a plan of reorganization within the first 90 days of the case, and to commit the funds only in connection with confirmation of the plan.

**2. Filing a Confirmable Plan** - Rather than commencing monthly payments, a single asset real estate debtor can prevent a secured creditor from obtaining relief under section 362(d)(3) by filing, within 90 days of entry of the order for relief, a plan of reorganization which has a reasonable possibility of being confirmed within a reasonable time. The debtor should file a disclosure statement together with the plan.<sup>17</sup> Most debtors can manage to draft and file a plan and disclosure statement within the 90-day period. Some actually expect the plan to be confirmed more or less as filed. Other debtors realize that the plan is not confirmable as filed, but find it nonetheless in the hope that this will gain them another few months of time during which something favorable may develop. This hope is often misplaced. If the plan is legally defective, or is not feasible, a secured creditor will assert that the plan has no reasonable possibility of being confirmed within a reasonable time, and that it thus does not satisfy section 362(d)(3)(A).

Debtor's counsel should anticipate the issues a secured creditor is likely to raise, and draft the plan so that it appears to be confirmable. The ultimate goal, of course, is to have a plan which is actually confirmable. For purposes of withstanding a motion for relief from stay, however, filing a plan which is facially confirmable will usually suffice. The same legal issues arise in case after case. It is usually possible to determine the law where a given issue in the circuit or district in which the case is pending, or the view of the bankruptcy judge to whom the case has been assigned.

**a. Classification and Treatment of Deficiency Claims** - One recurring plan issue relates to the classification and treatment of a partially secured creditor's deficiency claim. Must the deficiency claim be classified together with and receive the same treatment as other general unsecured claims? Or, may the deficiency claim be classified separately, or treated differently, or both? In a single asset real estate case, the aggregate amount of trade claims and other general unsecured claims is typically small. If the secured creditor's deficiency claim is classified together with other general unsecured claims, the secured creditor may control the vote of the class. If the deficiency claim is voted to reject the plan, it may be impossible for the debtor to confirm the plan, because the debtor may be unable to obtain acceptance by at least one class of impaired claims.<sup>18</sup>

<sup>17</sup> Fed. R. Bankr. P. 3016(b).

<sup>18</sup> 11 U.S.C. §1129(a)(10) and §1129(b)(1).

Also, inclusion of the deficiency claim in the same class as other general unsecured claims will require that the deficiency claim be given the same treatment as the other claims.<sup>19</sup> The debtor, who usually will have only a limited amount of cash available, may be unable to pay a substantial percentage distribution on all general unsecured claims, including the deficiency claim; and, the result may be that trade creditors are unwilling to accept the plan. In order to meet these problems, the debtor may wish to classify the secured creditor's deficiency claim in a separate class, and to provide less favorable treatment for that claim than for other general unsecured claims. The secured creditor may vote the deficiency claim against acceptance of the plan; but, assuming that the class of other general unsecured claims accepts the plan, section 1129(a)(10) would be satisfied, and the debtor could seek to cramdown the plan over the secured creditor's objection.

There are numerous judicial opinions dealing with these issues, and the views expressed therein are widely divergent.<sup>20</sup> Some cases hold that the deficiency claim must be classified with other general unsecured claims and receive the same treatment under the plan. Other cases hold that separate classification and treatment of a deficiency claim may be proper, if the debtor can establish a business or economic justification for the separate classification, and if treatment of the deficiency claim is not unfairly discriminatory. Most of the cases frown on separate classification where the debtor's purpose is to gerrymander the vote to obtain acceptance of the plan by an impaired class.<sup>21</sup> If a deficiency claim is separately classified, the debtor may face a dilemma in deciding how to treat the claim relative to other unsecured claims. If the deficiency claim receives less favorable treatment than other general unsecured claims, the creditor holding the deficiency claim will argue that its treatment is unfairly discriminatory. On the other hand, if the deficiency claim receives the same treatment as other general unsecured claims, the creditor will argue that the identical treatment establishes that there was no economic or business justification for separate classification, and that the debtor's purpose was to gerrymander acceptance of the plan by an impaired class. Whether the secured creditor's loan was made on a non-recourse basis may be relevant in considering whether a deficiency claim may properly be separately classified.

If a plan is filed in order to satisfy section 362(d)(3)(A), it should be drafted, to the extent possible, so that its treatment of a secured creditor's deficiency claim is consistent with the applicable case law. If there is an opinion at the court of appeals or bankruptcy appellate panel level in the circuit in which the case is pending, the views expressed in that opinion will control. If there is no opinion at the court of appeals or bankruptcy appellate panel level, it will be necessary to ascertain, if possible, the views of the bankruptcy judge to whom the case has been assigned.

**b. Alternative Treatment for Secured Creditor's Claim** - In drafting the plan, the debtor should consider including appropriate alternative treatments for a secured creditor's claim, depending on whether the secured creditor does or does not make the election available under 11 U.S.C. §1111(b). The appropriate treatment may vary widely depending on whether or not the election is made. Alternative treatment in the plan may be omitted where the secured creditor has indicated in advance that it will or will not be making the election.

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<sup>19</sup> 11 U.S.C. §1123(a)(4).

<sup>20</sup> The District of Massachusetts, which has five sitting bankruptcy judges, has generated six decisions on these issues, the sixth one having been written by a judge from another district who was sitting by designation in a Massachusetts Chapter 11 case.

<sup>21</sup> The leading cases are collected, and these issues are more fully discussed, in *Ordin On Contesting Confirmation*, at 3-28 - 3-76 (3d. ed., rev. by Sally McDonald Henry, 1999).

c. **Allocation and Characterization of Pre-Confirmation Payments Made to Secured Creditor** - See ¶II(B)(1)(h) above. This is really a subissue relating to the determination of the secured creditor's claim.

d. **Return of Collateral to Secured Creditor** - If the plan contemplates returning all or part of the collateral to the secured creditor in full or partial satisfaction of its claim, rather than cash payments to the creditor over time, and if the secured creditor has not agreed to this treatment, the plan's provisions should be drafted to comply with case law dealing with when such return of collateral is permissible.

e. **Post-Confirmation Interest Rate** - The secured creditor may be entitled to post-confirmation interest on the secured component of its claim. More precisely, if the debtor seeks to cramdown a plan which contemplates deferred cash payment of a secured claim over time, section 1129(b)(2)(A)(i)(II) provides that the value of the deferred cash payments, as of the effective date of the plan, must be at least equal to the value of the secured creditor's interest in the collateral. The discount rate used for determining the value of the deferred cash payments as of the plan's effective date is equivalent to a post-confirmation interest rate to be applied to the amount of the secured claim.

The plan should either state an interest rate, or state that the interest rate will be fixed by the court in connection with confirmation. If a rate is stated, it should be picked in accordance with the views and practice of the bankruptcy judge handling the case. A judge tends to favor a particular procedure for selecting an interest rate over other procedures which may be favored by other judges. For instance, some bankruptcy judges prefer to start with a risk-free rate for an obligation (usually a U.S. Treasury Note or Bond) having a maturity comparable to the period over which payments are to be made on the secured claim under the plan. This risk-free rate is then adjusted upwards to reflect that payments under the plan are not in fact risk-free, and the adjusted rate is used for the post-confirmation interest rate or discount rate. Other bankruptcy judges prefer to fix the rate on the basis of testimony as to what mortgage lenders are currently charging on new loans of comparable maturity and riskiness. This method of fixing the rate may appear less theoretical and more market placed than starting with a risk-free rate and then adjusting it. However, in practice, testimony as to the current market rate may be difficult to obtain because lenders are not making loans on terms comparable to the pay out terms contained in the plan. No method of determining a rate is clearly correct or preferable in all circumstances. What is important is that the rate used by the debtor in the plan has been determined in a manner which is generally consistent with the view of the bankruptcy judge who will be hearing the matter.

f. **Negative Amortization** - A debtor may file a "negative amortization" plan. Such a plan underpays a secured creditor's claim during the period immediately following confirmation, but makes up for this by increasing payments to the secured creditor made in later years. On an overall basis, if the debtor makes all payments under the plan, the secured creditor will receive the value of its secured claim, with interest at an appropriate rate. The problem is that the debtor may fail early on and be unable to make the later payments. The debtor should determine whether the judge before whom the case is pending will permit negative amortization plans, and, to what extent and for how long negative amortization will be allowed.

g. **Length of Pay Out on Secured Claim** - Where the collateral is developed, income producing real estate, the debtor may wish to satisfy the secured creditor's claim over an extended period of time, say 25 years. So long as the post-confirmation interest rate is a proper one, and so long as the plan provides for maintenance of and repairs to the property as required, and the property has an estimated useful life extending beyond the maturity of the plan's obligations, a long-term pay out of the secured claim does not violate any provision of the Bankruptcy Code. Many secured creditors, however, will strongly object to any plan containing such long-term pay out provisions. Some judges are sympathetic to such an objection by a secured creditor, believing that the uncertainty

inherent in any long-term pay out involves more risk than the secured creditor should be required to take. Judges who hold this belief may instead permit the pay out to the secured creditor be amortized on a 25-year basis, but insist that the plan provide for a balloon payment which will repay the creditor in full at the end of a shorter period, say, 5 years. If the court before whom the case is pending adheres to this view, the debtor probably should not file a plan calling for a 25-year pay out.

**h. 203 North LaSalle Street Partnership** - The debtor's plan should be drafted to take account of the Supreme Court's decision earlier this year in *Bank of America N.T.S.A. v. 203 North LaSalle Street Partnership*.<sup>22</sup> *LaSalle* held that a plan which did not provide for full payment of a partially secured creditor's deficiency claim, but did provide that certain of the debtor's former partners would have the exclusive opportunity to contribute new capital in exchange for obtaining entire ownership of the reorganized entity, was not fair and equitable and could not be confirmed. The Court expressly declined to decide whether or not a new value corollary to the absolute priority rule exists under the Bankruptcy Code. Even assuming the existence a new value corollary, the Court held, plans providing equity interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of section 1129(b)(2)(B)(ii). The proposed plan in *LaSalle* would have vested equity in the reorganized business in the debtor's partners without extending an opportunity to any one else to compete for that equity or to propose a competing plan. The best way to determine whether the value being supplied by the former partners represented top dollar was not to have the determination made by the bankruptcy judge. It was to have value determined by exposure to a market. The opinion refrained from deciding how market exposure should be provided, leaving that for later determination by a lower court.

It will take lower courts several years to work out all the ramifications of the *LaSalle* opinion. Meanwhile, a debtor in a single asset real estate case should take care not to file a plan which is inconsistent with the principles enunciated in *LaSalle*. What alternatives are open to the debtor?

One alternative is to file a plan which provides for full payment of the secured creditor's deficiency claim.<sup>23</sup> This solution, however, may not be economically possible. The debtor may not have the necessary resources.

A second solution would be to allow creditors and other parties in interest to file competing plans. If this approach is taken, can the terms on which competing plans are filed be limited? Could the court restrict the parties who will have the opportunity to file a competing plan? For instance, could the court order that competing plans may be filed only by creditors who voted against the debtor's plan or who filed an objection to confirmation of the debtor's plan? Could the court require that competing plans contain terms, other than price terms, which are generally similar to those of the debtor's proposed plan, on the theory that this will enable the court, and creditors and other parties in interest to compare competing plans on an apples to apples basis? Should creditors be allowed to file plans and have them considered along with the debtor's, or would *LaSalle* be satisfied if exclusivity were ended only after the debtor's plan failed to be confirmed?

Instead of allowing competing plans, a debtor might attempt to satisfy *LaSalle* by including in its plan some sort of auction mechanisms under which creditors or other third parties would be allowed to bid against the debtor's partners or other equity holders. This type of arrangement might be preferable to terminating exclusivity, from the debtor's

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<sup>22</sup> 119 S.Ct. 1411 (1999).

<sup>23</sup> The holding in *LaSalle* is not necessarily limited to real estate cases, or to deficiency claims. It would apply whenever a debtor attempts to cramdown a new value plan on any impaired class of unsecured claims. In the context of single asset real estate cases, however, the debtor's concern usually will be with a partially secured creditor's deficiency claim.

point of view, because it would introduce competition only as to price. The debtor could retain significant control as to the terms of the auction and the non-price terms of the deal. Bankruptcy courts may, however, be unwilling to permit the debtor to retain this much control, either because they believe it would not meet the test described in *LaSalle*, or because they believe that the bankruptcy judge, and not the debtor, should set the terms of any auction.

A related issue is what should be auctioned. In *LaSalle*, the plan provided that some of the debtor's former partners would make new capital contributions in return for entire ownership of the reorganized business. This sounds like it is the equity interest in the reorganized debtor which must be valued by an exposure to market forces. The secured creditor, however, may be reluctant to bid for a partnership interest, and may prefer to make a bid for the underlying real estate itself. Or, the secured creditor may have lined up a third party who is willing to bid on the real estate but is not interested in bidding for the equity interest. Should the debtor be required to open up the bidding process to permit bids on the real estate? Or, may the bidding be confined to the equity interest in the reorganized business?

It will be years before the questions set forth above can be answered with any certainty. Meanwhile, single asset real estate debtors should consider the issues and draft their plans so that, at the very least, they are not facially inconsistent with *LaSalle*.

3. **Miscellaneous Issues Under Section 362(d)(3) -**

a. **Burden of Proof** - The burden of proof will usually be on the debtor not the secured creditor.<sup>24</sup> However, the burden of proof is generally not critical. Most of the disputed issues will be issues of law, and any factual issues are not likely to give rise to a dispute resolution of which will turn on the burden of proof. For instance, there is unlikely to be a dispute as to whether the debtor filed a plan within 90 days after entry of the order for relief. Any dispute will likely center on whether the plan has a reasonable possibility of confirmation within a reasonable time, and arguments as to confirmability will usually be legal in nature. Similarly, whether the debtor commenced monthly payments to a secured creditor within 90 days, and the amount paid, will not usually be disputed. Whether the interest rate on which the payment was based is a current fair market rate may be disputed, as may be the value of the collateral. Resolution of such a dispute is unlikely to turn on the burden of proof.

b. **Extension of Time Period** - The court is authorized to extend the 90-day period for cause by order entered within the 90-day period. Because the intent of section 362(d)(3) is to protect secured creditors, by requiring that single asset real estate debtors progress expeditiously to confirmation of a plan if one is possible, a bankruptcy judge is likely to construe the requirement of cause quite strictly. A motion seeking an extension should set forth the facts justifying it in some detail. The motion should also be filed and marked for hearing well before the 90-day period expires, since the statute requires that the order granting the extension be entered within the 90-day period. The statutory provision is clear, and a bankruptcy judge is unlikely to be sympathetic when a debtor files a motion seeking an extension on the 89th day following entry of the order for relief.

On the other hand, some judges regard statutory provisions requiring that the court act according to a rigid timetable as unwise, and as an imposition on the court. There is an analogous provision in section 365(d)(4). A lease of non-residential real property is deemed rejected unless it is assumed by the trustee within 60 days from the order for relief, or within such additional time as the court fixes for cause within such 60-day period. The case law involving section 365(d)(4) illustrates that courts may interpret the requirement that the extension be granted within the original time period in a less than literal fashion. The debtor, of course, should not count on such judicial indulgence.

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24 11 U.S.C. §362(g).

c. **Remedy** - While a secured creditor is entitled to relief under section 362(d)(3) unless the debtor has satisfied one of the two conditions specified therein, the relief need not always be termination of the automatic stay. Instead, the court may modify or condition the stay.<sup>25</sup> Relief short of outright termination is particularly likely where the court is convinced that the debtor is acting in good faith and is proceeding expeditiously towards confirmation of a plan. Even though the debtor has commenced payments to the secured creditor or has filed a plan a bit belatedly, a judge may decline to terminate the stay on condition that the debtor continue the monthly payments, or proceed to confirmation of the plan by a date certain.

### III. SMALL BUSINESS CHAPTER 11 CASES

The Bankruptcy Code's provisions relating to Chapter 11 cases are more balanced than those relating to single asset real estate cases. Unlike section 362(d)(3), which protects only a secured creditor's interests, the small business provisions were intended to assist the reorganization of small businesses capable of reorganization, by stripping away some of the procedural complexity of a Chapter 11 case, and the resultant expenses, thus enabling a small business debtor to confirm a plan on a fast track schedule. The provisions have enjoyed somewhat spotty success. They have been utilized more frequently and successfully in some districts than others. The degree of success which they have enjoyed in a district appears to depend in large part on the attitude of the bankruptcy judges in that district. Where judges have encouraged use of the provisions by small business debtors, and have undertaken the extra administrative burden which supervision of small business cases imposes on the court, the provisions have worked reasonably well, although many small business debtors still fail. In districts where the court has not encouraged their use, the small business provisions have not often been utilized.

A. **Definition** - The definition of a small business debtor is contained in 11 U.S.C. §101(51C). It contains three elements:

1. **Person Engaged in Business** - A small business debtor must be a person engaged in commercial or business activities.

2. **Real Estate Business Excluded** - A person whose primary activity is the business of owning or operating real estate and activities incidental thereto is excluded from the definition. Thus, the class of single asset real estate debtors and the class of small business debtors are mutually exclusive.

3. **Limit on Secured and Unsecured Debts** - A small business debtor's aggregate, noncontingent, liquidated, secured and unsecured debts, as of the date of the Chapter 11 petition, must not exceed \$2,000,000. This debt limit, unlike that which applies to single asset real estate debtors, includes unsecured as well as secured debts.

B. **Eliminating the Creditors Committee** - On request of a party in interest and for cause, the court may order that a committee of creditors not be appointed in a small business Chapter 11 case.<sup>26</sup> The party in interest requesting that a creditors committee not be appointed will almost always be the debtor. Elimination of the creditors committee in a small business Chapter 11 case was intended to benefit the debtor by eliminating the cost associated with a committee, including the fees of any attorneys, accountants, or other professionals for the committee. Individual creditors in small business cases may hold relatively small claims, making it uneconomic for any single creditor to oppose a plan proposed by the debtor, or to monitor the debtor's activities while the case is pending. A committee, if one is appointed, may serve as a focus for opposition to the debtor. Also, eliminating the committee eliminates the need for negotiating the terms of the plan with the committee and makes it easier for the debtor to file and confirm a plan on an expedited schedule discussed below.

Whether a small business debtor should utilize section 1102(a)(3) is, however, not always clear. First, a creditors committee may not be formed in a small business case because creditors do not have a sufficient economic stake in the outcome of the case to make them willing to serve. If no committee is likely to be

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<sup>25</sup> Condor One v. Archway Apartments, Ltd. (In re Archway Apartments, Ltd.), 206 B.R. 463 (Bankr. M.D. Tenn. 1997).

<sup>26</sup> 11 U.S.C. §1102(a)(3).

appointed any way, there is no need for the debtor to utilize section 1102(a)(3). Second, appointment of the committee is to be dispensed with only for cause. What basis will the small business debtor assert as cause? If elimination of cost is the basis asserted, the question may then arise whether a committee should not be appointed, but not authorized to retain counsel or other professionals, or authorized to retain them only to a limited extent. Asserting that a committee should not be appointed because the debtor does not wish it to investigate the debtor's business and affairs, or does not want to be bothered to negotiate a plan with the committee is unlikely to create a favorable impression with the bankruptcy judge.

Also, in some circumstances, it may be to the debtor's advantage to have a creditors committee in place. A favorable recommendation from the committee often will enhance the debtor's ability to gain creditors acceptance of any plan which may be proposed. If the debtor encounters difficulties during the course of the case, support of the creditors committee may be useful in obtaining some judicial indulgence, in blocking the appointment of a trustee, in opposing a motion to dismiss, and so forth.

A small business debtor should decide whether to seek an order that a creditors committee not be appointed prior to or immediately following commencement of the Chapter 11 case. The debtor's chances of obtaining such an order will be materially better if the order is sought before the United States trustee has begun to contact creditors and to organize a committee.

Finally, section 1102(a)(3) is the only small business case provision which applies if the debtor satisfies the definition, without regard to whether the debtor has made an election to be treated as a small business debtor, as discussed below.

**C. Election To Be Treated As A Small Business Debtor** - A debtor who falls within the definition of a small business will be entitled to the benefits and subject to the burden of special provisions dealing with plan filing exclusivity and confirmation periods, and with the approval of disclosure statements and the mechanics for seeking acceptances of a plan, only if the debtor expressly elects to be treated as a small business debtor.<sup>27</sup> This election may be made in one of two ways:

First, *Official Form 1*, the form of voluntary petition used to commence a Chapter 11 case, contains a section entitled "Information Regarding the Debtor." In this section, the debtor may check a box indicating that it elects to be considered a small business debtor. Alternatively, if the debtor falls within the definition of a small business debtor contained in section 101(51C) but does not wish to elect small business treatment at the time the petition is filed, it may check a second box.

The second way in which a debtor may elect to be considered a small business is by filing a written statement of election not later than 60 days after the date of the order for relief.<sup>28</sup>

The election is simple and easy to make but should be made only with care and after due consideration. Once made, the debtor will be on a fast track schedule which it may be unable to meet. Because this fast track schedule provides certain advantages to the debtor, it would be unfair to allow the debtor to make the election, obtain or attempt to obtain its benefits, and then withdraw it if the schedule could not be met. Accordingly, the election once made may be irrevocable.<sup>29</sup>

**D. Plan Filing Exclusivity and Confirmation Periods** - In a case in which the debtor is a small business and has elected small business treatment, only the debtor may file a plan during the 100-day period after the date of the order for relief. All plans must be filed within 160 days after the date of the order for relief.<sup>30</sup> The court may, on request of a party in interest made within the respective periods, and after a notice and a hearing, reduce either the 100-day period or the 160-day period for cause. The court may also increase the 100-day period, but only if the debtor shows that the need for an increase is caused

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<sup>27</sup> 11 U.S.C. §1121(e) and §1125(f).

<sup>28</sup> Fed. R. Bankr. P. 1020. A number of bankruptcy courts have adopted Local Rules elaborating on the procedure for making the election.

<sup>29</sup> In re Win Trucking Co., Inc., 236 B.R. 774 (Bankr. D. Utah 1999). In that case, the court held that the debtor had no right to withdraw its small business election after the time fixed for filing a plan had expired. The possibility that a withdrawal might be allowed if sought within the plan filing period was left open.

<sup>30</sup> 11 U.S.C. §§1121(e)(1) and (2).

by circumstances for which the debtor should not be held accountable.<sup>31</sup> Section 1121(e)(3) does not provide for any extension of the 160-day period and it has been held that any extension of that period is not permitted.<sup>32</sup> A failure by the debtor to file a plan within the statutory deadline constitutes cause for dismissal of the case.<sup>33</sup> Read quickly and in isolation section 1121(e) seems clear and straightforward. It is not. The relationship between it and the other subsections of section 1121, and between the debtor's right to file a plan, and the right of creditors to file and seek confirmation of a competing plan are anything but clear. For instance, once the 100-day period has expired, may a creditor file a competing plan and then seek to have that plan confirmed on a fast track schedule parallel to the schedule for the debtor's plan, using the expedited disclosure statement approval and plan voting procedure provided in section 1125(f), discussed below? *In re Aspen Limousine Services, Inc.*<sup>34</sup> held that it was not possible to satisfactorily reconcile all of the statutory provisions without resort to the scheduling powers conferred upon the court by section 105(d). The opinion went on to hold that a creditor should be permitted to file a plan after the 100-day exclusivity period had expired, and would be allowed to seek confirmation of that plan, but only on a schedule which would allow the debtor priority in proceeding to move swiftly and effectively ahead to seek and obtain confirmation of its plan.

**E. Disclosure Statement and Plan Confirmation** - Section 1125(f) establishes an expedited and simplified procedure for approval of a disclosure statement and solicitation of acceptances of a plan in a small business case in which the debtor has elected to be treated as a small business. The expedited, simplified procedure expressly applies notwithstanding subsection (b) of section 1125 which would otherwise govern these matters. Under section 1125(f):

- (1) The court may conditionally approve a disclosure statement subject to final approval after notice and hearing;
- (2) Acceptances and rejections of the plan may be solicited based on the conditionally approved disclosure statement as long as the debtor provides adequate information to each holder of a claim or interest that is solicited. However, the conditionally approved disclosure statement must be mailed to creditors at least ten days prior to the date of the hearing on confirmation.
- (3) The final hearing on the disclosure statement may be combined with the hearing on confirmation of the plan.

Like other sections of the Bankruptcy Code, section 1125(f) does not deal extensively with procedural details. For instance, it does not specify how conditional approval of a disclosure statement is to be sought and obtained or who, if anyone, is entitled to notice with respect to conditional approval. Nor does it specify the details as to how a final hearing on the disclosure statement will be combined with the hearing on plan confirmation, including when objections to the disclosure statement or to plan confirmation are to be filed by persons who wish to raise such objections. These procedural issues are dealt with in Fed. R. Bankr. P. 3017.1, which applies only in small business cases in which the debtor has made the election. Rule 3017.1 and 11 U.S.C. §105(d), discussed below, also do not spell out the mechanics of obtaining approval of a disclosure statement and plan confirmation in detail. They do, however, provide the court with authority to fix deadlines, regulate notices, and otherwise establish an appropriate procedure consistent with §1125(f).

Not all of the difficulties in operating under section 1125(f) are mechanical and procedural. The small business provisions were intended to simplify the disclosure statements used in small business cases, but neither section 1125(f) nor any other provision establishes a standard for what information must be included in a disclosure statement. Presumably, therefore, the definition of "adequate information" contained in section 1125(a)(1) is applicable. If adequate information means the same thing in a small business Chapter 11 case as in any other Chapter 11 case, what justifies a small business debtor in omitting from a disclosure statement any information which would be required were the debtor not a small business? What standard should a bankruptcy court use in conditionally approving a disclosure statement?

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31 11 U.S.C. §1121(e)(3).

32 *In re Western Steel & Metals, Inc.*, 200 B.R. 873 (Bankr. S.D. Cal. 1996).

33 *Id.*

34 187 B.R. 989 (Bankr. D. Colo. 1996), *aff'd* 193 B.R. 325 (D. Colo. 1996).



Also, a process for conditional approval is subject to certain inherent risks, particularly if conditional approval is sought and obtained on very limited notice. At the final hearing on the disclosure statement, assuming that this hearing is combined with the confirmation hearing, the court may be presented with a situation in which the debtor has already obtained the necessary acceptances and seeks to confirm the plan. Suppose that a creditor has objected to failure to include certain information in the disclosure statement, claiming that the omission of this information renders the disclosure statement inadequate. Will the court, in ruling on the creditor's objection, be able to put out of its mind the facts that the disclosure statement has already been conditionally approved, and that the plan is ready to be confirmed if the creditor's objection is overruled. In cases where the omitted information was clearly important, or where the judge suspects that the debtor omitted this information knowing that it was material but fearing that its inclusion might lead some creditors to vote against the plan, the judge would undoubtedly decline to finally approve the disclosure statement. In other, closer cases where the significance of the omitted information is less clear, and the debtor's motives in omitting it do not appear suspicious, a court may be reluctant to withhold final approval of the disclosure statement.

**F. Section 105(d)** - Section 105(d) is not limited to small business Chapter 11 cases, However, it was added to the Bankruptcy Code along with those provisions as part of the Bankruptcy Reform Act of 1994. It authorizes the court to hold a status conference regarding any case or proceeding. It also authorizes the court to issue an order at any such conference proscribing limitations and conditions to ensure that the case is handled expeditiously and economically, so long as the limitations and conditions are not inconsistent with another provision of the Bankruptcy Code or with applicable Federal Rules of Bankruptcy Procedure. The matters which the court is authorized to deal with in a Chapter 11 case include setting dates by which the debtor, trustee, or other parties in interest may file plans and disclosure statements, and setting dates for soliciting acceptances of a plan. The court is also authorized to fix the scope and form of the notice to be provided regarding the hearing on approval of the disclosure statement and to provide for combining the hearing on approval of the disclosure statement with the hearing on confirmation of the plan.

Section 105(d) gives bankruptcy courts authority to resolve, on a case by case basis, and in a manner appropriate to the circumstances of a particular case, many of the procedural issues referred to above. Moreover, the ability to hold status conferences gives bankruptcy judges the ability to instruct small business debtors (as well as other debtors) as to their responsibilities in operating as a debtor in possession, to be sure that the debtors are aware of any scheduling deadlines in proceeding towards plan confirmation, and to ascertain whether the debtor is acting appropriately in operating its business and in seeking to formulate and confirm the plan.

Some bankruptcy judges have been more vigorous than others in using the powers granted by section 105(d). It must be recognized that utilizing their powers in numerous small business cases can impose a heavy administrative burden on the court. Nonetheless, many small business debtors would benefit from some increased judicial supervision of this type. Whether or not the small business provisions work in practice may turn on how active the court is in administering the cases.

#### **IV. PENDING LEGISLATIVE CHANGES**

Pending legislation, if enacted, would modify the Bankruptcy Code's provisions relating to single asset real estate cases and to small business Chapter 11 cases. The proposed modifications are significant; and, while they may themselves be subject to change as part of the legislative process, they are worth discussing in their present form.

**A. The Pending Legislation** - Separate versions of bankruptcy reform legislation are pending in the House and Senate.<sup>35</sup> The House version, H.R.833, was passed by the House May 5, 1999. The Senate version, S.625, was reported to the Senate which considered and acted on a number of proposed amendments but then adjourned without voting on the Bill. S.625 will be taken up by the Senate when Congress reconvenes in January, 2000. The provisions in H.R.833 and in S.625 relating to single asset real estate cases and to small business Chapter 11 cases are not identical but are quite similar. Accordingly

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<sup>35</sup> H.R. 833, 106th Cong. (1999) (as passed by the House on May 5, 1999); S.25, 106th Cong. (1999) (as reported to Senate with amendments May 11, 1999).

there should be little difficulty in reconciling the two versions of these provisions, assuming that S.625 passes.

**B. Changes Relating to Single Asset Real Estate Cases** - The proposed changes would modify the definition of single asset real estate<sup>36</sup> and would also revise section 362(d)(3).<sup>37</sup> The revision of the definition is probably more significant than the substantive changes dealing with relief from the automatic stay.

1. **Elimination of \$4,000,000 Secured Debt Limit** - Section 101(51B) would be amended by eliminating the \$4,000,000 limit on secured debt. This change would result in far more cases, and more economically substantial cases, being treated as single asset real estate cases.
2. **Family Farmers** - Section 101(51B) would also be amended to exclude family farmers from the definition of single asset real estate debtors.
3. **Changes to section 362(d)(3)** - Three changes would be made, two favorable to debtors and one to secured creditors.
  - a. **Time Period** - The debtor would not be required to file a confirmable plan or make monthly payments on secured debts until the later of 90-days after entry of the order for relief, or 30-days after the court determines that the debtor is a single asset real estate debtor.
  - b. **Use of Rents** - The debtor would be given the right, in its sole discretion, to use rents or other income generated before or after commencement of the case by or from the property to make required monthly payments to a secured creditor. This right would exist notwithstanding section 362(c)(2), and the debtor would thus apparently be free to make the payments without prior court approval.
  - c. **Interest Rate** - The amount of any required monthly payment would be calculated using the then-applicable nondefault contract rate of interest specified in the loan document rather than a current fair market rate. This change should usually result in a higher rate, to the benefit of a secured creditor. However, the change also eliminates uncertainty for the debtor and the need for a judicial determination as to what is the current fair market rate.

**C. Changes Relating to Small Business Cases** - The proposed changes relating to small business Chapter 11 cases are quite extensive and detailed.<sup>38</sup> They can be summarized as follows:

1. **Definition** - Section 101(51C) would be split into separate definitions of a "small business case" and a "small business debtor," in proposed new sections 101(51C) and 101(51D).<sup>39</sup> The present \$2,000,000 limit on aggregate noncontingent, liquidated secured and unsecured debts would be increased to \$4,000,000, and debts owed to affiliates or insiders would be excluded for purposes of determining whether a debtor falls within the limit. If several affiliated debtors are in bankruptcy, they would be treated as a group for purposes of the limit, so that, if their combined debts exceeded the \$4,000,000 limit, no member of the group would be a small business debtor. A person whose primary activity is owning or operating real property is currently excluded from the definition of a small business debtor. This exclusion would be eliminated, so that some debtors would be subject to both the single asset real estate and the small business provisions.
2. **Disclosure Statements** - The proposed changes to section 1125(f)<sup>40</sup> state that the court, in determining whether a disclosure statement provides adequate information, shall consider the

36 H.R.833 §1101(5) and S.625 §1101(5).

37 H.R.833 §415 and S.625 §435.

38 H.R.833 §§401-415 and S.625 §§421-425.

39 H.R.833 §402(a) and S.625 §422(a).

40 H.R.833 §833 401 and S.625 §421.

complexity of the case, the benefit of additional information to creditors and other parties, and the cost of providing additional information. The court may determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary. The court may approve a disclosure statement submitted on standard forms approved by the court or adopted under section 2075 of Title 28.<sup>41</sup> The proposed changes also clarify existing law providing that the court may conditionally approve a disclosure statement subject to final approval after notice and a hearing, that acceptances or rejections of a plan may be solicited based on a conditionally approved disclosure statement, and that the final hearing on the disclosure statement may be combined with the confirmation hearing on the plan. The conditionally approved disclosure statement will be required to be mailed not later than 20 days (10 days in the present section 1125(f)) before the hearing on confirmation.

**3. Plan Exclusivity Filing Deadline and Confirmation Deadline**<sup>42</sup> - The debtor would be required to file a plan and disclosure statement within 90 days (100 days in present section 1121(e)(1)) after entry of the order for relief, and would have the exclusive right to file a plan during that period. Any plan filed would be required to be confirmed within 150 days after entry of the order for relief, under a proposed new section 1129(e). The court would be authorized to extend the 90-day and 150-day periods on a restricted basis. Failure to comply with the deadlines would constitute grounds for dismissal or conversion of the case.

**4. Elimination of Election** - Amended sections 1121(e) and 1125(f), and new section 1129(e), would apply to all small business debtors. The requirement that the debtor have elected to be treated as a small business debtor would be eliminated.

**5. Operational and Reporting Requirements** - Under a proposed new section 1115, small business debtors in possession (or trustees in small business cases) would have to meet a number of operating requirements.<sup>43</sup> Under a proposed new section 308, small business debtors would be required to file periodic reports containing specified information as to their postbankruptcy operations and financial condition.<sup>44</sup> Failure to comply would constitute cause for dismissal or conversion of the case.

**6. Duties of United States Trustee** - Proposed amendments to 28 U.S.C. §586(a) would impose additional duties on United States trustees.<sup>45</sup> They would be required to conduct initial debtor interviews in small business cases, during which they would instruct the debtor as to its obligations, investigate the debtor's viability, and inquire as to its business plans. Follow up visits to the debtor's business premises would be made to ascertain the state of the debtor's books and records and to verify that the debtor has filed its tax returns. If the United States trustee determines that the debtor will be unable to confirm a plan, or finds material grounds for seeking

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<sup>41</sup> The bills provide that the Advisory Committee on Bankruptcy Rules of the Judicial Conference shall, within a reasonable period of time after enactment, propose for adoption standard form disclosure statements and plans of reorganization for small business debtors. H.R.833 §403 and S.625 §423. It does not appear that use of the standard forms will be mandatory, at least in the sense that bankruptcy judges will be free to approve other forms in cases where they think it appropriate. Debtors, however, will probably be strongly encouraged to use the standard forms once they are adopted.

<sup>42</sup> H.R.833 §§407, 408 and 409 and S.625 §§427, 428 and 429. The House and Senate versions of the legislation differ as to matters of detail, particularly as to the circumstances in which the court may grant extensions. Floor managers' amendments to S.625 proposed by Senators Grassley and Torricelli would increase the 150-day period for obtaining plan confirmation to 175 days.

<sup>43</sup> H.R.833 §406 and S.625 §426.

<sup>44</sup> H.R.833 §404 and S.65 §424. The bills provide that uniform rules and forms to be used by small business debtors in making their periodic financial and other reports are to be proposed by the Advisory Committee on Bankruptcy Rules of the Judicial Conference. H.R.833 §405 and S.625 §425.

<sup>45</sup> H.R.833 §410 and S.625 §430.

dismissal or conversion of the case under section 1112, the United States trustee would be required to promptly apply to the court for relief.

7. **Status Conferences** - Present section 105(d) would be amended and strengthened.<sup>46</sup> The court would be directed to hold such status conferences as are necessary to further the expeditious and economical resolution of a small business Chapter 11 case.

8. **Dismissal or Conversion** - Present section 1112(b) would be amended by adding numerous specific acts or conditions that would constitute grounds for dismissal or conversion of a case, or for appointment of a trustee or examiner.<sup>47</sup>

**D. Likely Effect of Proposed Changes** - The proposed changes to section 101(51B) will result in having more debtors, with more substantial assets and liabilities, treated as single asset real estate debtors. The proposed changes to section 362(d)(3), however, are relatively minor. If enacted, they will, I believe, have only a slight effect on the outcome of a single asset real estate case. The proposed changes relating to small business Chapter 11 cases are more significant. The increase in the debt limit from \$2,000,000 to \$4,000,000 will increase the number of debtors who fall within the definition, and elimination of the requirement that the debtor elect small business treatment will also swell the number of debtors to whom the special small business provisions apply. Although the additional burdens imposed on debtors seem generally reasonable when considered one at a time, their cumulative negative impact will be considerable. Most small business Chapter 11 cases fail even under the present statute. The amendments, if enacted, will likely result in an increase in the failure rate. (Proponents of the amendments would dispute this, arguing that the small business debtors who fail would ultimately have failed anyway, and that the amendments will accelerate the process but not cause an increase in the number or the percentage of debtors who fail.) The impact of the amendments may depend on how much attention the United States trustees (and bankruptcy judges) are able to devote to the new burdens being imposed on them in small business cases.

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<sup>46</sup> H.R.833 §411 and S.625 §431.

<sup>47</sup> H.R.833 §413 and S.625 §433.

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# **CROSS BORDER INSOLVENCIES**

**John J. Jerome  
Milbank, Tweed, Hadley & McCloy  
New York, New York**

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**SECTION G**

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# CROSS BORDER INSOLVENCIES

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## I. Introduction: Global Trade Patterns

International trade is measured in the trillions of dollars. Just two decades ago, those figures were significantly less. The explosion in international trade over the last two decades is the result of a number of factors, not the least of which is population growth and the concomitant growth in consumption. Two decades ago, world population was 3.7 billion. On October 12, 1999, world population crossed the 6 billion mark. It is estimated that world population will be 7.5 billion in 2020 and 9.2 billion in 2050.<sup>1</sup> This massive growth in population obviously will fuel the growth of cross-border business activity. That activity, particularly in the United States and Western Europe, will continue to grow as trade barriers fall, consumerism increases and multi-national corporations continue to aggressively seek increased market share in each other's "home" countries. The recent explosion of cross-border mergers and acquisitions bright-lines the arrival of a new economic order in which international corporations have become truly global in scope, permanently transcending the limits of their national borders.

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<sup>1</sup> United States Census Bureau: Appendix 'A' attached.

As this level of global activity grows and good times rise and fall, one can anticipate a greater volume of cross-border insolvencies. If this happens, there obviously will be a greater need for cross-border cooperation in order to better ensure the preservation of assets and the protection of creditors or, put another way, to prevent the chaos that results from the piece-meal dismembering of a debtor's estate. Preparation for such increased activity is underway. This involves greater acceptance of the concept of "universality", i.e., a common sharing of assets on a non-discriminatory basis and the limitation of "territoriality", i.e. the notion that local creditors should be advantaged at the expense of foreign creditors. Progress has been slow because of the natural reluctance of any country to cede sovereignty over assets and creditors located within its borders. However, it is increasingly recognized that nations and the interests of their multi-national corporations are better served by a more progressive and uniform system which embraces "universality". Consequently, the "territorial" approach is beginning to yield to a more "universal" approach with certain exceptions that recognize local prerogatives. These changes are embraced in a number of international initiatives and a new proposed Chapter of the Bankruptcy Code which this paper examines in an appropriate historical context.

## **II. Seeking A "Universal" Solution**

An historical analogue to international insolvency cases existed in our own country not long ago. This, of course, involved interstate insolvencies and serves as a reference point for the broader

international problems under discussion. The need for a universal approach to interstate insolvency cases was championed in 1888 by the renowned legal scholar, John Lowell, who made the following observation in connection with State insolvency proceedings which varied from one jurisdiction to another.

“It is obvious that, in the present state of commerce and communication, it would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding and generally at a single place, better for the creditors, who would thus share alike and better for the debtor because all his creditors would be equally bound by his discharge”.<sup>2</sup>

A decade later, Lowell’s observation was followed by the Federal Bankruptcy Act of 1898 which effectively preempted state insolvency proceedings and became the generic predecessor of the uniform system under which we operate today in the United States.

This uniform system, which is now embedded in the Bankruptcy Code, works within a legal framework in which the Federal Government is authorized to enact “uniform” laws relating to bankruptcy<sup>3</sup> but in which the substantive civil law of the respective States generally govern property rights, contacts, torts and the like.<sup>4</sup> That system is further strengthened by the requirement that each of the several States extend “full faith” and credit to each others' laws.<sup>5</sup>

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<sup>2</sup> Lowell, Conflicts of Law as Applied to Assignments for Creditors, 1 Harv. L. Rev. 259, 264 (1888)].

<sup>3</sup> United States Constitution, Article I, Section 8.

<sup>4</sup> Erie v. Tomkins Railroad, 304 U.S. 64, 58 S. CT. 817 (1938).

<sup>5</sup> United States Constitution, Article IV, Section 1.

## A. Comity

Our legal system for dealing with insolvencies is often looked upon with admiration and anxiety by foreign lawmakers who have the responsibility for making their systems work more efficiently. The closest paradigm to our system is England and the Commonwealth countries and the European Union. However, finding a balance between efficient commerce and jealously guarded sovereign rights within those communities is a difficult task which is complicated by the need to seek accommodation with other trading partners to ensure a global, uniform system. As will be seen below, the building blocks for such accommodation are being put into place. However, as was and still is the case with the United States, international accommodation in cross-border insolvencies is not the appropriate subject of inflexible legislative rules. Rather, it is the appropriate subject of international comity, as implemented by the courts on a case-by-case basis in the various cross border jurisdictions. To be sure, courts may be provided with mechanisms proscribed by legislative rules, but the balancing of conflicting local and international rights rests with the courts' reception of the limits of international comity in a given case. International comity, in this country, has been defined as follows:

“the recognition that one nation allows within its territory the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the requests of its own citizens or of other persons who are under the protection of its laws.”<sup>6</sup>

Comity thus requires a balancing of the insolvency laws of the foreign jurisdiction and the convenience, as well as rights, of citizens of and those who seek the protection of the local jurisdiction in which a foreign debtor might have assets. In arriving at a proper "balance" courts have variously taken a liberal "universal" view or a more restrictive "territorial" view.

### **B. Early Application of Comity**

Early on in our country, comity did not prevent an attitude that was “hostile towards claims asserted by foreign trustees in bankruptcy against alleged estate property located in the United States.”<sup>7</sup> However this earlier “hostility” has been tempered over the years. Prior to enactment of the bankruptcy Code, bankruptcy courts provided relief under Section 2(a) (22) of the 1898 Bankruptcy Act, as amended by the Chandler Act and subsequent amendments. Pursuant to Section 2(a)(22), a bankruptcy court was specifically authorized, in its discretion, to exercise jurisdiction when a debtor had been adjudged a bankrupt outside the United States (or withhold or suspend the exercise of such jurisdiction). Discretion was based upon principals of

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<sup>6</sup> Hilton v. Guyot, 159 U.S. 113, 164, 165, Ct 139, 143 L. Ed. 95 (1895).

<sup>7</sup> In the matter of Toga Manufacturing Limited, 28 B.R. 165, 167, citing Harrison v. Sterry (5 Cranch) 289, 3L. Ed. 1074 (1809); Odgen v. Saunders (12 Wheat) 213, 6 L Ed. 606 (1827).

international comity which recognized, inter alia, that insolvency laws were best served by preventing a race to the court house.<sup>8</sup> However, there was no provision under the 1898 Bankruptcy Act for ancillary assistance through which a foreign representative could marshal U.S. assets and have them returned to the foreign proceeding. The usual procedure followed to accomplish this end was to have the foreign debtor file a plenary proceeding in the U.S. and then move to suspend it under Section 2(a)(22) on the basis of comity.<sup>9</sup> The cases decided under Section 2(a)(22) generally accommodated this approach and adopted a more universalistic view to the application of comity, recognizing that that view usually resulted in greater efficiency in the administration of a debtor's estate and fairness to creditors. However, the suspension procedure was cumbersome and often fraught with procedural problems concerning standing of a foreign representative.<sup>10</sup> That procedure was reformed by Section 304 of the Bankruptcy Code.

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<sup>8</sup> Israel British Bank (London), Ltd. v. Federal Deposit Insurance Corp., 536 F.2d 509 (2d Cir 1974), cert. denied sub nom (and cases cited therein).

<sup>9</sup> Ibid; see also Axona, supra, n. 14, at 605.

<sup>10</sup> See, H.R. Doc. No. 137, 93d. Cong. 1<sup>st</sup> Sess., pt. II, pp. 69-71 (1973).

### III. Section 304 of the Bankruptcy Code

Section 304 of the Bankruptcy Code is a unilateral, statutory attempt by the United States to adopt a procedure which promotes a universalistic approach to cross-border insolvencies. This provision is the precursor of extant proposals adopted by various international bodies. It permits a United States bankruptcy court to offer ancillary, administrative relief to the non-U.S. debtor.<sup>11</sup> The stated purpose of the provision is to “enable the foreign trustee to protect the [foreign] estate against dismemberment by local actions in the United States without the necessity of commencing a bankruptcy or rehabilitation case under the U.S. Bankruptcy Code”.<sup>12</sup>

The bankruptcy court is given broad latitude in fashioning an appropriate remedy in a section 304 proceeding.<sup>13</sup> Upon the foreign debtor’s filing of a petition (or after consideration of a controverted petition under section 304), the bankruptcy court may enjoin actions affecting assets located in the United States or enforcement of judgments against the

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<sup>11</sup> 11 U.S.C. § 304; see also 11 U.S.C. §§ 305, 306 concerning, respectively, dismissal or suspension of a case involving a pending foreign proceeding and limited appearances by a foreign representative.

<sup>12</sup> Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93<sup>rd</sup> Cong., 1<sup>st</sup> Session Part 2, at 71 (1973).

<sup>13</sup> Id.



debtor. It may also order turnover of the Debtor's U.S. assets or their proceeds to a foreign representative. Finally, the court may "order other appropriate relief".<sup>14</sup>

A Section 304 petition, however, does not commence a full bankruptcy case and thus, the powers and benefits derived therefrom are not available. A Section 304 petition commences limited proceedings designed to operate in aid of a principal proceeding abroad. The automatic stay provisions of the Bankruptcy Code are not triggered automatically by a Section 304 petition. Rather, the foreign representative must request an injunction or other appropriate relief. If the relief sought is more extensive than that which would be available in the foreign jurisdiction, as where for example avoidance powers in the U.S. were more extensive than the foreign jurisdiction, the relief will not be granted because "it is not the purpose of section 304 to provide remedies not otherwise available to a foreign trustee."<sup>15</sup>

In determining whether to grant relief under section 304, a U.S. bankruptcy court is guided by concern for the economical and expeditious administration of the estate, consistent with the following guidelines:

- (1) just treatment of all creditors and equity security holders;

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<sup>14</sup> 11 U.S.C. 304 (b).

<sup>15</sup> *In re Metzeler*, 78 B.R. at 677; see also *in re Axona Int'l Credit & Commerce Ltd.*, 88 B.R. 597, at 607 n.17 ("Early authority suggested Bankruptcy Court's have discretion to authorize utilization of the avoiding

- (2) protection of U.S. creditors and equity security holders against prejudice and inconvenience in processing claims and interests in the foreign proceeding;
- (3) prevention of preferential or fraudulent disposition of property of the estate;
- (4) distribution of the proceeds of the estate substantially in conformity with the U.S. Code;
- (5) comity; and
- (6) if the debtor is an individual, the provision of an opportunity of a “fresh start”.<sup>16</sup>

The enactment of Section 304(c) demonstrates Congress’ desire for greater international cooperation in cross-border insolvencies. The guidelines set forth in Section 304(c) were designed to give the court the maximum flexibility in handling cross-border cases in an ancillary context. “Principles of international comity and respect for the judgments and laws of other nations suggest that the court be permitted to make the appropriate orders rather than being

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powers under the Code in a §304 ancillary proceeding. (citations omitted). However, later cases and the commentators have concluded that the avoiding powers under the Code are not available in an ancillary proceeding. (citations omitted).”

<sup>16</sup> 11 U.S.C. §304 (c).

prescribed with inflexible rules.”<sup>17</sup> This flexible approach was carried over to the provisions of the proposed Chapter 15 discussed below.

#### IV. Case Law Application under Section 304

Case law interpretation of section 304 is generally represented by the inapposite cases of In re Culmer<sup>18</sup> and In re Toga Manufacturing Ltd.<sup>19</sup> and their progeny. The Culmer courts are more “universal” in recognizing the substantive insolvency laws of foreign jurisdictions and granting the requested section 304 relief.<sup>20</sup> Courts adopting the Toga approach and have been said to be more “territorial”<sup>21</sup>

In re Culmer<sup>22</sup> involved the highly publicized voluntary liquidation of Banco Amrosiano Overseas Limited in which the Vatican had an interest. Several creditors of the bank's Bahamian banking subsidiary attached its U.S. assets on August 9, 1982 and one bank set-off balances against obligations owing to it. The subsidiary commenced insolvency proceedings in the

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<sup>17</sup> H.R. Rep. No. 95-595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. 324-325 (1977), S. Rep. No. 95-989, 95<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 35 (1978), reprinted in 1978 U.S.C.C.A.N 5821.

<sup>18</sup> 25 B.R. 621 (Bankr. S.D.N.Y. 1982).

<sup>19</sup> 28 B.R. 165 (Bankr. E.D. Mich. 1983).

<sup>20</sup> In re Koreag, 130 B.R. 705; In re 81 B.R. 267 (Bankr. S.D.N.Y. 1988); In re Metzeler, 78 B.R. 674.

<sup>21</sup> In re Papeleras Reunidas, S.A., 92 B.R. 584 (Bankr. E.D.N.Y. 1988); Interpool, Ltd. v. Certain Freights of M/VS Venture Star, 102 B.R. 373

Bahamas on August 16, 1982. On September 1982, the Bahamian Liquidator petitioned the Bankruptcy Court in Southern District of New York for relief under section 304.

The Bankruptcy Court first considered whether the requested relief would promote equality of asset distribution in the Bahamian liquidation proceeding. It analyzed Bahamian insolvency law and concluded that that law required orderly, equitable asset distribution among all creditors, thereby satisfying the criteria of §304 (c)(1).<sup>23</sup> The Bankruptcy Court then concluded that the Bahamas Supreme Court would serve as the most efficient and economical forum for administering the estate; that the debtors records and officers were in the Bahamas; that the Bahamian Liquidator remained subject to the order of the Bahamas Supreme Court; and that many of its principal creditors had supported the Bahamian petition. The considerations led the Bankruptcy Court to conclude that the Bahamas had a greater interest in the debtors' liquidation than did the United States. The court found that Bahamian liquidation law satisfied section 304 (c) (2) since creditors were protected from prejudice and inconvenience in the processing of their claims<sup>24</sup>. The Court also found that the Bahamian liquidation laws

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<sup>22</sup> 25 bankr. 621.

<sup>23</sup> Id. at 628-29.

<sup>24</sup> Id. At 630. These laws allowed claim proofs to be submitted by mail and provided adequate notice, disclosure and due process protections.

prohibited fraudulent conveyances and preferences, like the United States Bankruptcy Code.<sup>25</sup>

The court found that distributions from the estate under the Bahamian Companies Act would be in substantial accord with a distribution under the U.S. Code.<sup>26</sup> For all of these reasons, the court held that comity should be granted to the Bahamian liquidation proceeding.<sup>27</sup> Although it was argued that comity was only one element of Section 304(c) the court noted that “all of the factors listed in section 304 (c) have historically been considered within a court’s determination to afford comity to a proceeding in a foreign nation.”<sup>28</sup>

The Bankruptcy Court permanently enjoined all proceedings against the debtor's U.S. assets and ordered all such assets turned over to the foreign liquidator. In so doing, the Bankruptcy Court reasoned that it was facilitating the cross-border administration of the debtor’s estate through local Bahamian administrators. In that connection, the Culmer court also cited the long held U.S. doctrine that anyone who conducts business with a foreign corporation subjects

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<sup>25</sup> Id. (satisfying §304 (c) (3)).

<sup>26</sup> Id. at 630-31 (satisfying §304 (c) (4)).

<sup>27</sup> Id. At 631. In Culmer, comity was given central prominence in assessing the guidelines for applying section 304; see also In re Axona Int’l Credit & Commerce Ltd., 88 Bankr. At 608 (comity is the “guiding factor” for the section 304 (c) determination).

<sup>28</sup> Id. At 629.

himself to the foreign government's laws and, hence, implicitly to the foreign government insolvency laws in the event that the corporation files for bankruptcy.<sup>29</sup> The court found that no undue prejudice or inconvenience to U.S. creditors would result because the order and priority of asset distribution remained substantially the same in both jurisdictions. The court noted that the English Companies Act formed the basis for the Bahamian liquidation rules and that those rules were substantially similar to the American bankruptcy law.<sup>30</sup>

In re Toga<sup>31</sup> addressed disputes between Toga, a Canadian corporation, and Hesse, its exclusive U.S. sales representative. Hesse, a creditor of Toga, obtained a judgment against it and served garnishments on Toga's account debtors in the United States on June 10, 1982. Hesse's garnishments were disputed by another creditor to the extent that that creditor alleged it had a superior lien. Involuntary bankruptcy proceedings were commenced against Toga in Canada on October 14, 1982. On December 14, 1982, the Canadian trustee sought filed ancillary proceedings in the United States under section 304 and requested the bankruptcy court in the

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<sup>29</sup> Id. At 632.

<sup>30</sup> Id. At 631. Like Culmer, several courts have concluded that bankruptcy laws derived from the English Companies Act are substantially similar to the American bankruptcy laws. See In re Gee, 53 B.R. 891, 904 (Bankr. S.D.N.Y. 1985) (Cayman Islands) ("After Reviewing the (Cayman Island) Companies Law, this court finds it appropriate to grant relief under section 304 in an effort to best assure an economical and expeditious administration of (the debtor's) estate. It is not necessary that the Companies Law be a carbon copy of the Bankruptcy Code; rather, it must be of a nature that it is not repugnant to the American laws and policies – and clearly it is not."); In re Axona Int'l Credit & Commerce Ltd., 88 B.R. at 612-13 (Hongkong); and Cornfeld v. Investors Overseas Services, Ltd., 471 F. Supp. 1255, aff'd 614 F.2d 1286 (2d Cir. 1979) (Canada).

Eastern District of Michigan to enjoin all actions against Toga's local assets by its United States creditors. The trustee also sought a turnover of all garnished sums held in custody by a local court pending resolution of the disputes between Hess and a secured Canadian creditor.<sup>32</sup>

There is little question but that Hesse, as a judgment lien creditor whose lien became perfected more than 90 days prior to the commencement of the Canadian proceedings, would have had a secured status if the bankruptcy proceedings had been in the United States, subject, of course, to the conflicting claim of the other secured creditor. In Canada, however, Hesse would only have held an unsecured claim under the authority of Canadian Credit Men's Trust Assoc. Ltd. v. Beaver Trucking, Ltd.<sup>33</sup> Thus, although Hesse would not have been greatly inconvenienced by having to pursue its claim in Canada and would have received "just treatment", the Court denied the relief sought because Hesse would not have enjoyed the same distributive rights under both United States and Canadian Law.<sup>34</sup>

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<sup>31</sup> 28 B.R. 165.

<sup>32</sup> Id. At 166.

<sup>33</sup> 1959 S. C.R. 311 (Can. Sup. Ct.).

<sup>34</sup> In re Toga, 28 B.R. at 168-69.

## V. Critique of Culmer and Toga

Commentators have viewed the Toga decision as being unduly restrictive in that the Bankruptcy Court required as a condition to relief an almost “mirror image” between Canadian and United States bankruptcy laws.<sup>35</sup> Recent cases have also criticized the Toga court’s view of comity.<sup>36</sup> In the Axona Case<sup>37</sup>, the court noted that the “Limited focus in Toga on the minor substantive differences between Canadian and U.S. law prevented the Court from considering the full scope and procedural fairness of Canadian law. This case (Toga) is simply an example of ‘the court’s paramount concern with the protection of the rights of U.S. creditors.’”<sup>38</sup> The Axona court concluded that the Toga view of comity was incongruous with the flexibility required for international bankruptcies and asserted that the goal of creditor equality in transnational bankruptcies mitigates against the Toga view of comity favoring

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<sup>35</sup> See Gallagher & Hartje, Section 304 of the Bankruptcy Code: Has it fostered development of an “International Bankruptcy System”?, 22 Colum. J. Transnat’l L. 541, 566 (1984).

<sup>36</sup> See In re Koreag, 130 B.R. 705; In re Axona Int’l, 88 B.R. 597.

<sup>37</sup> In re Axona International Credit & Commerce, 88 B.R. 597.

<sup>38</sup> Id. At 611 (quoting Gallagher & Hartje, supra note 35, at 566).



protection of local creditors.<sup>39</sup> The court in Axona, was the same court that decided Culmer. In the Axona case, Axona's Hong Kong liquidators filed an involuntary case on February 9, 1983 under Section 303(b)(4) of the Bankruptcy Code for the purpose of utilizing Sections 547, 548 and 550 of the Bankruptcy Code to set aside alleged preferential and fraudulent transfers of U.S. assets to U.S. creditors. Chemical Bank of New York was paid on a pre-petition debt by Axona on or after November 15, 1982 and within the U.S. preference period. After arriving at a settlement with a number of parties including Chemical Bank) the Hong Kong Liquidator moved to suspend the Section 303 proceeding and return the settlement proceeds to Hong Kong. In the settlement, Chemical reserved the right to challenge the bankruptcy courts' administration of the estate asserting, in effect, that the plenary case could not be suspended or, alternatively, that the Liquidator was limited to filing a Section 304 ancillary proceeding. Chemical also asserted that the relief could not be granted because it would result in Chemical being treated unfairly and comity would not permit such result. The court held that it could suspend the proceeding and send the proceeds to Hong Kong since Section 2(a)(22) of the Bankruptcy Act of 1898 permitted suspension and was the forerunner of Section 305 pursuant to which suspension was sought. The court also held that all of the requirements of Section 304(c) had been met and

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<sup>39</sup> Id. at 623 see also, Comment, 1988 Developments and the Conflicts Arising Under Section 304, 6 Bankr. Dev. J. 345, 370 (1989).

that U.S. law and Hong Kong law were dissimilar only in minor respects which did not prejudice Chemical. Axona addressed the issue, raised by Chemical Bank, of Chemical Bank's rights under the Fifth Amendment prohibition against the taking of private property without just compensation, to wit: the taking of the payment to Chemical which was included in the Settlement Agreement. Citing Louisville Joint Stock Land Bank v. Radford<sup>40</sup> and quoting from Shanghai Power Co. v. United States, the Axona court dismissed this issue out of hand stating that it had long been settled that "The filing of . . . a [bankruptcy petition] has a profound effect upon the rights of the creditors".<sup>41</sup> The court also observed that the "taking" was accomplished by private agreement.

The Koreag case is another case critical of Toga. In that case, on May 5, 1989, a U.S. creditor obtained an ex parte attachment of a bank account belonging to a Swiss bank. The Swiss Bank had been placed in liquidation proceedings in Switzerland on April 27, 1989. The Swiss Liquidator filed a Section 304 proceeding on January 5, 1990, eight months after the attachment had been obtained. Finding that the facts in Toga and Koreag were "strikingly similar", the Koreag Court found Toga "protectionist", quoting Axona. The court ordered the return of the attached bank account to Switzerland. The attaching creditor's claim that it would not be recognized as a secured creditor in Switzerland was dismissed by the court which

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<sup>40</sup> 295 U.S. 555, 55 S. CT. 854

<sup>41</sup> 4 Cl. Ct. 237, 246 aff'd 765 F.2d 159 (Fed. Cir.), cert. denied 479 U.S. 909, 106 S. Ct. 279.

observed that the creditor, having done business in Switzerland with the liquidated Swiss bank, had to expect to be governed by Swiss rules.

Toga, however, is not the lone sentinel of “protectionism” in the exercise of comity under Section 304. Papeleras is another such case, although it can be distinguished on its facts. In Papeleras, the court dismissed the section 304 ancillary proceeding brought by a Spanish Liquidator appointed in Spain. Although the Papeleras court did not view comity as the central factor in a section 304 (c) analysis, the ancillary proceeding was dismissed only after an extensive examination of the factors enumerated in section 304 (c) revealed that under Spanish law, the Spanish liquidation proceeding would not recognize the U.S. creditor’s claim because it had not been liquidated when the Spanish proceeding had been commenced. Additionally, the creditor received no notice of the foreign proceeding and was thereby denied the opportunity to participate in the liquidation proceeding in Spain. The court also found that the U.S. creditor’s attachment lien would not have been recognized in Spain. The court concluded that due to the “omissions of Spanish law and the lack of candor by (the debtor) and liquidators,” the principles of §304 (c) mandated a dismissal of the ancillary proceeding.<sup>42</sup>

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<sup>42</sup> Id. at 590-95

Although Toga and its approach has been said to be antithetical to Culmer, the fact is that Culmer and its progeny, except for Koreag, do not appear to involve “vested” property rights of U.S. creditors that would be “divested” in the foreign jurisdictions to which the property is being returned pursuant to Section 304. In Culmer, the attached property was attached within the 90 day U.S. preference period as distinguished from the garnishment in Toga which had become “perfected” within the preference period. It is also noted that in Axona, the order returning the property to the foreign jurisdiction stipulated that U.S. creditors having a priority under Section 507 of the Bankruptcy Code were required to be paid from the proceeds of the returned property.

The foregoing cases are discussed at some length because they represent samples of extant case law in ancillary proceedings and will continue to be of influence under the newly proposed Chapter 15. What is clear from the foregoing is that comity, while stated as a broad principle, is applied on a case by case basis by the trier of the facts. Discussed below is a case in which the trier of the facts had the opportunity to see the “before” and “after” effects of the application comity.

Drexel Lambert Group, Inc. v. Galadari arose in the Southern District of New York in 1985. In that case, which does not appear in the extensive literature on the subject of cross-border insolvencies, Wahab Muhammad Galadari and his Trading Companies were placed in receivership by Royal Decree in Dubai, U.A.E.. Drexel and another U.S. company, Refco,

instituted suit against Galadari and his companies in the Southern District of New York where jurisdiction was not disputed. The Dubai Receivers requested the District Court in New York to stay the New York suit and defer to the Dubai proceedings, thereby requiring Drexel and Refco to pursue their claims in Dubai. The District Court issued the stay on the basis of international comity, making the following finding:

In *Canada Southern Railway Co. v. Gebhard* (1883) [citation omitted], Supreme Court held that the "true spirit of international comity" required American Courts to defer to a Canadian bankruptcy procedure that blocked the pursuit of individual claims. In *Clarkson Co. V. Shaheen*, (1976), [citations omitted] the Court of Appeals held similarly, and added that allegations of fraud interposed to defeat comity must be demonstrated by "clear and convincing evidence." These cases establish a presumption that American courts should defer to bankruptcy proceedings in other countries which are essentially fair.<sup>43</sup>

However, Dubai had no statutory scheme for insolvency which was simply regulated on a Royal Decree, ad hoc, basis. The second circuit reversed and remanded the case for a hearing, making the following observation which is set forth at length because it is particularly instructive:

Because the Dubai decree appears to be Dubai's first attempt to frame an insolvency law, our courts have had no experience with Dubai bankruptcy practices and procedures. In that respect, this case is unlike *Clarkson Co., v. Shaheen*, *supra*, 544 F 2d 624, relied upon by the court below. In *Clarkson*, this Court gave deference to proceedings in Canada, "a sister common law jurisdiction with [bankruptcy] procedures akin to our own. *Id* at 630. Here, the district court is sending Drexel into uncharted territory. In fairness to Drexel, therefore, it should have been afforded reasonable discovery and an evidentiary hearing. Although the committee did not bring an ancillary bankruptcy proceeding under 11 U.S.C. §304, that

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<sup>43</sup> 610 f. Supp. 114, 120

section provides guidance in this area by analogy. Under section 304 (b), if a party in interest controverts the section 304 (a) petition, the court can enjoin the continuation of an action only after a trial or hearing. The court then must decide whether to grant relief on the basis of the factors enumerated in section 304 ( c). See *in re Culmer*, 25 Bankr. 621 (Bankr. S.D.N.Y. 1982). In addition, general case law suggests that, when there are disputed issues of material fact, a motion to dismiss an action on a basis of international comity should not be granted without an evidentiary hearing [citations omitted]. We conclude that the facts relating to the Dubai proceedings and its consonance with domestic law and public policy were sufficiently in dispute to warrant further inquiry.<sup>44</sup>

After extensive hearings as to the efficacy of the Dubai proceedings and evenhanded treatment of creditors, including the right to appeal, the District Court stayed Drexel's and Refco's actions and Drexel and Refco submitted their claims in the Dubai proceedings. In 1991, six years after the initial stay, Drexel and Refco, frustrated by their inability to have their claims adjudicated in Dubai, requested the District Court to lift the stay. In its opinion, the Court took the Dubai Receivers to task for acting as judges and adversaries in respect of Drexel's and Refco's claims. In an unusual "second" look the District Court revisited its original findings and made the following observation:

In 1987, this Court expressed the view that the proceedings in Dubai will be conducted substantially in accordance with bankruptcy procedures in the United States. [citations omitted]. United States Bankruptcy Law requires that the functions of a trustee be separate and distinct from that of the presiding judge.\*\*\*It is clear that, under United States law, a trustee may not serve in the dual capacity of judge and trustee. Thus, a system of checks and balances is used to protect the integrity of the process. \* \* \* By contrast this Court finds that the Dubai proceedings do not provide any

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<sup>44</sup> *The Drexel Lambert Group, Inc., v. Galadari* 777 F 2 d 877 (2<sup>nd</sup> Cir. 1985).

similar protection to creditors. For example, the Committee [of Receivers] acts both as trustee (collecting the assets of the estate and determining which claims are to be disputed) and as the court (determining which disputed claims are to be approved, the amount to be paid on each claim and whether to discharge the debtor). This court would not condone a bankruptcy proceeding where the judge were both the tired of the facts and law and the trustee. However, in Dubai, the Committee [of Receivers] admittedly sits as both the trustee and judge. Thus, the Dubai proceeding does not adequately protect creditors or the integrity of the process and offends our notions of due process and fundamental fairness. The evil inherent in the Committee's [of Receivers] dual roles is compounded by the fact that the Committee [of Receivers] has unilaterally appointed [its own] advisors [names omitted] The Committee's [of Receivers] appointees have proven to be partial adversaries and adverse witnesses rather than impartial assistants to a fact-finding body. In sum, the Dubai proceedings are not in substantial conformity with our notions of fundamental fairness and due process. Accordingly, if the Committee [of Receivers] has not decided [the] claim[s] by April 16, 1991, this court will lift the stay of this action so that [they] may proceed in this Court.<sup>45</sup>

The Dubai Receivers entered a judgment against Drexel and Refco within the time frame required by the District Court. That judgment was promptly appealed in 1991. In June, 1998, a Tribunal in Dubai ruled that the Receiver's judgment was not appealable – a position that the Receivers themselves espoused during the course of the Dubai appeal, notwithstanding their representations that their judgments were appealable. To date, the Receivers have paid out \$600 million. Drexel and Refco have not been paid.

Thus far, we have examined the application of comity in the United States in several cross-border contexts. We have seen that our courts generally take a liberal review in

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<sup>45</sup> The Drexel Burnham Lambert Group, Inc. v. A.W. Galadari 127 Bankr. 87, 105-106.

sending property back to a foreign country. We now turn to the application of comity by foreign countries to request from the United States.

## VI. Ancillary Proceedings Outside the United States

There is no foreign statutory framework which would extend to a United States trustee the same ancillary relief as provided for in Section 304 of the Bankruptcy Code. Section 541 of the Bankruptcy Code gives the bankruptcy court and U.S trustees jurisdiction over a debtor's property "wherever located".<sup>46</sup> But that provision, for all practical purposes, is recognized only on an ad hoc basis which is dependent upon the policy judgment of the foreign courts in jurisdictions in which the assets are found. This policy judgment, in turn, rests on the foreign court's application of the "universality" theory or the "territoriality" theory.

In Felixstone Dock & Railway Co v. U.S. Lines, Inc.,<sup>47</sup> the English High Court, on that basis of international comity was asked to intervene where local creditors in the United Kingdom had obtained Mareva injunctions restraining depletion of the debtor's U.K. assets below sums sufficient to satisfy their claims. Refusing to lift the injunctions, the Court stated:

"... even if an appeal to comity has any force (which is doubtful) it is improbable, with one possible exception, that the liquidator's authority would be recognized as extending beyond those affairs of the company which are local to the country where the appointment was made. The exception is where there is no likelihood of a liquidation in the country of incorporation."

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<sup>46</sup> 11 U.S.C. §541 (a).

<sup>47</sup> (1989) 2 W.L.R. 109.



Although the High Court acknowledged the importance of the United States Chapter 11 case, it did not treat this circumstance as overriding. In its ruling, the English court found that the English creditors would have been treated equally in a liquidation, but would be discriminated against in a chapter 11 reorganization. The court stated that in the chapter 11 reorganization, in which the debtor was retrenching from its overseas activities, the English assets would be “ploughed into the [debtor’s] general funds” and that the English creditors would not benefit from this repatriation of funds to the United States.<sup>48</sup> The court felt that it was commercially inevitable that the United States creditors, who would be dealing with the restructured debtor, “would be paid off at least in part in order to induce them to carry on doing business” with the restructured debtor. On the other hand, the English creditors would receive no such benefit. In reality, the Mareva injunctions invested local creditors with property rights in the U.K. which, once obtained, the High Court was loathe to dilute.

The U.S. Lines case was truly global in nature. The Company, which had over a billion dollars of creditors, operated container ships which circumnavigated the globe returning goods to ports of origin in the United States. Unfortunately, ships could be seized in ports all over the world by creditors. If those creditors could have been stayed, U.S. Lines might have

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<sup>48</sup> (1989) 2 W.L.R. 109.

had a chance to reorganize. Instead, it was liquidated and creditors, other than those with liens on the ships and those attaching assets overseas received very little. The reasoning of the English court presumably would have reached the same conclusion if the U.K. assets had been "ploughed back" into the liquidation proceeding but U.K. creditors, while receiving a pro rata share of liquidation proceeds, would have received significantly less than they received as a consequence of the Marena injunctions.

Subsequent to the U.S. Lines case, the Insolvency Act of 1986 was passed in England. Section 426 of the Insolvency Act directs English courts having jurisdiction in relation to insolvency law to "assist the courts having corresponding jurisdiction in any part of the United Kingdom or any relevant country or territory."<sup>49</sup> Thus, if a foreign proceeding originates in a "relevant country or territory," the English courts may be used to assist that proceeding. To be considered "relevant", however, a country must be so designated by legislation.<sup>50</sup> Some commentators feel that this provision should be interpreted liberally to more easily grant comity to foreign bankruptcy proceeding.<sup>51</sup>

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<sup>49</sup> Insolvency Act 1986 § 426 (10) (d).

<sup>50</sup> See Lewis, Trans-National Insolvencies: Securing the Assistance of the Courts of England and Wales, 4 Insolvency L. & Prac. 155-56 (September/October 1988) (noting seventeen countries designated as a relevant country or territory including Ireland, Hong Kong, Australia, Canada, New Zealand, Anguilla, Cayman Island, The Turks & Caicos Island, The Virgin Islands and the Falkland Islands).

<sup>51</sup> Smart, Carrying on Business as a Basis of Recognition of Foreign Bankruptcies in English Private Law, 9 Oxford J. of Legal Stud. 557, 569 (Winter 1989). 76 B.R. 291 (Bankr. S.D.N.Y. 1987)

Ancillary situations in which a U.S. representative seeks the return of foreign assets are for the most part, anecdotal. Two such fairly recent cases are Delta Corp. 89 B 11759 (TLB) and In re Paolo Gucci et al 94 B 40614 (JHG). In the Delta Corp. case, which was commenced in 1989, a U.S. trustee sought recognition in France where he was required to apply for a judgment as “exequatur”. That process of being so recognized was opposed and, while ultimately successful, cost over \$500,000 in legal fees and related expenses and took a year and three months to conclude. Even then, the trustee faced continuing legal hurdles in actually obtaining a return of property to the U.S. and did not actually receive the U.S. debtor’s property until just recently, after almost ten years. That same trustee faced a similar problem in Sweden and the U.K.. In the U.K., solicitors advised the trustee his position would not be recognized under the applicable U.K. statutory scheme as “an aggrieved person”. This problem was also encountered in the Gucci case where the U.S. trustee was also not recognized and had to obtain the appointment of a separate Receiver (Compare: U.S. Lines in which was the “debtor” was an “aggrieved person”). In the Gucci case, the U.S. trustee also sought to obtain discovery by having Letters Rogatory issued for use in Switzerland. This attempt at discovery was opposed in Switzerland on the ground that it violated Swiss public policy. The trustee was eventually successful, but it took one year to accomplish his objective, at great expense. The Gucci trustee encountering resistance to marshalling the debtor’s assets in France, Italy, Bermuda and Korea.

Both the Delta Corp., and Gucci experience were described in testimony to Congress urging it to adopt the UNICITRAL Model Law discussed below

## VII. Caveat for U.S. Creditors

U.S. creditors would not enjoy the same advantage as the Felixstone creditors.

Although the automatic stay provisions of Section 362 of the Bankruptcy Code do operate worldwide, as practical matter, they operate only as to U.S. citizens and other within the bankruptcy court's jurisdiction. Thus, persons subject to United States jurisdiction proceed at their peril against a U.S. debtor's assets outside the United States. Any action to attach or seize assets outside the U.S., though perhaps legal in the foreign forum, would be a violation of the automatic stay under the United States Bankruptcy Code and consequently, an act subject to the contempt powers of the United States bankruptcy court.

In the U.S. Lines case, the court enforced its orders through contempt proceedings in which the debtor, to satisfy monetary sanctions, attached the bank accounts and other United States assets of a foreign creditor who had violated the automatic stay overseas.<sup>52</sup> In that case, the Bankruptcy Court imposed on defendants present in the United States a fine of \$5,000 per day following their instigation of arrest proceedings against the debtor's vessels in foreign ports.

The defendants argued, in part, that the Bankruptcy Court was impermissibly “extending” its jurisdiction by holding in contempt those foreigners who permissibly seized foreign assets of a United States debtor outside the jurisdiction of the United States. The Bankruptcy Court disposed of this argument as follows:

“If by its argument GAC Marine is asserting that the automatic stay should not, as a matter of discretion, be enforced against foreign creditors who transact or do business in the United States, it is plainly apparent, given GAC Marine’s conduct, that to fail to enforce the automatic stay would be an abuse.<sup>53</sup>”

#### VIII. The Maxwell Experience

Thus far we have reviewed requests for ancillary assistance on the basis of comity with some mixed results. We now turn to those situations in which plenary – as distinguished from ancillary – jurisdiction is involved in cross-border cases. Maxwell Communications, Inc. is the quintessential case in which dual jurisdiction has been invoked and in which creditors could have experienced disastrous results if the dual proceeding had not been coordinated on the basis of comity. That was accomplished by the mechanism of a protocol through which the plenary proceedings in each court were coordinated without raising untoward jurisdictional disputes.

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<sup>52</sup> In United States Lines, Inc. v. GAC. Marine Fuels Ltd. (In re McLean Industries, Inc.).

<sup>53</sup> Id. at 296.

The Maxwell Communications' protocol was the first and most famous of its kind and the facts were unique. Maxwell was the London holding company of Robert Maxwell. Over 75% of its assets were located in the United States in various subsidiaries. The U.S. assets consisted of publishing assets which recently had been purchased with loans of a \$3 billion from a consortium of London based banks. There were few, if any, U.S. creditors. The U.S. subsidiaries were solvent.

On December 16, 1991, after failing to reach an accord with its London bankers, Maxwell filed a Chapter 11 proceeding in the Southern District of New York. On December 17, 1991, Maxwell presented a petition for Administration under the Insolvency Act of 1986 with the High Court of London, requesting that its accountants, Coopers-Lybrand be appointed as Administrators. This request was contested by the bank consortium and after a hearing before the High Court, the consortium's choice for Administrators, Price Waterhouse, was appointed. In the meantime, Maxwell had obtained, ex parte, the appointment of an examiner in the U.S. Chapter 11 proceedings who was vested with special powers similar to that of a trustee.

There were now two plenary proceedings with an English Administrator and a U.S. Examiner asserting "governance" power over the debtor. The options were clear: a motion to dismiss the Chapter 11 or a negotiated accommodation. Thought also was given to holding the directors of Maxwell in contempt in London for having moved ex parte for the appointment of an Examiner after the petition for Administration had been filed with the High Court of

London. Accommodation won out because of the fear that litigation could cause irreparable damage to the publishing business, the value of which, to a large degree, depended on maintaining the confidence of authors contracted to publish books with Maxwell's subsidiaries. Thus, arose the Maxwell protocol<sup>54</sup>.

The Maxwell Protocol essentially recognized the English Administrator as the "corporate governance" of Maxwell and the Examiner was recognized as a party in interest in the English Administration. The Administrator consulted with the Examiner in disposing of assets – U.S. or English – in excess of a certain amount. The protocol also provided that on matters of importance, orders would be sought from both the High Court of London and the U.S. bankruptcy court. The English Administrator was authorized to retain professionals to assist in fashioning a plan of reorganization [or liquidation] in connection with which the Administrator would consult the Examiner but not be bound by the Examiner's views. The U.S. bankruptcy court reviewed the fee requests of professionals retained by the Administrators, but they were paid from London by the Administrators. In addition to the forgoing, a creditors Committee was appointed in England but, at the request of the Administrators, no Committee was appointed in the United States by the U.S. trustee who also cooperated.

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<sup>54</sup> Appendix B.

In February, 1993, a joint plan of reorganization was filed in the U.S. which incorporated an English law "Scheme of Arrangement". The plan and Scheme provided for the liquidation of Maxwell assets and the pro rata distribution of proceeds to unsecured creditors worldwide. Claims were to be filed with the Administrators either in the U.S. or U.K. and were considered to be filed in both cases. Troublesome issues were dealt with in a variety of creative ways. Post-petition interest on unsecured debt, which is not payable in the U.S. but is required to be paid in the U.K., contractual or otherwise, was dealt with by taking the highest U.K. contractual interest rate and paying it to all creditors, thereby negating the unfairness which the U.S. rule was designed to prevent. Priority claims, which could have been a problem, did not materialize after a U.S. Priority Claim Bar Order was issued and no priority claims were asserted. Landlord claims were negotiated out in the U.K. to the satisfaction of the Administrators.

#### **IX. Comity Wins Out**

The entire Maxwell process went very smoothly, except for one problem – preferences. Just prior to the filings in the U.S. and U.K., three non-consortium banks received \$200 million of preferential payments. In England, such preferences are recoverable only if Maxwell had "intended" that the banks be preferred over other creditors. The chief witness was Robert Maxwell's son who was in or contemplating a criminal prosecution. A decision was



taken to sue the banks pursuant to Section 547 and 502(d) of the Bankruptcy Code. One of the banks attempted to enjoin the Administrators in the High Court of London from commencing the U.S. action. The High Court of London held that question of "preference" was a conflict of interest question and that applicable law was to be determined by the U.S. Bankruptcy Court in the first instance. The U.S. Bankruptcy Court concluded that U.S. law did not apply because the acts occurred in England thereby requiring dismissal on the basis of comity.

#### **X. Other Protocols and the Concordat**

Following the Maxwell case, protocols were entered into in a number of cases.<sup>55</sup>

In 1996, the International Bar Association, relying on Maxwell and other protocols, adopted a Cross-Border Insolvency Concordat which is intended to be used by courts in different countries to coordinate cross-border insolvencies. The Concordat has 10 basic principals which promote the universality concept of a single forum for all claims and distributions but recognize that there may be multiple plenary forums or plenary forums combined with ancillary forums. The Concordat also recognizes that particular jurisdictions may want to determine certain claims and

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<sup>55</sup> In re AIOC Corporation and AIOC Resources AG between United States and Switzerland: U.S. Bankruptcy Court for Southern District Court of New York (April 3,1998); In re Solv-Ex Canada Limited and In re Solv-Ex Corporation between Alberta Court of Queen's Bench and U.S. Bankruptcy Court for the District of Mexico (January 28,1998); In re Tee-Comm Electronics Inc. between Ontario Court of Justice and U.S. Bankruptcy Court for the District of Delaware (June 27,1997); In re Nakash: U.S. Bankruptcy Court for the Southern District of New York and District Court of Jerusalem (May 23,1996);In re Everfresh Beverages Inc.: Ontario Court of Justice, Toronto and U.S. Bankruptcy Court for the Southern District of New York (December 20, 1995); and In re Olympia & York Developments Ltd: Ontario Court of Justice

preferences on the basis of their own local law. The Concordat has been cited recently as a “guidance for the treatment of cross-border problems”.<sup>56</sup> The Concordat’s principles have been incorporated into the cross-border protocols in In re Everfresh Beverages, Inc. and In re Joseph Nakash<sup>57</sup> which, respectively, facilitated the coordination of U.S., Canadian and Israeli law in those cases. On a practical level, the Concordat meshes concepts universality and territoriality so as to accomplish what can be practically accomplished on a political scale. The Concordat is a non-binding guide which is intended to be used to illuminate, on a relatively uniform basis, the private law expectations of creditors in a global, commercial context.

#### **XI. Treaties and Other Initiatives**

At the moment, there are very few treaties in existence. Those that do exist are regional in nature. In Scandinavia, the Nordic Convention of 1933 includes Sweden, Denmark, Norway and Finland. In South America, the Montevideo treaties of 1889 and 1940 and the Havana Convention of 1928, include Argentina, Peru, Colombia, Bolivia, Uruguay, Paraguay

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and U.S. Bankruptcy Court for the Southern District of New York (July, 1993). Selected sample protocols are annexed as Appendices C, D and E.

<sup>56</sup> In re Hackett 184 B.R., 658 n.3 (Bankr. S.D.N.Y. 1995).

<sup>57</sup> F.N. 58, infra.

and Cuba.<sup>58</sup> The United States of America and Canada attempted to enter a treaty designated United States of America-Canada Bankruptcy treaty (1979). That attempt failed. Two parallel Western European Conventions have also drawn up insolvency agreements; but they are not fully executed. The first is the Council of Europe Convention and the second is the European Union Convention.

A. The Council of Europe Convention.

The Council of Europe Convention deals with certain limited aspects of cross-border insolvencies. It permits a liquidator to exercise powers beyond national borders, subject to approval of the foreign territory and takes a universal approach which recognizes to a single jurisdiction for purposes of insolvency administration.<sup>59</sup> That convention which has not been fully executed, will be superseded by the European Union Convention on Insolvency Proceedings. Consequently, it will probably never come into being.

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<sup>58</sup> International Solution To International Insolvency: An Insoluble Problem? McKenzie (1997) 26 W Bolt. L, Rev. 15, 16.

<sup>59</sup> Ibid., P. 22

B. The European Union Convention on Insolvency Proceedings

This convention is generally limited to liquidation proceedings but goes further than the Council of Europe Convention upon which it was based. It provides for rules of mandatory jurisdiction which override national rules; all filed proceedings are automatically recognized but the debtor's center of "main interests" is the primary jurisdiction and the liquidator is entitled to exercise his powers in any other member state without much restriction; the primary proceeding is "universal" in nature but ancillary proceedings are recognized as being "territorial" and the law of the local forum relating to insolvency and the debtor's assets is still applicable; the rules of the convention are limited to its members and do not deal with proceedings outside the European Union.<sup>60</sup> The European Convention, in short, attempts to provide a "universal" forum for processing claims while recognizing the territorial prerogatives of other forums that may be involved. Fourteen of the fifteen members of European Union have signed the Convention. The U.K. has not. Neither of these conventions effectively provides for rehabilitation and a fresh start in the U.S. sense.

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<sup>60</sup> Ibid

C. The United Nations Model.

Working from the European Council and European Union Convention initiatives, and the practical and flexible extant protocols, the United Nations Commission on International Trade Law (UNCITRAL) has prepared a Model Law at the suggestion of practitioners with practical working knowledge in the field.<sup>61</sup> The Model Law<sup>62</sup> is based upon the proposition that it is appropriate to facilitate cooperation between various courts was done in Maxwell and other protocols and thereby to protect the interests of all creditors worldwide through fair and equal distribution and efficient administration of assets on the basis of comity. Importantly, the Model Law also recognizes the principal of “rescuing” viable businesses, a concept which had not heretofore received much international acceptance. The cross-border insolvency process under the Model Law requires recognition of a sister States’ insolvency proceedings, permits sister States’ representatives to have access to legal mechanisms in another Model Law states; and entitles those representatives to limited relief designed to protect a debtor’s assets and distribution thereof to all creditors.<sup>63</sup> The Model Law would rely mostly on judicial cooperation to give effect to its policy goals and would expect that States would individually revise their domestic laws where necessary.<sup>64</sup> Presumably, local law would continue to be “territorial” where appropriate but would otherwise invoke the “universality” concept in order to implement the underlying policy principles of the Model Law. The Model Law has been accepted by a number of member States of the United Nations and probably is the best existing framework for

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<sup>61</sup> UNICITRAL Model Law on Cross-Border Insolvencies Garzon, Gad.

<sup>62</sup> Appendix G annexed hereto.

<sup>63</sup> International Creditors’ Rights and Bankruptcy, Gaa and Garzon, 31 Int’l Law 273.

<sup>64</sup> Ibid p. 274.

developing a reasonably workable, international approach to cross-border insolvencies. Chapter 15 of the newly proposed and yet to be enacted Bankruptcy Code dealing with cross-border insolvencies, incorporates many of the Model Law concepts. Those concepts are not here included since many of them are discussed below in connection with the proposed Chapter 15 of the new Bankruptcy Code which had support from bankruptcy judges in the United States.<sup>65</sup>

## **XII. The New Proposed Bankruptcy Amendments (Chapter 15)**

Chapter 15 authorizes a U.S. representative to act in a foreign jurisdiction (section 1505). It authorizes a foreign representative in a “main” foreign proceeding or “non-main” foreign proceeding to institute an ancillary proceeding in the U.S. bankruptcy courts (§§ 1504, 1507) upon obtaining “recognition” of the foreign proceeding (§1515). The gate way to relief under Chapter 15 and other relevant provision of the Bankruptcy Code is the application for recognition required by §1515 and the determination as to whether the foreign proceeding is a “main proceeding” or a “non-main proceeding”(§1517). Pending such determination of recognition, the foreign representative may request a variety of relief including stays of execution and marshalling of assets (§1519). After recognition, whether the foreign proceeding is “main” or “non-main”, the foreign representative may continue to stay execution, stay commencement of new proceedings, examine witnesses, continue to marshall assets and request

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<sup>65</sup> Appendix F, testimony of Hon. Tina Borzman before The Senate Committee on the Judiciary.

other appropriate relief other than, generally, that involving preferences and fraudulent transfers (§1521). If the foreign proceeding is a “main proceeding”, §362 applies automatically. In addition, the foreign representative may operate the debtor’s business and may exercise the powers of a trustee under §549 of the Bankruptcy Code to set aside post-petition transfers. Providing ancillary relief to a recognized foreign representative is not automatic. The U.S. bankruptcy court must find such ancillary relief consistent with principals of comity and that such relief will reasonably ensure “just” treatment of all creditors, protect of U.S. creditors from “prejudice” or “inconvenience”, prevent “preferential or fraudulent disposition of the debtor’s property”, ensure proper “distribution of proceeds”, and, if appropriate, provide a “fresh start” (§1512).<sup>66</sup>

Chapter 15 also provides that a foreign representation obtaining recognition under §1515 has a right of direct access to Federal or State Courts (§1509). Chapter 15 also provides that a recognized foreign representative may participate as a party in interest in any case pending in regard to the debtor under Title 11 (§1512), has standing to initiate preference and fraudulent conveyance actions in such cases (§1523) and has standing to intervene in any State or Federal case in which the debtor is a party (§1524). A “recognized” foreign representative is authorized

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<sup>66</sup> See also 11 U.S.C. §304 ( c) for similar requirements.

to commence an involuntary case against the debtor under §303 of the Bankruptcy Code, or, if recognized as a representative in a “main foreign proceeding”, is authorized to commence a voluntary case under §301 or 302 of the Bankruptcy Code.

Requesting recognition as a representative of a foreign proceeding (main or non-main), which is required to “commence a case under Chapter 15 (§1504), is not pro forma but also does not require a great deal of effort. A certification of the decision commencing the foreign case or certification from the foreign court are sufficient, provided they are in English. Notarization is not required – a gift from the Model, the drafters of which have had significant experience with that the notarization process which can be time consuming. As in the case of the Model Law, Chapter 15 utilizes the notion of the debtor’s “center of its main activity” in determining whether the foreign proceeding is a “main” proceeding or “non-main” proceeding. Section 1502 (4) defines the “foreign main proceeding” as the proceeding where the debtor has the center of its main activity. In determining “recognition” under §1515, the bankruptcy court may “presume”, in the absence of evidence to the contrary, that the debtor’s registered office or habitual residence is the “center of the debtor’s main interests”.

In an unusual provision, Chapter 15 also provides for cooperation and direct communication between courts, thereby codifying what was accomplished in the Maxwell protocol and the protocols following it (§§ 1529-30). The drafters have facilitated the filing of an involuntary, plenary proceeding by a foreign representative by permitting the bankruptcy court to



indulge the presumption that, if there is a foreign proceeding or proceedings, the debtor is not paying its debts as they became due (§1531) and therefore is insolvent for §303 purposes.

Finally, §1532 provides for a leveling of payments to general unsecured creditors who may have received, in a foreign proceeding, a greater percentage share of their claims than U.S. creditors. Such foreign creditor's claim in the U.S. will not be paid until U.S. creditors catch-up (§1532).<sup>67</sup> Chapter 15 does not apply to individual debtors.

In sum, Chapter 15 of the proposed United States Bankruptcy Code not only reflects another effort to streamline cross-border insolvency cases but, by incorporating the concepts of the UNICITRAL Model Law, Congress has sent a clear message inviting broad scale participation in that effort by other nations.

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<sup>67</sup> See also, 11 U.S.C. §508.

# Total Midyear Population for the World: 1950-2050

Year	Population	Average annual growth rate (%)	Average annual population change
1950	2,556,000,053	1.47	37,766,790
1951	2,593,766,843	1.61	42,041,598
1952	2,635,808,441	1.70	45,320,042
1953	2,681,128,483	1.77	47,842,411
1954	2,728,970,894	1.86	51,338,406
1955	2,780,309,300	1.88	52,854,200
1956	2,833,163,500	1.95	55,719,931
1957	2,888,883,431	1.93	56,395,552
1958	2,945,278,983	1.76	52,219,857
1959	2,997,498,840	1.39	41,952,183
1960	3,039,451,023	1.33	40,623,555
1961	3,080,074,578	1.80	56,010,616
1962	3,136,085,194	2.19	69,397,019
1963	3,205,482,213	2.19	71,006,484
1964	3,276,488,697	2.08	68,914,399
1965	3,345,403,096	2.07	70,127,783
1966	3,415,530,879	2.02	69,642,954
1967	3,485,173,833	2.04	71,746,016
1968	3,556,919,849	2.07	74,525,312
1969	3,631,445,161	2.05	75,116,177
1970	3,706,561,338	2.07	77,388,931
1971	3,783,950,269	2.01	76,776,513
1972	3,860,726,782	1.96	76,368,413
1973	3,937,095,195	1.90	75,720,203
1974	4,012,815,398	1.81	73,475,831
1975	4,086,291,229	1.75	72,044,154
1976	4,158,335,383	1.72	72,332,978
1977	4,230,668,361	1.69	72,277,796
1978	4,302,946,157	1.73	75,190,224
1979	4,378,136,381	1.71	75,641,253
1980	4,453,777,634	1.69	76,123,370
1981	4,529,901,004	1.76	80,253,129
1982	4,610,154,133	1.73	80,342,268
1983	4,690,496,401	1.68	79,417,677
1984	4,769,914,078	1.68	80,660,545
1985	4,850,574,623	1.68	82,406,206
1986	4,932,980,829	1.72	85,511,175
1987	5,018,492,004	1.70	86,077,510
1988	5,104,569,514	1.67	85,734,318
1989	5,190,303,832	1.66	86,688,377

1990	5,276,992,209	1.55	82,450,957
1991	5,359,443,166	1.52	82,324,488
1992	5,441,767,654	1.48	81,119,962
1993	5,522,887,616	1.43	79,698,088
1994	5,602,585,704	1.41	79,779,384
1995	5,682,365,088	1.37	78,566,560
1996	5,760,931,648	1.37	79,513,568
1997	5,840,445,216	1.33	78,179,152
1998	5,918,624,368	1.30	77,590,972
1999	5,996,215,340	1.27	76,883,461
2000	6,073,098,801	1.25	76,318,084
2001	6,149,416,885	1.23	76,100,673
2002	6,225,517,558	1.21	75,881,416
2003	6,301,398,974	1.20	75,784,025
2004	6,377,182,999	1.18	75,600,445
2005	6,452,783,444	1.16	75,488,026
2006	6,528,416,885	1.15	75,639,900
2007	6,603,911,370	1.14	75,803,406
2008	6,679,714,776	1.13	75,957,093
2009	6,755,671,869	1.12	76,021,656
2010	6,831,693,525	1.11	76,016,106
2011	6,907,709,631	1.09	75,848,884
2012	6,983,558,515	1.07	75,343,702
2013	7,058,902,217	1.05	74,603,276
2014	7,133,505,493	1.03	73,698,107
2015	7,207,203,600	1.00	72,789,490
2016	7,279,993,090	0.98	71,927,865
2017	7,351,920,955	0.96	70,996,881
2018	7,422,917,836	0.94	70,028,383
2019	7,492,946,219	0.92	69,012,634
2020	7,561,958,853	0.90	68,174,549
2021	7,630,133,402	0.88	67,514,394
2022	7,697,647,796	0.86	66,784,632
2023	7,764,432,428	0.85	66,045,314
2024	7,830,477,742	0.83	65,307,539
2025	7,895,785,281	0.82	64,711,394
2026	7,960,496,675	0.80	64,250,325
2027	8,024,747,000	0.79	63,748,570
2028	8,088,495,570	0.78	63,259,317
2029	8,151,754,887	0.77	62,796,790
2030	8,214,551,677	0.76	62,388,961
2031	8,276,940,638	0.75	61,987,647
2032	8,338,928,285	0.73	61,459,983
2033	8,400,388,268	0.72	60,884,464
2034	8,461,272,732	0.71	60,295,790
2035	8,521,568,522	0.70	59,651,156
2036	8,581,219,678	0.68	58,893,539
2037	8,640,113,217	0.67	57,891,484
2038	8,698,004,701	0.65	56,768,630
2039	8,754,773,331	0.63	55,673,280

TOTAL MID-YEAR POPULATION OF THE WORLD 1950-2050

Total Midyear Population for the World: 1950-2050

2040	8,810,446,611	0.62	54,545,937
2041	8,864,992,548	0.60	53,361,282
2042	8,918,353,830	0.58	52,056,622
2043	8,970,410,452	0.56	50,709,435
2044	9,021,119,887	0.55	49,440,868
2045	9,070,560,755	0.53	48,202,451
2046	9,118,763,206	0.51	46,946,055
2047	9,165,709,261	0.50	45,561,602
2048	9,211,270,863	0.48	44,126,908
2049	9,255,397,771	0.46	42,814,533
2050	9,298,212,304		

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Source: U.S. Bureau of the Census, International Data Base.  
Note: Data updated 12-28-98.



B. The Joint Administrators and the Examiner shall be recognized as "parties in interest" in this case within the contemplation of Bankruptcy Code section 1109(b), and the Joint Administrators will support an application by the Examiner for leave to be heard in the High Court in respect of the Administration.

C. The Examiner shall:

- (i) investigate the assets, liabilities and financial condition of the Debtor, the operation of the Debtor's business and the desirability of the continuance of such business, and any other matter relevant to this case or to the formulation of a plan of reorganization and report the results of such investigation as provided in Bankruptcy Code section 1106(a)(4). In order to reduce duplication of effort and the needless incurrence of expense, the Examiner may, in his discretion, defer to the Joint Administrators with respect to matters being investigated by them (other than investigations relevant to the formulation of a plan of reorganization) unless the Examiner believes that an independent or supplemental investigation by the Examiner is appropriate under the circumstances, such as where there

- may be a potential conflict of interest. In deciding whether to exercise his discretion to conduct an independent or supplemental investigation, the Examiner shall be mindful of, and give serious consideration to, the additional costs and expenses that would be involved in conducting such investigation. In order to facilitate the full and cooperative exchange of information, the Joint Administrators and the Examiner (including their respective professionals) are authorized and directed to hold in confidence and not disclose, except to this Court or to the High Court under such circumstances so that the confidential nature of such information will be protected or as otherwise required by applicable law, to third parties without the consent of the other any information designated as confidential provided by one to the other in connection with the investigations described in this paragraph:
- (ii) act to harmonize, for the benefit of all of the Debtor's creditors and stockholders and other parties in interest, the Debtor's United States Chapter 11 case and the Administration so as to maximize the Debtor's prospects for rehabilitation and reorganization; ~~if appropriate,~~

- (iii) canvas, determine and identify the issues and impediments that must be resolved to facilitate a reorganization of the Debtor;
- (iv) with the Joint Administrators, the ad hoc bank committee (as described on Schedule 2 of the Protocol annexed hereto as Exhibit C) (the "Bank Committee") and any official committee appointed in this case, inquire of major parties in interest in the Debtor's case concerning their respective positions as to the resolution of any issues and impediments to the formulation of a plan of reorganization;
- (v) mediate any differences in respect of the positions of the various parties in interest vis-a-vis any issues and impediments identified or arising with respect to a plan of reorganization;
- (vi) promote a consensus among all parties in interest so that a consensual plan of reorganization may be proposed, confirmed and consummated consistent with the Bankruptcy Code; and
- (vii) act as a facilitator in respect of all of the foregoing matters.

D. The Examiner be and the same hereby is authorized, subject to this Court's approval, to appoint or employ pursuant to Bankruptcy Code section 327, accountants, attorneys and/or other agents or representatives to assist him in the performance of his duties and the exercise of his powers hereunder, and the Examiner may seek compensation for his services and reimbursement of his costs and expenses in accordance with Bankruptcy Code sections 330 and 331.

E. The Joint Administrators be and the same hereby are recognized as the corporate governance of the Debtor subject to the terms of this Order.

F. The Protocol between the Examiner and the Administrators, annexed hereto as Exhibit C, including without limitation paragraph G.5(c) and (d) thereof authorizing without further notice and a hearing, pursuant to Sections 363 and 364 of the Bankruptcy Code, the transactions provided for therein, is hereby approved and the Examiner and the Joint Administrators shall exercise their powers and authority in accordance with the Protocol.

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G. The Joint Administrators, the Debtor under the supervision of the Joint Administrators as corporate governance, David Shaffer ("Shaffer"), and the Examiner shall take such steps as are necessary in good faith in order to effectuate the provisions, spirit and intent of this Order.

H. Pursuant to Section 105 of the Bankruptcy Code and subject to the limits of this Court's jurisdiction, each member of the M&O Group and their respective directors and officers shall not direct, cause or cause another entity to consent to the following, without the consent of the Examiner and the Joint Administrators (with concurrent notice to U.S. counsel for the Bank Committee) or approval of the Court in accordance with this Order:

- (i) the filing of proceedings under the bankruptcy or insolvency law of any jurisdiction with respect to any member of the M&O Group; or
- (ii) any sale or other disposition of any member of the M&O Group, or any material assets ~~(i.e., assets with a value of at least \$3 million)~~ of any of the foregoing.

- I. Nothing contained herein ~~or in the Protocol~~ shall:
- (i) be construed to affect, diminish or increase in any way the jurisdiction provided to this Court under United States law with respect to the within proceedings or the jurisdiction provided under English law to the High Court with respect to the Administration;
  - (ii) require the Joint Administrators to do anything or refrain from doing anything which would or would be likely to result in their being in breach of any duty imposed on them by any applicable law; <sup>herein or in the Protocol</sup>
  - (iii) authorize the taking of any action which requires notice and a hearing or court authorization under the Bankruptcy Code, unless (a) the requirement of notice and a hearing or court authorization has been met or (b) the action is taken pursuant to paragraphs G.5(c) or G.5(d) of the Protocol; or
  - (iv) preclude any party in interest from seeking further relief from this Court (whether by way of modification of this Order, expansion or reduction of the Examiner's powers, obtaining injunctive or mandatory relief or otherwise).

J. The Joint Administrators shall concurrently with delivery to the Examiner provide to (i) U.S. counsel for the Bank Committee, and (ii) the U.S. counsel for any official committee appointed in this case, copies of all notices or requests for consent or approval (including copies of all materials provided to justify such consent or approval) sent or furnished by the Joint Administrators to the Examiner pursuant to the Protocol (subject to appropriate confidentiality restrictions), provided that the Joint Administrators shall have leave to seek relief from this Court from the provisions of this paragraph J if the Joint Administrators determine in good faith that such disclosure in any individual case could be prejudicial to the interests of the Debtor's estate.

K. The Joint Administrators shall not incur personal liability for ~~any actions taken or not taken pursuant to this Order or the Protocol~~, failure to give any notices required hereid or in the Protocol.

Dated: January 15, 1992  
New York, New York



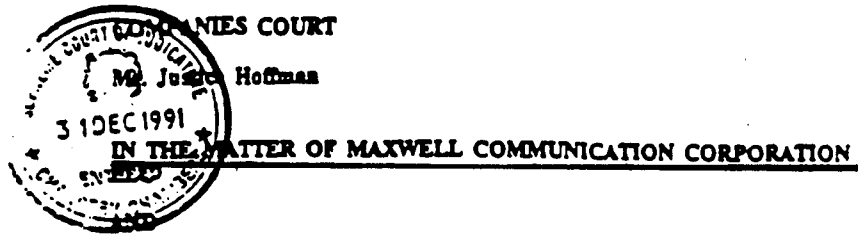
The Honorable Tina L. Brozman  
UNITED STATES BANKRUPTCY JUDGE

Nothing contained herein shall preclude any other party in interest from applying to this Court to receive the same copies of notices or requests for consent or approval as are to be provided to U.S. Counsel for the Bank Committee or U.S. counsel for any official committee appointed in this case.



IN THE HIGH COURT OF JUSTICE  
CHANCERY DIVISION

EXHIBIT B  
No. 0014001 of 1991



IN THE MATTER OF THE INSOLVENCY ACT 1986

MINUTE OF ORDER

UPON the application of Andrew Mark Homan, Colin Graham Bird and Jonathan Guy Anthony Phillips, the Joint Administrators of Maxwell Communication Corporation plc (the "Company") by ordinary application dated the 3<sup>rd</sup> day of DECEMBER 1991

AND UPON HEARING Counsel for the applicants and Counsel for Richard A. Gitlin the Examiner appointed by the United States Bankruptcy Court, Southern District of New York ("the US Bankruptcy Court") ("the US Examiner")

And upon reading the Affidavits of Colin Graham Bird sworn the 31<sup>st</sup> day of December 1991 and Evan Daniel Flaschen sworn the 31<sup>st</sup> day of December 1991

IT IS HEREBY ORDERED that subject to the approval of the US Bankruptcy Court of an Order substantially in the form of the draft annexed hereto:

the Joint Administrators be at liberty to consent to the making of an Order of the US Bankruptcy Court substantially in the form of the draft annexed hereto

- 2 the Order of Mr. Justice Hoffmann dated 20th December 1991 be discharged insofar as it relates to David Herbert Joseph Shaffer
- 3 the Joint Administrators of the Company and the US Examiner have liberty to apply to the Court in these proceedings

And it is ordered that the costs of the Joint Administrators of the US Examiner of and incidental to this application be costs in the Administration



**PROTOCOL**

The Examiner and the Joint Administrators hereby agree, subject to entry by the Bankruptcy Court of the Final Supplemental Order Appointing Examiner and Approving Agreement Between Examiner and Joint Administrators (the "Proposed Order") to which this Protocol is an exhibit, as follows:

A. Annexed hereto as Schedule 1 is a list of entities that are integral parts of the businesses of Macmillan, Inc. ("Macmillan") and Official Airline Guides, Inc. ("OAG"), whether subsidiaries or affiliates thereof (as identified on Schedule 1 hereto, the "M&O Group" as may be varied from time to time by further agreement between the Examiner and the Joint Administrators subject to the approval, or further order, of the Bankruptcy Court).

B. With respect to those members of the M&O Group that are identified with an asterisk on Schedule 1 hereto (the "M&O Affiliates"), the Joint Administrators have expressed the need to analyze their duties and responsibilities under English or other applicable law concerning the potential rights of the shareholders and creditors of the M&O Affiliates and the Joint Administrators and the Examiner agree to work together in good faith to effectuate the current desire and intent for David Shaffer ("Shaffer") to continue overseeing the M&O Group, as provided in paragraph C hereof, without causing the Joint Administrators to be in breach of their duties and responsibilities under English or other applicable law, with the Joint Administrators and the Examiner reserving the right to seek relief from the Bankruptcy Court in the event the foregoing cannot be accomplished.

C. Subject to paragraph G.3(i) hereof, Shaffer shall (i) remain the Chairman, President and Chief Executive Officer of Macmillan, Inc., (ii) remain the Chairman of Official Airline Guides, Inc. ("OAG"), (iii) be paid by OAG and Macmillan, and (iv) be employed by the Debtor but without the Joint Administrators adopting or the Debtor assuming his contract of employment, it being the current desire and intent (subject to paragraph G.3(i) hereof) that his management role include overseeing management of the M&O Group.

D. The Joint Administrators and the Examiner shall consult and together agree as to the appropriate composition of the boards of directors of Macmillan and OAG. The Debtor under the direction of the Joint Administrators, in its capacity as the ultimate parent company of the M&O Group, shall procure the appointment of new boards of directors for Macmillan and OAG, provided that subject to paragraph G.3(i) hereof (i) Shaffer shall be a member of both boards, (ii) the Joint Administrators shall consult with Shaffer as to whether it may be appropriate to appoint one or more members of operating management of Macmillan or OAG to their respective boards, (iii) the remaining members of the respective boards shall be independent, outside directors of distinction, and (iv) the Joint Administrators and the Examiner shall have consented to each proposed appointment.

E. Should the Joint Administrators consider it appropriate to commence insolvency or other similar proceedings in respect of all or any of the intermediate holding companies between the Debtor and the M&O Group, they may commence such proceedings subject to giving such prior notice as is reasonable in all the circumstances of the commencement of such proceedings to the Examiner, and in that event they shall, or they shall cause the Debtor to,

subject to prior consultation with the Examiner, commence parallel proceedings under Chapter 11 in the United States with respect to such intermediate holding companies in which event the Joint Administrators and the Examiner shall apply to the Bankruptcy Court for an Order in relation to such companies appointing the Examiner to serve in such cases and otherwise in substantially the same terms as the terms of the Proposed Order insofar as they may be relevant.

F. The Debtor and the Examiner may retain on a joint basis (subject to approval by the Bankruptcy Court of the specific joint retention application) an investment banker of national and international reputation selected by the Joint Administrators and the Examiner.

G. The Joint Administrators and the Examiner shall exercise their powers and authority in accordance with the following:

1. With respect to the Debtor, the Joint Administrators and the Debtor at the direction of the Joint Administrators shall:
  - (i) except as provided in this Protocol and the Proposed Order, attempt, in good faith, to obtain the prior approval of the Examiner and shall obtain the approval of the Bankruptcy Court to borrow funds or pledge or charge any assets of the Debtor;
  - (ii) in good faith attempt to obtain the consent of the Examiner prior to seeking to convert the Debtor's case to a case under Chapter 7 of the Bankruptcy Code and shall obtain the approval of the Bankruptcy Court to any such conversion;

(iii) obtain the prior consent of the Examiner or, having first attempted in good faith to obtain such consent, approval of this Court prior to filing a plan of reorganization for the Debtor during the period in which the Debtor has the exclusive right to file a plan of reorganization ("Plan") and seek acceptance of such a Plan as provided in Section 1121 of the Bankruptcy Code.

2. With respect to the M&O Group, and regardless of whether authorization to take such action is otherwise required from this Court or the English High Court, the Joint Administrators and the Debtor under the direction of the Joint Administrators shall, in good faith, attempt to obtain the consent of the Examiner and shall obtain the approval of the Bankruptcy Court prior to:

- (i) commencing, or causing to be commenced or consented to, bankruptcy or insolvency proceedings (whether in the United States or elsewhere) with respect to any member of the M&O Group;
- (ii) in any Chapter 11 case involving any member of the M&O Group, acting to convert or seek to convert such case to a case under Chapter 7 of the Bankruptcy Code;
- (iii) causing any member of the M&O Group to borrow funds;
- (iv) causing any member of the M&O Group to pledge or charge any assets;
- (v) causing any member of the M&O Group to sell or dispose of any shares or other assets outside the ordinary course of business.

3. The Joint Administrators and the Debtor under the direction of the Joint Administrators shall attempt in good faith to obtain the prior consent of the Examiner and, if such consent is not given, shall obtain the approval of the Bankruptcy Court prior to:

- (i) replacing, firing, or materially reducing the operating responsibilities of Shaffer (Without otherwise detracting from the Joint Administrators' powers and authority as corporate governance of the Debtor);
- (ii) exercising the voting rights of the Debtor or the M&O Group with respect to stock of any member of the M&O Group, except that such consent or approval shall not be required to exercise the voting rights of stock of M&O Affiliates to the extent:
  - (1) the Joint Administrators have first consulted with the Examiner concerning such exercise; and
  - (2) such voting rights are not exercised in a manner inconsistent with the provisions, spirit or intent of this Order;
- (iii) filing a plan of reorganization under Chapter 11 for any member of the M&O Group (to the extent that any of them is the subject of a Chapter 11 case) during the period in which such member has the exclusive right to file a plan of reorganization and seek acceptance of such plan as provided in Section 1121 of the Bankruptcy Code;

- (iv) causing any member of the M&O Group to commence material legal proceedings;
- (v) except as provided in paragraph D, procuring the appointment of any director of any member of the M&O Group;
- (vi) causing the Debtor or any of its subsidiaries to take any action which is intended to or the reasonably anticipated consequences of which would have a material adverse impact on any significant member of the M&O Group.

- 4. The Joint Administrators may, without the prior consent of the Examiner and without giving prior notice to him, carry out investigations into the financial dealings of the members of the M&O Group provided that the Joint Administrators shall report on the details of such matters to the Examiner at weekly or such other intervals as may be agreed between the Joint Administrators and the Examiner.
- 5. With respect to the subsidiaries and affiliates of the Debtor that are not members of the M&O Group (the "Other Subsidiaries") or any other assets outside the M&O Group,
  - (a) The Joint Administrators and the Debtor under the direction of the Joint Administrators shall, in good faith, attempt to obtain the prior consent of the Examiner and shall obtain the approval of the Bankruptcy Court prior to:
    - (i) disposing of shares in any of the Other Subsidiaries or any other assets outside the M&O Group or cause any of the Other Subsidiaries to dispose

- of any assets, for a consideration, in any one case, in excess of £25,000,000;
- (ii) causing any of the Other Subsidiaries to borrow funds or pledge or charge any of its assets to secure indebtedness (if the aggregate of all such borrowings, pledges and charges for any single Other Subsidiary is in an amount exceeding £25,000,000 at any one time) or lend money to Other Subsidiaries (if the aggregate amount so loaned by any single Other Subsidiary shall exceed £25,000,000 at any one time); or
- (iii) causing any Other Subsidiary to commence a case under the Bankruptcy Code or file a petition for relief under Section 304 of the Bankruptcy Code.
- (b) The Joint Administrators and the Debtor under the direction of the Joint Administrators shall, in good faith attempt to obtain the prior consent of the Examiner and, if such consent is not given, shall obtain the approval of the Bankruptcy Court, prior to filing a plan of reorganization under Chapter 11 for any of the Other Subsidiaries (to the extent that any of them is the subject of a Chapter 11 case) during the period in which the relevant company has the exclusive right to file a plan of reorganization and to seek acceptance of such a plan as provided in Section 1121 of the Bankruptcy Code.
- (c) The Joint Administrators and the Debtor under the direction of the Joint Administrators may, subject to prior notification to the Examiner:

- (i) exercise the voting rights of the relevant company with respect to stock of any of the Other Subsidiaries other than to effect matters covered by Clause (d) below;
- (ii) dispose of shares in any of the Other Subsidiaries or any other assets outside the M&O Group, or cause any of the Other Subsidiaries to dispose of any assets, for a consideration, in any one case, in excess of £7,000,000 but not exceeding £25,000,000;
- (iii) cause any of the Other Subsidiaries to borrow funds or pledge or charge any of its assets to secure indebtedness (if the aggregate of all such borrowings, pledges and charges for any single Other Subsidiary is in an amount exceeding £7,000,000 but not exceeding £25,000,000 at any one time) or lend money to Other Subsidiaries (if the aggregate amount so loaned by any single Other Subsidiary is in an amount exceeding £7,000,000 but not exceeding £25,000,000 at any one time);
- (iv) cause any of the Other Subsidiaries to commence material legal proceedings;
- (v) commence, cause to be commenced or consented to, bankruptcy or insolvency proceedings with regard to any of the Other Subsidiaries.
- (d) The Joint Administrators and the Debtor under the direction of the Joint Administrators may without the prior consent of the Examiner and without giving prior notice to him:

- (i) cause any of the Other Subsidiaries to borrow funds or pledge or charge any of its assets to secure indebtedness (if the aggregate of all such borrowings, pledges and charges for any single Other Subsidiary is in an amount not exceeding £7,000,000 at any one time) or lend money to Other Subsidiaries (if the aggregate amount so loaned by any single Other Subsidiary is in an amount not exceeding £7,000,000 at any one time);
  - (ii) dispose of shares in any of the Other Subsidiaries or any other assets outside the M&O Group, or cause any of the Other Subsidiaries to dispose of assets, for a consideration, in any one case, not exceeding £7,000,000
  - (iii) cause any of the Other Subsidiaries to replace, fire or materially reduce the operating responsibilities of any executive officer; and
  - (iv) carry out investigations into the financial dealings of any of the Other Subsidiaries; provided that, with respect to each of the matters described in this paragraph G.5(d), the Joint Administrators shall report on the details of such matters to the Examiner at weekly or such other intervals as may be agreed between the Joint Administrators and the Examiner.
- (e) For the purposes of this Clause G.5, "consideration" in relation to the sale of shares means the consideration for the shares plus the amount of inter-company debt repaid.
6. The Joint Administrators and the Examiner confirm that (i) the objective of the parties is for the Debtor's Chapter 11 plan and the Joint Administrators' proposals

In the Administration to provide for essentially similar arrangements with respect to the M&O Group, (ii) during the period specified in paragraph G.1(iii), the Examiner will be consulted with respect to and be involved in the formulation and negotiation of any plan of reorganization in Chapter 11 that the Debtor under the direction of the Joint Administrators or the Joint Administrators propose to file at any time and after such period the Joint Administrators will keep the Examiner informed of any plan and will consult with the Examiner with respect to the formulation thereof, and (iii) Shaffer (subject to paragraph G.3(f) hereof) will also be consulted with, and his views will be considered, with respect to any such plan.

Dated: January 15, 1992  
New York, New York

\_\_\_\_\_  
\_\_\_\_\_  
/s/ Richard Gitlin  
Richard Gitlin, Examiner

\_\_\_\_\_  
\_\_\_\_\_  
/s/ Andrew Mark Homan  
The Joint Administrators  
by Andrew Mark Homan



UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

----- x  
In re : Chapter 11  
AIOC CORPORATION and : Case Nos. 96 B 41895  
AIOC RESOURCES AG, : and 96 B 41896 (TLB)  
: Debtors. (Jointly Administered)  
: ----- x

**ORDER  
AUTHORIZING CHAPTER 11 TRUSTEE OF AIOC RESOURCES AG  
TO EXECUTE CROSS-BORDER LIQUIDATION PROTOCOL  
WITH THE SWISS BANKRUPTCY OFFICE**

Upon the motion (the "Motion") of Edward G. Moran, chapter 11 trustee (the "Trustee") in the cases of AIOC Corporation and AIOC Resources AG (collectively, the "Debtors"), for an order of this Court pursuant to sections 105(a) of title 11 of the United States Code, authorizing the Trustee to execute that certain agreement between the Trustee and the Swiss Bankruptcy for the Canton of Zug, Switzerland (the "Swiss Bankruptcy Office") entitled "Cross-Border Liquidation Protocol For AIOC Resources AG, et al.," a copy of which is attached in its substantially final form as Exhibit 1 to this order (the "Protocol"); and it appearing from the affidavit of service filed with this court that due and sufficient notice of the Motion has been given to the United States Trustee, Counsel to the Official Committee of Unsecured Creditors and all parties who have requested notice pursuant to Rule 2002 of the Federal Rules of Bankruptcy Procedure; and a hearing having been held before this Court (the "Hearing"); and based upon the pleadings herein, the evidence presented at the Hearing and the arguments of counsel; and due deliberations having been had thereon; and

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this Court having rendered its decision at the Hearing, which decision, findings of fact and conclusions of law are hereby incorporated herein by reference as if fully set forth herein; NOW THEREFORE,

IT IS HEREBY FURTHER ORDERED, that the relief sought in the Motion is granted in its entirety; and

IT IS HEREBY FURTHER ORDERED, that the Trustee is authorized and directed to execute the Protocol on behalf of AIOC Resources AG; and

IT IS HEREBY FURTHER ORDERED, that the Trustee is hereby authorized to take such actions and execute such documents as may be necessary and appropriate to implement and effectuate the Protocol; and

IT IS HEREBY FURTHER ORDERED, that the requirement in Rule 9013-1(b) of the Local Rules for the United States Bankruptcy Court for the Southern District of New York that any application filed shall have an accompanying memorandum of law is hereby waived and dispensed with.

Dated: New York, New York  
April 3, 1998

/s/ Tina L. Brozman  
UNITED STATES BANKRUPTCY JUDGE

AIOC CORPORATION and AIOC RESOURCES AG PROTOCOL

APPENDIX C



CROSS-BORDER LIQUIDATION PROTOCOL  
FOR AIOC RESOURCES, AG, et al.

I. OVERVIEW

Mr. Edward G. Moran, the duly appointed trustee (the "Chapter 11 Trustee" and, alternatively, a "Party") in the bankruptcy cases of AIOC Corporation ("Corp.") and AIOC Resources AG ("Resources" and, collectively, the "Chapter 11 Debtors") pending in the Southern District of New York with assigned case numbers 96-B 41895 (the "Corp. Chapter 11 Case") and 96-B-41896 (the "Resources Chapter 11 Case" and, collectively, the "Chapter 11 Cases"), and the Bankruptcy Office for the Canton of Zug, Switzerland (the "Swiss Bankruptcy Office," alternatively, a "Party" and, collectively with the Chapter 11 Trustee, the "Parties"), the duly appointed trustee in the case of Resources pending in the Kanton of Zug Switzerland with the assigned case number 1996/180 (the "Swiss Proceeding") hereby agree, subject to (i) entry by the Bankruptcy Court (defined below) of a final Order approving this agreement and (ii) the decision of the Swiss Bankruptcy Office to approve this agreement being (a) transmitted by letter to the

creditors that have filed<sup>1</sup> claims in the Swiss Proceeding and (b) approved in accordance with the laws of Switzerland, as follows:

A. The Chapter 11 Cases were commenced as plenary proceedings by the filing of involuntary petitions on April 11, 1996 with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). The Chapter 11 Cases were assigned to the Honorable Tina L. Brozman, Chief United States Bankruptcy Judge of the Bankruptcy Court. By Order of the Bankruptcy Court dated September 17, 1996, the Chapter 11 Trustee was vested with the authority to act as the corporate governance of the Chapter 11 Debtors.

B. The Swiss Proceeding was commenced by the filing of an involuntary petition on August 13, 1996 before the district court for the canton of Zug, Switzerland (the "Swiss Court"). Thereafter, the Swiss Court referred the Swiss Proceeding to the Swiss Bankruptcy Office for administration as a plenary proceeding pursuant to the laws of Switzerland. The Swiss Bankruptcy Office assigned the Swiss proceeding to Herr Bernhard Häusler for administration.

C. The Chapter 11 Trustee and the Swiss Bankruptcy Office each need to analyze under United States, Swiss and other

---

<sup>1</sup> Throughout this Agreement, a claim that has been filed is deemed to include, but not be limited to, claims which have been filed in either the Resources Chapter 11 Case or the Swiss Proceeding whether or not such claim has been subsequently withdrawn.

applicable law their duties and responsibilities concerning the potential rights of the creditors and, where applicable, shareholders of the Resources Group (as defined below) and the Chapter 11 Trustee and Swiss Bankruptcy Office have agreed to work together in good faith to effectuate an orderly and equitable liquidation of the Resources Group.

D. The Chapter 11 Trustee and the Swiss Bankruptcy Office have each reviewed the principles proposed in the article of Committee J of the Section on Business Law of the International Bar Association entitled Cross-Border Insolvency Concordat (the "Concordat"), a copy of which is attached hereto as Exhibit A, and believe that an agreement upon general administrative matters is essential to the orderly and efficient administration of these cross-border insolvency proceedings.

E. The Chapter 11 Trustee and the Swiss Bankruptcy Office confirm that their objective in entering into this agreement is to harmonize the administration of the Chapter 11 Cases and the Swiss Proceeding in order:

(i) to promote international cooperation and respect for comity among the bankruptcy courts, the duly appointed representatives and any other competent authority involved in the Resources Chapter 11 Case and the Swiss Proceeding;

(ii) to facilitate, for the benefit of all of the creditors of Resources and other interested parties, wherever located, the fair and efficient administration of the Resources Chapter 11 Case and the Swiss Proceeding;

(iii) to establish a coordinated claims reconciliation process;

(iv) to establish a coordinated litigation strategy with respect to any matter which cannot be resolved through good faith efforts in the first instance;

(v) to establish a coordinated strategy to marshal and liquidate any remaining assets, wherever located, of Resources and/or any member of the Resources Group;

(vi) to establish a coordinated and fair mechanism for distributing assets to creditors of Resources which, inter alia, (a) is consistent with, to the extent possible, the laws of the United States and Switzerland that establish an entitlement for priority in distributions among unsecured creditors of these insolvency proceedings,<sup>2</sup> and (b) provides an essentially ratable distribution, to the extent possible, to creditors of Resources wherever located;

(vii) to adopt a framework of general principles to address issues that are likely to arise in connection with the administration of these cross-border insolvency proceedings.

F. The Chapter 11 Trustee and the Swiss Bankruptcy Office shall exercise their powers and authority in accordance with paragraphs III-VI hereof.

## II. GENERAL PROVISIONS

A. Annexed hereto as Schedule 1 is a list of all known subsidiaries or affiliates of Resources (collectively, and as may be varied from time to time by further agreement between the Chapter 11 Trustee and the Swiss Bankruptcy Office, the "Resources Group"). The members of the Resources Group that are incorporated under the laws of Switzerland are each identified

<sup>2</sup> See, e.g., 11 U.S.C. § 507; Article 219 of the Swiss Debt Enforcement and Bankruptcy Law.

with an asterisk on Schedule 1 and shall be referred to as a "Swiss Subsidiary" and collectively, the "Swiss Subsidiaries". All other members of the Resources Group listed on Schedule 1 shall be referred to as a "Non-Swiss Subsidiary" and collectively, the "Non-Swiss Subsidiaries".

B. Annexed hereto as Schedule 2 is a list of entities that are prepetition commercial lenders to the Resources Group (collectively, the "Resources Banks"). The Resources Banks that are organized under the laws of Switzerland are each identified with an asterisk on Schedule 2, and shall be referred to as a "Swiss Bank" and collectively, the "Swiss Banks". All other Resources Banks listed on Schedule 2 shall be referred to as a "Non-Swiss Bank" and collectively, the "Non-Swiss Banks".

C. In furtherance of principle 4C of the Concordat, the Chapter 11 Trustee will seek approval of the Bankruptcy Court and the Swiss Bankruptcy Office will take whatever actions are required under Swiss law to have any and all claims allowed in one proceeding recognized in both the Resources Chapter 11 Case and the Swiss Proceeding without the need for additional filings by any creditor that has not filed a claim in both proceedings.<sup>3</sup> Towards that end, the Chapter 11 Trustee and the Swiss Bankruptcy Office shall exchange periodically a register of the

<sup>3</sup> Principle 4C of the Concordat provides in relevant part that "[a] claim should be filed in one, and only one, plenary forum, at the election of the holder of the claim."

claims filed in the Resources Chapter 11 Proceeding and the Swiss Proceeding.

D. In furtherance of Principle 4C of the Concordat, if a claim has been filed in both the Resources Chapter 11 Proceeding and the Swiss Proceeding, either in the same or a different amount and/or priority, following the allowance of such claim, the holder of such claim shall be entitled to (i) a distribution from assets of Resources, wherever located, as though a single claim had been filed in either proceeding, and (ii) a ratable recovery from assets of Resources not greater than would be permitted under the laws of both the United States and Switzerland.<sup>4</sup>

E. Where notice is required to be given, notice shall be afforded in writing, and a Party shall provide advance notice to the other Party in accordance with the law governing the respective case in which the Party is appointed unless circumstances reasonably prevent the giving of such advance notice and, in such event, subject to providing notice as soon thereafter as practicable.

F. In furtherance of principle 3A, 3C and 3D of the Concordat, each Party, any creditor of Resources and the Official Committee of Unsecured Creditors in the Chapter 11

<sup>4</sup> Principle 4C of the Concordat provides in relevant part that "[i]f a claim is filed in more than one plenary forum, distribution must be adjusted so that recovery is not greater than if the claim were filed in only one forum."

Cases shall have the right, but not the obligation, to (i) appear in all proceedings in the Resources Chapter 11 Proceeding and in the Swiss Proceeding, to the extent such action shall not be inconsistent with local law, and (ii) have access to all documents which are of public record in any proceeding.<sup>5</sup>

G. Where a transaction shall require the computation of an amount in both U.S. Dollars and Swiss Francs, the foreign currency exchange rate to be applied to such transaction shall be the midrange of the Swiss Franc to U.S. Dollar conversion rate for August 13, 1996. This rate shall be deemed to be 1.2035 Swiss Francs to 1 U.S. Dollar.

H. Where a transaction calls for funds to be transferred to Resources, such funds shall be (i) maintained in an interest bearing account located in Switzerland if the funds being transferred arise from a source within Switzerland, (ii) maintained in an interest bearing account located in the United States if the funds being transferred arise from a source within the United States, and (iii) maintained in an interest bearing account to be determined by the Parties on a case-by-case basis in all other instances.

<sup>5</sup> Principle 3C of the Concordat provides in relevant part that "[a]ll creditors should have the right to appear in any forum to the same extent as creditors of the forum state, . . . without subjecting themselves to jurisdiction in that forum . . ." Principle 3D of the Concordat provides in relevant part that "[i]nformation publicly available in any forum shall be publicly available in all fora."

I. Nothing in this agreement shall prevent the Bankruptcy Court and the Swiss Court from refusing to approve or take an action required by this agreement if such action would be manifestly contrary to public policy.

J. In case a matter is not specifically provided for herein, the parties shall act in a manner designed to promote the goals of Paragraph I(E) hereof.

### III. RESOURCES PROVISIONS

A. The Chapter 11 Trustee and the Swiss Bankruptcy Office will jointly oversee and administer the orderly winddown of Resources. For the avoidance of doubt, except as otherwise provided for herein, transactions relating to the disposition of Resources' assets will be subject to the joint jurisdiction of the Bankruptcy Court and the Swiss Bankruptcy Office.

B. Each Party shall attempt in good faith to obtain the consent of the other Party prior to taking any of the following actions:

1. disposing of shares or interests in any entity in the Resources Group or causing Resources to dispose of any assets;
2. seeking or consenting to the substantive consolidation (or merger, if applicable) of Resources with any other entity;
3. causing Resources or any entity in the Resources Group to take any action which is intended to or the reasonably anticipated consequences of which would have a material adverse impact on any member of the Resources Group.

C. Notwithstanding the preceding two paragraphs, any Party may act without the prior consent of the other Party as though such consent were given and (except as otherwise provided herein) without giving prior notice to the other Party on any matter which does not require notice to be given to interested parties under the law governing the respective case in which the Party is appointed.

D. The Parties shall coordinate mechanisms for providing distributions and recoveries to creditors of Resources wherever located whether such distributions and recoveries are accomplished pursuant to a plan of reorganization,<sup>6</sup> distribution plan and final account, or otherwise.

E. The claims reconciliation process for claims filed in the Resources Chapter 11 Case<sup>7</sup> and/or in the Swiss Proceeding shall be administered as follows:

1. Non-Bank Claims

a. Delegation of Responsibilities: The Chapter 11 Trustee shall administer the claims reconciliation process (as more fully described in paragraph III(E)(1)(c) hereof) for claims filed in the Resources Chapter 11 Case only. The Swiss Bankruptcy Office shall administer the claims reconciliation process (as more fully described in paragraph

III(E)(1)(c) hereof) for all claims filed in the Swiss Proceeding only. The Parties shall jointly determine which Party shall administer the claims reconciliation process (as more fully described in paragraph III(E)(1)(c) hereof) for the claims of creditors, where any such creditor actually filed claims in both the Resources Chapter 11 Case and the Swiss Proceeding.

b. Choice of Law: The claims reconciliation process shall be administered in accordance with the procedural and substantive laws (both bankruptcy and nonbankruptcy) governing the respective case in which the Party is appointed unless considerations of comity otherwise require.

c. Duties: Each Party's authority and responsibility shall include, but not be limited to, the right to:

- (1) reconcile the amount of any asserted claim;
- (2) review the validity of any asserted lien or priority with respect to an asserted claim;
- (3) fix and allow the amount and priority of asserted claims in accordance with paragraph III(E)(3)(a) hereof;
- (4) object to asserted claims, if necessary.

<sup>6</sup> See, e.g., 11 U.S.C. § 1129.

<sup>7</sup> For the avoidance of doubt, this Agreement is not intended to nor shall it be construed to alter the Chapter 11 ... (continued)

(continued)

Trustee's duty to reconcile the claims filed in the Corp. Chapter 11 Case.

2. Bank Claims

a. Delegation of Responsibilities: The Chapter 11 Trustee shall and the Swiss Bankruptcy Office agrees to coordinate the administration of the claims reconciliation process (the "Bank Reconciliation Process") (as more fully described in paragraph III(E)(2)(b) hereof) with respect to all claims of the Resources Banks. The Chapter 11 Trustee shall have primary responsibility for administering the claims reconciliation process (as more fully described in paragraph III(E)(2)(b) hereof) of the Resources Banks who have filed a claim or claims in the Resources Chapter 11 Case, irrespective of whether such creditors have also filed claims in the Swiss Proceeding. The Swiss Bankruptcy Office shall have primary responsibility for administering the claims reconciliation process (as more fully described in paragraph III(E)(2)(b) hereof) of any Resources Bank which has filed a claim in the Swiss Proceeding only; provided, however, that the Chapter 11 Trustee shall, where appropriate, actively assist the Swiss Bankruptcy Office in any endeavor contemplated by paragraph III(E)(2)(b)(1) and III(E)(2)(b)(2) hereof.

b. Duties: Each Party's authority and responsibility shall include, but not be limited to, the right to:

(1) reconcile the amount of any asserted claim;

(2) review the validity of any asserted lien or priority with respect to an asserted claim;

(3) fix and allow the amount and priority of asserted claims in accordance with paragraph III(E)(3)(b) hereof;

(4) object to asserted claims, if necessary.

3. Procedures For Fixing And Allowing Claims:

a. Non-Bank Claims: Further to Paragraph III(E)(1), any Party may fix and allow a claim in accordance with the laws of the jurisdiction in which the Party is appointed without the prior consent of the other Party and without giving prior notice to the other Party.

b. Bank Claims:

(1) Where a Resources Bank has filed a claim in both the Resources Chapter 11 Proceeding and in the Swiss Proceeding, any compromise reached between the Chapter 11 Trustee and such Resources Bank shall (a) include as a condition of effectiveness that the compromise is subject to (i) final court approval in the Resources Chapter 11 Case, and (ii) final approval in the Swiss Proceeding, and (b) be consummated according to the following procedures:

(a) Bankruptcy Court approval of a compromise shall be obtained first in accordance with the relevant provisions of the Bankruptcy Code and the Bankruptcy Rules.

(b) Promptly after receiving notice of the entry of an order of the Bankruptcy Court approving the compromise, the Resources Bank shall: (i) file an amended claim in the Swiss Proceeding (the "Amended Swiss Claim") which lists, as the amount of the claim, the Swiss currency equivalent (employing the Currency Exchange Rate) of the compromised amount, and (ii) provide notice of the filing of the Amended Swiss Claim to the Chapter 11 Trustee and the Swiss Bankruptcy Office.

(c) Promptly thereafter, the Swiss Bankruptcy Office shall publish notice in accordance with the laws of Switzerland that (i) the Amended Swiss Claim, filed by the respective Resources Bank in connection with the proposed compromise, was accepted by the Swiss Bankruptcy Office, and (ii) interested parties shall have the opportunity to be heard in opposition to the proposed compromise for a period of time prescribed by the laws of Switzerland. At the earliest opportunity after the conclusion of the noticed period, the Swiss Bankruptcy Office shall advise the Chapter 11 Trustee whether the proposed compromise is finally approved under Swiss law.

(d) Promptly after notification to the Chapter 11 Trustee by the Swiss Bankruptcy Office that the proposed compromise is finally approved under Swiss law, the Chapter 11 Trustee shall advise the respective Resources Bank in

writing that the conditions of effectiveness have been satisfied, and of the effective date of the compromise.

(e) If the Swiss Bankruptcy Office notifies the Chapter 11 Trustee that the proposed compromise is not approved under Swiss Law, the Chapter 11 Trustee shall advise the respective Resources Bank in writing that a condition of effectiveness has failed and that the proposed compromise shall be void and of no further force and effect. The Amended Swiss Claim shall be deemed withdrawn in the Swiss Proceeding.

(2) Where a Resources Bank has filed a claim in either proceeding, but not both proceedings, the Parties shall employ a claims adjustment process which (i) is similar (to the extent practicable) to the process set forth in paragraph III(E)(b)(i), and (ii) conforms to the requirements of the laws of the United States and the laws of Switzerland.

#### IV. Litigation and Investigations (Non-Claim Related)

The Chapter 11 Trustee and the Swiss Bankruptcy Office shall consult with respect to litigation strategy on a case-by-case basis. Where appropriate, the Parties shall have the right (consistent with the laws of the jurisdiction where a particular litigation is commenced) to pursue, or join in the pursuit of, claims or causes of action in either proceeding, provided, however that nothing contained herein shall limit any rights under substantive law of either the United States or Switzerland

or require the consent of the other with respect to the commencement of any litigation.

V. NON-SWISS SUBSIDIARY PROVISIONS

A. The Chapter 11 Trustee will oversee and administer the orderly winddown of the Non-Swiss Subsidiaries, with the assistance of the Swiss Bankruptcy Office where needed, and may act without the prior consent of the Swiss Bankruptcy Office as though such consent were given and without giving prior notice to the Swiss Bankruptcy Office on any matter which does not require notice to be given to interested parties under the law governing the Chapter 11 Trustee. The Chapter 11 Trustee shall attempt in good faith to obtain the consent of the Swiss Bankruptcy Office prior to:

1. disposing of shares in any Non-Swiss Subsidiary or causing any Non-Swiss Subsidiary to dispose of any assets;
2. commencing, causing to be commenced or consenting to, dissolution, bankruptcy or insolvency proceedings (whether in the United States, Switzerland or elsewhere) for any Non-Swiss Subsidiary;
3. causing any Non-Swiss Subsidiary to commence material legal proceedings.

B. The Chapter 11 Trustee shall where appropriate effect the appointment of new boards of directors for the Non-Swiss Subsidiaries.

VI. SWISS SUBSIDIARY PROVISIONS

A. The Swiss Bankruptcy Office will oversee and administer the orderly winddown of the Swiss Subsidiaries, with the assistance of the Chapter 11 Trustee where needed, and may act without the prior consent of the Chapter 11 Trustee as though such consent were given and without giving prior notice to the Chapter 11 Trustee on any matter which does not require notice to be given to interested parties under Swiss law. The Swiss Bankruptcy Office shall attempt in good faith to obtain the consent of the Chapter 11 Trustee prior to:

1. disposing of shares in any Swiss Subsidiary or causing any Swiss Subsidiary to dispose of any assets;
2. commencing, causing to be commenced or consenting to, dissolution, bankruptcy or insolvency proceedings (whether in the United States, Switzerland or elsewhere) for any Swiss Subsidiary;
3. causing any Swiss Subsidiary to commence material legal proceedings.

B. In furtherance of paragraph VI(A)(2), should the Swiss Bankruptcy Office consider it appropriate to commence insolvency or other similar proceedings in respect of all or any of the Swiss Subsidiaries, the Chapter 11 Trustee shall be authorized, if he deems it appropriate under the circumstances and the governing provisions of the Bankruptcy Code, to cause the commencement of a parallel proceeding in the United States for such Swiss Subsidiary and to apply to the Bankruptcy Court for



an Order appointing the Chapter 11 Trustee to serve as chapter 11 trustee in such case.

VII. CORP. PROVISIONS

A. The Chapter 11 Trustee will oversee and administer the orderly winddown of Corp. and may act without the prior consent of the Swiss Bankruptcy Office and without giving notice to him, except that the Chapter 11 Trustee shall provide notice to the Swiss Bankruptcy Office prior to:

1. seeking or consenting to the substantive consolidation (or merger if applicable) of Corp. with Resources or any Swiss Subsidiary;
2. causing Corp. to take any action which is intended to, or the reasonably anticipated consequences of which would, have a material adverse impact on Resources or any Swiss Subsidiary;
3. causing Corp. to (i) obtain confirmation of a plan of reorganization, or (b) convert or consent to the conversion of the Corp. Chapter 11 case to a case under Chapter 7 of the Bankruptcy Code.

Dated: \_\_\_\_\_  
Zug, Switzerland

\_\_\_\_\_  
Edward G. Moran

Dated: \_\_\_\_\_  
Zug, Switzerland

\_\_\_\_\_  
Bernard Häusler

Witness: \_\_\_\_\_  
Michael N. Gottfried, Esq.

SCHEDULE 1  
THE RESOURCES GROUP

AIOC Trading AG\*  
(Zug, Switzerland)

AIOC Alloys Ltd\*  
(Zug, Switzerland)

Saunders Trading (formerly Sibalco Ltd.)  
(Grand Cayman, BWI)

AIOC Africa Properties (Pty) Ltd  
(Johannesburg, South Africa)

AIOC Ferrous GmbH\*  
(Zug, Switzerland)

AIOC Brasil Limitada  
(Rio de Janeiro, Brazil)

AIOC Trading AOZT  
(Moscow, Russia)

AIOC Japan Limited  
(Tokyo, Japan)

AJ Resources AB  
(Sweden)

AIOC Ore & Metals AB  
(Sweden)

AIOC UK Limited  
(London, England)

AIOC Ore & Metals GmbH  
(Cologne, Germany)

AIOC Ore & Metals AG \*  
(Lugano, Switzerland)

Sakoc Trading AG\*  
(Zug, Switzerland)

SCHEDULE 2  
The Resources Banks

	U.S. Proceeding Proof of Claim #	Swiss Claim
Banque Bruxelles Lambert (Suisse) SA	89	Yes
Banque Commerciale Pour L'Europe Du Nord	228	
Credit Agricole Indosuez F/K/A Banque Indosuez	181	
Banque Nationale De Paris	204	
Banque Nationale De Paris (Suisse)	258	Yes
Banque Paribas	196	
Banque Paribas (Suisse) SA	253	Yes
Bayerisches Vereinsbank	None Filed	
BHF Bank AG	251	
Caisse Nationale De Credit Agricole	256	
Credit Suisse	None Filed <sup>8</sup>	Yes
Generale Bank	185	
Hill Samuel Bank Ltd.	235	
ING Bank. N.V.	184	Yes
Investec	None Filed	
Kredietbank N.V.	206	Yes
Meespierson N.V.	90	
Moscow Narodny Bank Ltd.	218	Yes
Rand Merchant Bank	None Filed	
Societe Generale	248	
Swiss Bank Corporation	267	Yes
Toko Bank	271	
United Overseas Bank	132	Yes
Westdeutsche Landesbank Girozentrale	270	

<sup>8</sup> Credit Suisse has filed a claim in the Corp. Chapter 11 Case which claim has been designated as claim 268.



UNITED STATES BANKRUPTCY COURT  
DISTRICT OF NEW MEXICO

SEP 29 1997  
ALBUQUERQUE, NM

In re: Case No. 11-97-14361 MA

SOLV-EX Corporation  
a New Mexico corporation,  
85-0283729

Debtor.

MOTION TO APPROVE CROSS-BORDER INSOLVENCY PROTOCOL

COMES NOW the Debtor Solv-Ex Corporation, and moves this Court for an order approving and bringing into effect the terms of the proposed Cross-Border Insolvency Protocol (the "Proposed Protocol"), a copy of which is attached hereto as Exhibit "A", and as reasons therefor state:

1. This Court has inherent power pursuant to 11 U.S.C. 105(a) to enter such order, process or judgment as is necessary or appropriate to carry out the provisions of Title XI of the United States Bankruptcy Code.
2. By an order entered by the Court of Queens Bench of Alberta (the "Canadian Court") on July 14, 1997, Solv-Ex Corporation and Solv-Ex Canada Limited were each declared to be entities to which the *Companies Creditors Arrangement Act* (Canada) applies, and were authorized by the Canadian Court to file a formal plan of compromise or arrangement with their creditors. In turn, Solv-Ex Corporation and Solv-Ex Canada Limited filed voluntary petitions for reorganization with this Court on August 1, 1997 under Chapter 11 of Title 11 of the U.S.C.
3. The Canadian Court has previously given directions that a submission be made to it on a cross-border protocol to govern the relationship between the U.S. and Canadian reorganization proceedings and representations have in turn been made to this Court that such a cross-border protocol would be submitted to it.

4. The Debtor believes that approval of the Proposed Protocol by this Court, and the Canadian Court, will be in the best interest of the Debtor's Estate, will protect the interests of all parties affected by the U.S. and Canadian proceedings wherever located, and will protect the integrity of the process by which the U.S. and Canadian proceedings are administered

5. Furthermore, adoption of the Proposed Protocol will aid the efficacious reorganization of the Debtor and will serve judicial economy.

6. Concurrent approval of the Proposed Protocol is being sought in the Canadian Court and the Debtor will seek a joint hearing to be held by this Court and the Canadian Court, should any objections to the Proposed Protocol be filed.

7. Approval of the Proposed Protocol has been sought by circulating the same among the U.S. Unsecured Creditors Committee, United TriStar Resources Ltd., Koch Exploration Canada Ltd., the Canadian Unsecured Creditors Committee and Price Waterhouse, in its capacity as Monitor for Solv-Ex Corporation and Solv-Ex Canada Limited, in the Canadian proceeding.

WHEREFORE, the undersigned requests that this Court approve and bring into effect the terms of the Proposed Protocol.

Submitted by :  
HINKLE, COX, EATON, COFFIELD  
& HENSLEY, L.L.P.

By: Margaret C. Ludwig  
Margaret C. Ludwig  
John D. Phillips  
Attorneys for Solv-Ex Corporation  
and Solv-Ex Canada Limited  
500 Marquette NW, Ste. 800  
Albuquerque, NM 87102

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SOLV-EX CORPORATION PROTOCOL

APPENDIX D

I hereby certify that a true  
copy of the foregoing was mailed to:

Leonard Martinez-Metzgar  
P.O. Box 608  
Albuquerque, NM 87103-0608  
U.S. Trustee

James S. Starzynski  
Starzynski & Strauser, P.A.  
320 Gold Ave SW, Suite 800  
Albuquerque, NM 87102  
Attorney for the Unsecured  
Creditors Committee

this 29<sup>th</sup> day of December, 1997.

Margaret C. Ludwig

9750294/39124

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UNITED STATES BANKRUPTCY COURT  
DISTRICT OF NEW MEXICO

Chapter 11  
Case Nos. 11-97-14362-MA and  
11-97-1436-MA

In re:  
SOLV-EX CANADA LIMITED  
and SOLV-EX CORPORATION

The Honourable Judge Mark McFeeley,  
USBJ

DEBTORS

In the Court of Queen's Bench of Alberta  
Judicial District of Calgary

Case No. 9701-10022  
The Honourable Justice G.R. Forsyth

IN THE MATTER OF THE COMPANIES  
CREDITORS ARRANGEMENT ACT, R.S.C.  
1985, c.C-36, AS AMENDED

AND IN THE MATTER OF SOLV-EX  
CORPORATION AND SOLV-EX  
CANADA LIMITED

CROSS-BORDER INSOLVENCY PROTOCOL

WHEREAS Solv-Ex Canada Limited ("Solv-Ex Canada") is a corporation incorporated according to the laws of the Province of Alberta, in Canada, and Solv-Ex Corporation ("Solv-Ex") is a corporation incorporated according to the laws of the State of New Mexico in the United States of America (together, the "Corporations"); and

WHEREAS on July 14, 1997, the Corporations made application under the *Companies Creditors Arrangement Act* (Canada) (the "CCAA") for various kinds of relief (the "Canadian Proceedings"). By an order of the Court of Queen's Bench of Alberta (the "Canadian Court") made July 14, 1997, (the "CCAA Order") the Corporations were each declared to be entities to which the CCAA applies, and were permitted to file a formal plan of compromise or arrangement with their creditors, and if appropriate, shareholders by November 30, 1997, which date has been extended to February 15, 1998, or such other date as the Canadian Court might subsequently order; and

WHEREAS the CCAA Order was amended on July 23, 1997 to confirm the appointment of Price Waterhouse Limited as Monitor of the Corporations (the "Monitor"), with the rights, powers, duties and limitations upon liabilities set out in the CCAA Order; and

WHEREAS on August 1<sup>st</sup>, 1997, the Corporations filed voluntary petitions for reorganization (the "US Proceedings") in the United States Bankruptcy Court for the District of New

Mexico (the "US Court") under Chapter 11 of title 11, United States Bankruptcy Code, 11 U.S.C. (the "Bankruptcy Code"), and no trustee has been appointed in the US Proceedings and pursuant to Sections 1107 and 1108 of the Bankruptcy Code, the Corporations are continuing to operate their businesses and manage their properties as debtors-in-possession; and

WHEREAS in August of 1997 an Unsecured Creditors Committee was formed (the "US Creditors' Committee") and on August 15, 1997 the Canadian Court directed the creation of a committee of the Corporations' Canadian creditors (the "Canadian Creditors' Committee"); and

WHEREAS the Canadian Court has given directions that submissions be made to it on a cross-border Protocol to govern the relationship between the US and Canadian reorganization proceedings, and representations have been made to the US Court that such a cross border protocol likewise would be submitted to it; and

WHEREAS Solv-Ex Canada is the general partner and a limited partner in the Solv-Ex Canada Limited Partnership (the "Solv-Ex LP"); and

WHEREAS the relative interests of Solv-Ex Canada, Solv-Ex and the Solv-Ex LP in and to certain leases, and the improvements and equipment located thereon, located near the Town of Fort McMurray (the "Fort McMurray Project") are as yet undetermined, as are the liabilities each has incurred in connection therewith; and

WHEREAS United Tristar Resources Ltd. ("UTS") holds a 10% interest in certain leases related to the Fort McMurray Project, as well as being a 10% limited partner in the Solv-Ex LP; and

WHEREAS the Corporations, UTS and the Solv-Ex LP have entered into an agreement with Koch Exploration Canada Ltd. ("Koch") for the sale of a significant portion of the Fort McMurray Project, and it is currently anticipated that such a sale will occur which will enable the Corporations to propose a distribution and/or a restructuring of debt to parties having valid secured and unsecured claims, including valid contingent claims (such parties hereinafter referred to together as "Claimants"); and

WHEREAS a framework of general principles should be agreed upon to address, among other things, issues that are likely to arise in connection with the cross-border insolvency proceedings of the Corporations, including, without limitation, (a) the sale to Koch; (b) the determination of claims asserted against the Corporations, and the allowability and priority status of such claims; (c) the manner in which claims arising in different jurisdictions should be classified and dealt with; (d) harmonizing the filing and implementation of a plan of reorganization under the Bankruptcy Code and a plan of arrangement under the CCAA for each of the Corporations; and (e) general administrative matters; and

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WHEREAS the purpose of this Protocol is to protect the interests of all parties affected by the US and Canadian Proceedings wherever located and to protect the integrity of the process by which the US and the Canadian Proceedings are administered; and

NOW THEREFORE, the following terms and provisions shall apply to the US Proceedings and the Canadian Proceedings:

1. The Corporations will coordinate actions taken in the US and Canadian Proceedings.
2. In addition to effecting notice of any motion upon creditors and other interested parties in accordance with the practice of the court in which the motion is brought, the Corporations, the US Trustee, the US and Canadian Creditors' Committees, Koch and the Monitor, and any other official representative that may be appointed by the US Court or the Canadian Court, shall receive notice of all proceedings. Except as otherwise set forth herein, the Corporations shall be subject to jurisdiction in both fora for any matter related to the US and Canadian proceedings.
3. The Corporations shall act in a manner consistent with the terms of the CCAA, the Bankruptcy Code, and the CCAA Order, as amended, and in addition:
  - (a) There shall be no further sales or dispositions of material assets of the Corporations in the US or Canada without approval of both of the US and Canadian Courts. For purposes of this Protocol a material asset shall be an asset having a realizable value to the Corporations in excess of \$40,000 (US) or the equivalent amount in Canadian currency;
  - (b) The Corporations shall provide such prior advance notice of an application for joint approval of a sale or disposition of material assets, together with an application for directions as to the use of the proceeds of such sale, as is reasonably practicable under the circumstances and as may be required by the rules of the respective Courts and paragraph 2 hereof.
  - (c) Subject to the terms of the above referenced sale to Koch, and the obtaining of any necessary orders of the US Court, the Corporations shall be entitled to sell non-material assets without an order of either Court provided that such sales shall be at arm's length and commercially reasonable. The net proceeds of any such sales shall be paid to and dealt with by the Monitor for purpose of making payment of ongoing operating and other allowable expenses of the Corporations.
4. All claimants and other interested parties shall have the right to appear in any forum to the same extent as claimants and other interested parties domiciled in the forum state, regardless of whether they have filed claims in that particular forum provided, however, that such appearance or participation may subject such claimant or interested party to the jurisdiction

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of the Court in which the notice or appearance is filed or made.

5. The US and Canadian Courts may conduct joint hearings with respect to any matter related to the conduct, administration, determination or disposition of any aspect of the Canadian or US Proceedings where considered by both Courts to be necessary or advisable and in particular, without limiting the generality of the foregoing, to facilitate or coordinate the proper and efficient conduct of the US and Canadian Proceedings. With respect to any such hearings, unless otherwise ordered, the following directions are made:
  - a) A telephone link shall be established such that both Courts shall be able to simultaneously hear the proceedings in the other Court.
  - b) Any party intending to rely upon any written evidentiary material in support of a submission to the Canadian Court or the US Court in connection with any joint application shall file materials, which shall be identical insofar as possible and shall be consistent with the procedural and evidentiary rules and requirements of each Court, in advance of such application. If a party has not previously appeared in or attorned, or does not wish to attorn to the jurisdiction of either Court it shall be entitled to file such material without, by the act of filing, being deemed to have attorned to the jurisdiction of the Court in which such material is filed, so long as it does not request in its materials or submissions any affirmative relief from the Court to which it does not wish to attorn.
  - c) Submissions or applications by any party shall be made only to the Court in which it is appearing unless specifically given leave by the other Court to make submissions or applications to it.
  - d) The Justice of the Canadian Court and the Judge of the U.S. Court who will hear any such application shall be entitled to communicate with one another in advance of the said applications, without counsel being present, to establish guidelines for the orderly making of submissions and rendering of decisions by the Canadian and the U.S. Courts, and to deal with any other procedural, administrative or preliminary matters.
  - e) The Justice of the Canadian Court and the Judge of the U.S. Court, having heard any such application, shall be entitled to communicate with one another after any such application, without counsel present, for the purpose of determining whether consistent rulings can be made by both this Court and the U.S. Court, and the terms upon which such rulings should be made, and to deal with any other procedural or non-substantive matter in relation to such applications.
6. In order to be entitled to participate in or vote upon any Plan of Arrangement or Plan of Reorganization, claimants must file proofs of their claims in accordance with the following procedure:
  - (a) The claim of a claimant will be dealt with in all respects, including all issues of quantification, allowance or disallowance, classification and treatment of those

claims in any plan of arrangement, in the Canadian Proceedings, and shall be governed by Canadian substantive and procedural law if:

- (i) the claim arises from the supply of goods and/or services directly to the Corporations or either of them in Canada;
- (ii) the claim arises from or in connection with a charge, secured claim or security interest over real or personal property of the Corporations or either of them granted or created under Canadian law;
- (iii) the claim arises out of a tort committed in Canada;
- (iv) the claim arises in respect of real property located in Canada;
- (v) the claim arises in respect of a contract which is by its terms or by implication governed by Canadian law.

unless the claims against the Corporations have a substantial connection, as that term is understood under the principles of private international law, with the US or another jurisdiction;

- (b) The claims of all other claimants will be dealt with in all respects, including all issues of quantification, allowance or disallowance, classification and treatment of those claims in any plan of arrangement, in the US Proceedings, and shall be governed by US substantive and procedural law, unless their claims against the Corporations have a substantial connection, as that term is understood under the principles of private international law, with Canada;
- (c) Notwithstanding anything contained elsewhere in this Protocol it shall be irrelevant to the determination of where claims are to be adjudicated that the Corporations have disallowed a claim, or that a claimant has participated in any way in the proceedings in either jurisdiction whether by filing a Claim, an objection to a Disallowance of that claim, a Motion for an Order valuing the claim, or otherwise;
- (d) If, in the case of a claim filed in Canada, the Corporations conclude that the claim should under this Protocol be dealt with in the US Proceedings, the Corporations may forthwith transmit the claim documents to the US, and immediately notify the claimant that its claim will be transferred to and dealt with in the US Proceedings. If such claim was, at the date the notice of transfer was issued by the Monitor, properly filed in the Canadian Proceedings, the Corporations shall treat the claim as having been properly filed in the US notwithstanding that such claim might not have been filed in the US Proceedings, either in a timely manner or at all, and shall, subject to (f) below, in all respects be entitled to treat the claim as if it had originally been filed in the US Proceedings;
- (e) If, in the case of a claim filed in the US, the Corporations conclude that the claim should under this Protocol be dealt with in the Canadian Proceedings, the Corporations may forthwith transmit the claim documents to Canada, and immediately notify the claimant that its claim will be transferred to and dealt with in

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the Canadian Proceedings. The Monitor shall treat the claim as having been properly filed in Canada notwithstanding that such claim might not have been filed in the Canadian Proceedings, either in a timely manner or at all, and shall subject to (f) below, in all respects be entitled to treat the claim as if it had originally been filed in the Canadian Proceedings;

- (f) Any claimant wishing to object to its claim having been transferred to the other jurisdiction pursuant to paragraphs (d) or (e) above must file an objection to the transfer of the claim in the appropriate court in the jurisdiction from which the claim has been transferred within 18 days after mailings of notice of transfer, which notice shall inform said claimant of the 18 day time limit, failing which it shall be conclusively deemed to have accepted the transfer;
- (g) Each individual claim shall be dealt with by one of the US or Canadian Courts, but not both. A claimant with two or more separate and distinct claims, which under this Protocol should be dealt with in different jurisdictions, shall prove each claim in the appropriate jurisdiction;
- (h) The Corporations shall review and deal with all proofs of claim properly submitted in Canada or transferred to Canada pursuant to this Protocol in accordance with usual procedures under the CCAA and the terms of any plan of arrangement. The Corporations shall review and deal with all other proofs of claim in accordance with applicable laws of the US and the terms of any plan of reorganization;
- (i) Claims procedures for the Corporations shall be conducted pursuant to the Bankruptcy Code, in the US, and pursuant to the CCAA and direction of the Canadian Court, in Canada, and in each case disallowance procedures and appeals therefrom shall be governed by the laws of the jurisdiction in which the claim is to be dealt with pursuant to this Protocol;
- (j) Appeals from disallowance of claims shall be dealt with by the appropriate court in the jurisdiction in which a claim is proven or to which it may be transferred under this Protocol in accordance with the law and usual practices in that jurisdiction and as provided under any plan of arrangement or plan of reorganization.
- (k) The validity and quantum of any contingent or unliquidated claim upon which litigation was commenced in Canada prior to July 14<sup>th</sup>, 1997, and in the US or elsewhere prior to August 1<sup>st</sup>, 1997, shall, notwithstanding anything else herein be determined by the courts of the jurisdiction in which such litigation was commenced unless the Corporations elect to move the litigation, or have such claims determined, elsewhere pursuant to a right to do so under the Bankruptcy Code or otherwise.
- (l) Notwithstanding anything contained elsewhere in this paragraph 6, the Corporations'



objections to the claims of Gee & Co. and ABN Amro Bank (Switzerland) A.G. (together, the "ABN/Gee Claims"), if any, shall be heard by the US Court pursuant to the Bankruptcy Code's claims objection procedures. The determination of the Corporations' objections to the ABN/Gee Claims shall be limited to the validity of the ABN/Gee Claims under applicable non-bankruptcy law, and shall not involve considerations of the rights of Gee & Co. and ABN Amro Bank (Switzerland) A.G. under the CCAA or the Canadian Proceedings. The US Court's ruling on the Corporations' objections to the ABN/Gee Claims shall be binding upon Gee & Co. and ABN Amro Bank (Switzerland) A.G. and the Corporations in the Canadian Proceedings, under the common law principles of res judicata. Once the US Court has ruled on the Corporations' objections to the ABN/Gee Claims, the ABN/Gee Claims, if allowed, shall be treated in the plans of reorganization filed in the US and Canada in accordance with the agreement of the parties or as determined by further order of the US and Canadian Courts, to be determined at a joint hearing of the US and Canadian Courts.

7. Claims that have been finally allowed, settled, disallowed or determined by the Corporations or the Courts in one jurisdiction shall be recognized by the Corporations as having been likewise allowed, settled, disallowed or determined in the other jurisdiction in the same amount, and the Corporations shall take all appropriate or necessary steps to obtain recognition of such claims in the other jurisdiction.
8. The court adjudicating upon any disputed or contingent claim shall decide the value, allowability, priority and eligibility to vote of such claims filed using a choice of law analysis based upon the choice of law principles applicable in that forum. A claimant's rights to collateral and set-off will be determined under the choice of law principles applicable in that forum. No person will be subject to a forum's substantive rules unless under the choice of law principles applicable in that forum such persons would be subject to the forum's substantive laws in a lawsuit on the same transaction in a non-insolvency proceeding.
9. To the extent permitted by the laws of the respective jurisdictions and to the extent practicable, the Corporations shall submit a plan of arrangement in Canada and a plan of reorganization in the United States substantially similar to each other. The Corporations shall coordinate all procedures in connection therewith, including, without limitation, all solicitation proceedings relating thereto, and all procedures regarding voting, the treatment of creditors, classification of claims, and the like, and all such procedures will either be established by the Corporations after consultation with the Monitor or set by applicable law or further orders of the US Court and the Canadian Court. In order to co-ordinate the contemporaneous filing of plans of arrangement and plans of reorganization the Corporations shall take the actions necessary to seek extensions of the date for the filing of the plans of arrangement under the CCAA, and of the exclusive time period during which only the Corporations may file a plan of reorganization pursuant to Section 1121 of the Bankruptcy Code.

10. Except with respect to matters where the Monitor appears before the US Court pursuant to paragraph 2 hereof, the Canadian Court shall have sole jurisdiction and power over the Monitor, including without limitation, its tenure in office, the retention and compensation of the Monitor and other Canadian professionals, the extent of its liability to the Corporations and third parties, and the hearing and determination of matters arising in the Canadian Proceedings under Canadian law. The Monitor and the Monitor's counsel shall be compensated for their services in accordance with Canadian law, such that the Monitor and the Monitor's counsel are not required to file fee applications in the US Court.
11. The Monitor and its employees, counsel and agents, including those retained in the US, shall be entitled to the same protections and immunities in the US as those granted to them under the CCAA Order, and in particular the Monitor and its employees, counsel and agents shall, except as specifically otherwise provided in any order made in the Canadian Proceedings, incur no liability or obligation as a result of the making of the CCAA Order, as amended, the appointment of the Monitor or carrying out of the provisions of such order, save and except that the Monitor shall be liable for gross negligence or willful misconduct on its part.
12. The US Court shall have sole jurisdiction and power over the conduct of the US Proceedings, the compensation of professionals rendering services to the Corporations in the US and the US Creditors' Committee, and the hearing and determination of matters arising in the US Proceedings.
13. A plan of arrangement, in Canada, and a plan of reorganization, in the US, shall be binding upon claimants in the US and Canada if both are approved in their respective jurisdictions, and not otherwise.
14. Claimants in the US and Canadian Proceedings shall have similar access to relevant information as to the financial condition, status and activities of the Corporations, the nature and effect of any plan of reorganization or arrangement, and the status of proceedings in each jurisdiction.
15. Once approved by orders of the US and Canadian Courts, this Protocol may not be amended or modified in any other way or manner (including, without limitation, pursuant to a plan of arrangement or reorganization of the Corporations) except by authorization of the US Court or the Canadian Court as may be necessary and appropriate under the circumstances. Notice of any proposed amendment or modification of this Protocol shall be provided by the party proposing such in accordance with paragraph 2 hereof.
16. Any request for the entry of an order which is contrary to the provisions of this Protocol must be made on notice by the proponent of the order in accordance with paragraph 2 hereof.
17. The Corporations are hereby authorized and directed to take such actions and execute such documents as may be necessary and appropriate to implement and effectuate this Protocol.
18. This Protocol shall be deemed effective upon its approval by the US Court and the Canadian Court.

UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

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 In re: : Chapter 11  
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EVERFRESH BEVERAGES, INC. AND : Case Nos. 95 B 45405 and  
SUNDANCE BEVERAGES, INC., : 95 B 45406 (JHG)  
 : The Honorable Burton  
 Debtors. : R. Lifland, USBJ  
 :  
 : (Jointly Administered)  
 :  
 -----x  
 ONTARIO COURT (GENERAL DIVISION) :  
 IN BANKRUPTCY : Case No. 32-077978  
 :  
 IN THE MATTER OF THE PROPOSAL OF : The Honourable Mr. Justice  
 EVERFRESH BEVERAGES, INC. OF THE : Farley  
 REGIONAL MUNICIPALITY OF PEEL, IN :  
 THE PROVINCE OF ONTARIO :  
 :  
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STIPULATION REGARDING CROSS-BORDER INSOLVENCY PROTOCOL

WHEREAS, on November 17, 1995 (the "Filing Date"), Everfresh Beverages, Inc. ("Everfresh"), debtor and debtor-in-possession, and Sundance Beverages, Inc. ("Sundance"), debtor and debtor-in-possession (jointly, the "Debtors"), filed in the United States Bankruptcy Court for the Southern District of New York (together with any other court having jurisdiction over the bankruptcy cases, the "Bankruptcy Court") their respective voluntary petitions for reorganization (the "Chapter 11 cases") under Chapter 11 of Title 11, United States Code, 11 U.S.C. §§ 101 et seq. (the "Bankruptcy Code"); and

WHEREAS, no trustee has been appointed in the Chapter 11 cases and pursuant to Sections 1107 and 1108 of the Bankruptcy Code, the Debtors are continuing to operate their

businesses and manage their properties as debtors-in-possession, and the Bankruptcy Court entered an order authorizing the joint administration of the Debtors' Chapter 11 cases for procedural purposes; and

WHEREAS, on December 1, 1995, the Bankruptcy Court appointed an official committee of unsecured creditors in these Chapter 11 cases (the "Creditors' Committee") and the Creditors' Committee has selected Obermayer, Rebmann, Maxwell & Hippel as its counsel (the "Committee's Counsel"); and

WHEREAS, Everfresh manufactures and distributes juices, juice drinks, lemonade, and related products throughout the United States and Canada under the brand names of Everfresh, Rich 'n Ready and, only in the United States, Wagner (collectively, the "Product"), and maintains offices in Chicago, Illinois, and Mississauga, Ontario, and operates manufacturing plants in Warren, Michigan and Windsor, Ontario, Canada; and

WHEREAS, on the Filing Date, the Bankruptcy Court entered an order (the "Emergency Order") and thereafter on November 22, 1995, a preliminary order (the "Preliminary Order"), which orders, among other things, authorized the Debtors' use of cash collateral and the receipt of discretionary post-petition financing from The CIT Group/Business Credit, Inc. ("CITBC"), the Debtors' secured lender, pursuant to the terms and conditions of the Emergency Order and the Preliminary Order (together with any further orders concerning cash collateral

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and/or financing, the "Cash Collateral/Financing Order") and pursuant to the terms of the stipulation and order (the "Stipulation") between the Debtors and CITBC, as approved by the Cash Collateral/Financing Order, of an aggregate amount of \$750,000 (the "Advance") for the purposes set forth in a budget (the "Budget") annexed to the Stipulation, through December 12, 1995; and

WHEREAS, on the Filing Date, Everfresh filed a Notice of Intention to Make a Proposal (the "NOI") to its creditors under the Bankruptcy and Insolvency Act of Canada (the "Act") in which Ernst & Young Inc. was named as trustee under the proposal (the "Trustee"), and Everfresh filed a motion for an order in the Ontario Court (General Division), in Bankruptcy (together with any other court having jurisdiction over Everfresh's insolvency proceeding, the "Canadian Court") seeking the appointment of Ernst & Young Inc., as interim receiver (the "Interim Receiver") of the property, business, and assets of Everfresh situated in Canada, which order was entered simultaneously with the filing of the NOI (the "Interim Receiver Order"), a copy of which is annexed hereto as Exhibit "A" (the proceedings under the Act and pursuant to the Interim Receiver Order being referred to as the "Canadian Proceeding"); and

WHEREAS, pursuant to the Interim Receiver Order, the Interim Receiver has been authorized to borrow from time-to-time up to an amount not to exceed \$400,000 from CITBC for the

purposes of carrying out its responsibilities under the terms of the Interim Receiver Order; and

WHEREAS, on November 27, 1995, Everfresh filed with the Official Receiver, appointed under the Act, a cash flow statement (the "Cash Flow Statement"), together with the Trustee's and Everfresh's reports on the Cash Flow Statement, in connection with the Canadian Proceeding; and

WHEREAS, it is presently contemplated that all (a) of the business and assets of every nature, tangible and intangible arising from or relating to the manufacture, distribution and sale of the Product in Canada as reflected on the books and records of Everfresh (the "Canadian Assets") and (b) of the business and assets of every nature, tangible and intangible arising from or relating to the manufacture, distribution and sale of the Product in the United States as reflected on the books and records of Everfresh (the "US Assets") will be liquidated through the sale thereof by the Debtors in accordance with the applicable provisions of the Bankruptcy Code and Act for the benefit of all secured, priority, and non-insider unsecured creditors of Everfresh, with the net proceeds of sale to be distributed in accordance with priorities established under the Bankruptcy Code and the Act; and

WHEREAS, as of the date hereof, the Debtors have been engaged in extensive negotiations with a number of potential buyers regarding the sale of Everfresh's assets in Canada, and

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have reviewed letters of intent, and, accordingly, it is presently anticipated that a sale of Everfresh's assets in Canada will occur prior to a sale of Everfresh's assets located in the United States; and

WHEREAS, pursuant to paragraph 29 of the Interim Receiver Order, the Interim Receiver is ordered to have regard to the Everfresh Chapter 11 case, to cooperate with actions taken in the Everfresh Chapter 11 case and to take such steps as are required to coordinate his administration under the Interim Receiver Order with the administration of the Everfresh Chapter 11 case, where so doing would enhance the value of the Canadian Assets and to review the appropriateness or advisability of a Cross-Border Insolvency Protocol to be submitted for the consideration of the Canadian Court and the Bankruptcy Court; and

WHEREAS, a framework of general principles should be agreed upon to address, among other things, issues that are likely to arise in connection with the cross-border insolvency proceedings of Everfresh, including, without limitation, (a) the sale of Everfresh's Canadian Assets; (b) the sale of Everfresh's US Assets; (c) the disposition of the proceeds of sale of the Canadian Assets and the US Assets (together, the "Assets"); (d) the determination of claims asserted against Everfresh, and the allowability and priority status of such claims; (e) the filing and implementation of a plan of reorganization under the Bankruptcy Code and a scheme or proposal under the Act (the

"Proposal"); and (f) general administrative matters, similar to the principles proposed in the article of Committee J of the Section on Business Law of the International Bar Association entitled Cross-Border Insolvency Concordat (the "Concordat"), a copy of which is attached hereto as Exhibit "B", and that an agreement upon such matters is essential to the orderly and efficient administration of these cross-border cases; and

WHEREAS, the purpose of the protocol proposed in this Stipulation is to protect the interests of all creditors of Everfresh (in a situation where there is more than one plenary forum and no main forum as provided for in Principle 4 of the Concordat) wherever located and to protect the integrity of the process by which the Chapter 11 case and the Canadian Proceeding is administered.

NOW THEREFORE, the Debtors, CITBC, and the Creditors' Committee by their respective counsel, and Ernst & Young Inc., in its capacity as Interim Receiver and Trustee under the Proposal, hereby stipulate and agree, subject to Bankruptcy Court and Canadian Court approval, as follows:

1. The Debtors and the Interim Receiver will (i) have regard to the proceedings initiated by Everfresh under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court and under the Act in the Canadian Court; (ii) co-operate with actions taken in both the Bankruptcy Court and the Canadian Court; and (iii) take steps to co-ordinate their respective

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administrations under the Bankruptcy Code and the Act in the Bankruptcy Court and the Canadian Court.

2. The Debtors, the Creditors' Committee and the Interim Receiver, and any other official representative that may be appointed by the Bankruptcy Court or the Canadian Court, shall receive notice of all proceedings in accordance with the practices of the respective Courts, and have the right to appear in all proceedings in any fora, whether in the Bankruptcy Court or the Canadian Court, subject to paragraph 7 hereof. The Debtors and the Interim Receiver shall be subject to jurisdiction in both fora for any matter related to the insolvency proceedings, but appearing in a forum shall not subject him/her to jurisdiction for any other purpose in the forum state, except to the extent otherwise set forth herein to the contrary.

3. The Interim Receiver shall be permitted to act in a manner consistent with the terms of the Interim Receiver Order under Canadian law, and Everfresh shall be permitted to act in a manner consistent with the terms of the Act, the Bankruptcy Code, the Interim Receiver Order, and the Cash Collateral/Financing Order, provided, that, (a) such prior advance notice as is reasonably practicable under the circumstances of any transaction and hearing thereon concerning the use, sale or lease of Everfresh's Assets outside the ordinary course of business (the "Transactions") and (b) prior notice of those actions proposed to be taken in either the

Chapter 11 cases or the Canadian Proceeding where notice of such action is required to be given under the applicable laws of procedures of the governing forum, shall be provided (the "Notice Procedures") by overnight mail, overnight delivery service or facsimile to counsel to the Debtors, Angel & Frankel, P.C., 460 Park Avenue, New York, New York 10022, Attn: Bruce Frankel, Esq., the Interim Receiver at Ernst & Young, Inc., P.O. Box 251 - 21st Floor, Toronto Dominion Centre, Canada M5K 1S7, Attn: Alex Morrison, counsel to CITBC, Dewey Ballantine, 1301 Avenue of the Americas 10019, Attn: Stuart Hirshfield, Esq., special counsel to the Debtors, Lang Michener, BCE Place, Suite 2500, 181 Bay Street, Toronto, Ontario, Canada M5J 2T7, Attn: Joseph Marin, Esq., Canadian counsel to CITBC, Cassels, Brock & Blackwell, Scotia Plaza, Suite 2100, 40 King Street West, Toronto, Ontario, Canada M5H 3C2, Attn: Bruce Leonard, Esq., the Office of the United States Trustee, 80 Broad Street, Third Floor, New York, New York 10004, Attn: Catherine Lotrionte, Esq., the Committee's Counsel, Obermayer, Rebmann, Maxwell & Hippel, Packard Building, 111 South 15th Street, Philadelphia, PA 19102-2688, Attn: Lawrence J. Tabas, Esq., and the Committee's Canadian counsel, Stikeman, Elliott, Commerce Court West, P.O. Box 5300 - Suite 5300, Toronto, Ontario, Canada M5L 1B9 Attn: David Byer, Esq., and all persons appearing on the notice of appearance list as reflected on the docket of the Chapter 11 cases and supplied by Everfresh to the Interim Receiver (the "Specified Parties"), which foregoing notice shall be in lieu of notice to all creditors of Everfresh.

4. All creditors of Everfresh shall have the right to appear in any forum to the same extent as creditors of the forum state, regardless of whether they have filed claims in that particular forum. All creditors shall have the opportunity to file a notice of appearance with the Clerk of the Bankruptcy Court, the Alexander Hamilton U.S. Custom House, One Bowling Green, 5th Floor, New York, New York 10004 or to participate in the proceedings in the Canadian Court; provided, however, that such filing or participation may subject such creditor to the jurisdiction in the Court in which the notice or appearance is filed or made.

5. Information publicly available in any forum state shall be publicly available in both fora. To the extent permitted, non-public information shall be made available to official representatives of the Debtors, including any official committee appointed in these cases and shall be shared with other official representatives, subject to appropriate confidentiality arrangements and all privileges under the applicable rules of evidence.

6. Transactions relating to the Canadian Assets will be subject to the sole approval of the Canadian Court. Transactions relating to the US Assets will be subject to the sole approval of the Bankruptcy Court. Any Transactions involving the Assets located both in Canada and the United States will be subject to the joint jurisdiction of the Bankruptcy Court and the Canadian Court. To the extent not

otherwise provided for under the Act or the Bankruptcy Code, notice and requirements for approval and authorization of any Transactions shall be in accordance with the Notice Procedures and shall be provided by the Interim Receiver or the Debtors, as the case may be, to the Specified Parties.

7. All creditors of Sundance must file their proofs of claim with the Clerk of the Bankruptcy Court, the Alexander Hamilton U.S. Custom House, One Bowling Green, 5th Floor, New York, New York 10004. Any creditor of Everfresh may file a proof of claim in either the Bankruptcy Court or in the Canadian Proceeding. However, if a creditor files a claim in both the Bankruptcy Court and the Canadian Proceeding, then distribution to such creditor will be adjusted so that recovery is not greater than if the claim were filed in only one forum. A timely filed claim in either the Bankruptcy Court or the Canadian Proceeding will be deemed timely filed in both the Bankruptcy Court and the Canadian Proceeding. The Debtors and the Interim Receiver will endeavor to coordinate notice procedures and establish the same deadline for the filing of claims against the Debtors in both the Bankruptcy Court and the Canadian Proceeding, and all other matters regarding the filing, reviewing and objecting to claims.

8. The Bankruptcy Court shall have jurisdiction over all claims governed principally by the laws of the United States or any of its states. In the event that claims are governed principally by the laws of Canada, the objection to such claims

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may be brought in either the Canadian Proceeding or the Bankruptcy Court, as mutually agreed upon by the Interim Receiver and the Debtors, or if an agreement cannot be reached, by further order of the Canadian Court. Nothing in this Stipulation shall be deemed to bind a creditor to the foregoing forum selection for filing of objections to claims. The adjudicating forum shall decide the value, allowability and priority of claims filed using a choice of law analysis based upon the choice of law principles applicable in that forum. A creditor's rights to collateral and set-off will be determined under the choice of law principles applicable in that forum, except to the extent set forth in paragraph 12 hereof. No person will be subject to a forum's substantive rules unless under the choice of law principles applicable in that forum such persons would be subject to the forum's substantive laws in a lawsuit on the same transaction in a non-insolvency proceeding, except to the extent set forth in paragraph 12 hereof. Nothing herein shall limit the right of any party-in-interest to object to claims to the extent permitted under Section 502(a) of the Bankruptcy Code and the Bankruptcy Rules nor shall anything herein alter the substantive rights of any party filing a claim in any fora.

9. Neither this Stipulation nor any actions taken pursuant hereto is intended nor shall it have any affect on the rights of creditors, the Interim Receiver, or the estates of the Debtors with regard to the applicability of Section 508(a) of

the Bankruptcy Code and any similar provisions under the Act or the Interim Receiver Order, it being intended that such Section 508(a) be, to the extent applicable, enforced in both fora. Neither this Stipulation nor any actions taken pursuant hereto are intended to nor shall they in any manner prejudice or affect the powers, rights, claims and defenses of (i) E&Y, the Debtors, their estates or any of their creditors under applicable law, including the Act and any other relevant Canadian law and the Bankruptcy Code, or (ii) the Creditors' Committee under Section 1103 of the Bankruptcy Code.

10. The proceeds of all Transactions shall be distributed in accordance with the laws of the jurisdiction approving such Transactions. The Bankruptcy Court and the Canadian Court shall apply their respective schemes for distribution to creditors, including, without limitation, the priority treatment respectively accorded to such claims under the Bankruptcy Code or the Act. Any proceeds available after the satisfaction in full of all valid allowed secured claims asserted against Everfresh, and the funding of the Budget, and the Cash Flow Statement as from time-to-time amended shall be maintained by Everfresh in the United States, in an account specifically designated for plan funding (the "Account"), which Account shall be maintained in accordance with Section 345 of the Bankruptcy Code. The distribution of all monies in the Account shall be pursuant to the terms of the Bankruptcy Code and the Act.

11. The classification and treatment of unsecured claims, meaning claims other than priority or secured claims, shall be determined by the Debtors, as to the Canadian Proceedings after consultation with the Trustee under the Proposal.

12. Except to the extent set forth in an order of the Canadian Court, all creditors subject to the jurisdiction of the Bankruptcy Court shall be subject to the avoiding laws set forth in the Bankruptcy Code, and other applicable laws of the United States which shall be the controlling law of each case to the extent permitted by applicable international law, notwithstanding anything to the contrary in paragraph 8. No avoiding actions will be taken by the Interim Receiver in Canada without the express written consent of the Debtors or as may be directed by the Canadian Court.

13. To the extent permitted by the laws of the respective jurisdictions and to the extent practicable, the Interim Receiver and the Debtors shall endeavor to submit a proposal in Canada and a plan of reorganization in the United States substantially similar to each other and the Debtors, the Interim Receiver and the Trustee shall endeavor to coordinate all procedures in connection therewith, including, without limitation, all solicitation proceedings relating thereto, and all procedures regarding voting, the treatment of creditors, classification of claims, and the like, will either be established by the Debtors after consultation with the Trustee

of the Proposal or be dealt with pursuant to a further order of the Bankruptcy Court and or the Canadian Court. In order to coordinate the contemporaneous filing of the Proposal and the plan of reorganization, the Debtors shall take the actions necessary to seek extensions from time-to-time of the date for the filing of the Proposal, and the Debtors shall take the actions necessary from time-to-time to seek extensions of the exclusive time period during which only the Debtors may file a plan of reorganization pursuant to Section 1121 of the Bankruptcy Code.

14. Except with respect to matters where the Interim Receiver appears before the Bankruptcy Court pursuant to paragraph 2, hereof, the Canadian Court shall have sole jurisdiction and power over the Interim Receiver, including, without limitation, its tenure in office, the conduct of the liquidation proceedings under Canadian law, the retention and compensation of the Interim Receiver and other Canadian professionals, and the hearing and determination of matters arising in the liquidation proceedings under Canadian law. The Interim Receiver, and Lang Michener, shall be compensated for their services in accordance with Canadian principles under Canadian law, such that the Interim Receiver and Lang Michener are not required to file fee applications with the Bankruptcy Court, provided, that, they be paid as provided for in the Budget and the Cash Flow Statement to the extent contemplated by the Cash Collateral/Financing Order, the Interim Receiver be



compensated under the provisions of the Interim Receiver Order to the extent consistent with the Cash Collateral/Financing Order, and notice of such payment is given pursuant to the Notice Procedures to the Specified Parties. The order entered by the Bankruptcy Court authorizing the retention of Lang Michener as Canadian counsel to the Debtors is hereby deemed to be modified to conform to the foregoing provisions.

15. The Bankruptcy Court shall have sole jurisdiction and power over the conduct of the Chapter 11 cases, the compensation of the professionals rendering services to the Debtors and to the Creditors' Committee in the United States, and the hearing and determination of matters arising in the Chapter 11 cases. This Stipulation shall be without prejudice to the rights of the Debtors to seek the substantive consolidation of their estates in accordance with the Bankruptcy Code.

16. This Stipulation shall be binding on and inure to the benefit of the parties hereto and their respective successors, assigns, representatives, heirs, executors, administrators, trustees (including any trustees of the Debtors under Chapters 7 or 11 of the Bankruptcy Code), and receivers, receiver managers, or custodians appointed under Canadian law, as the case may be.

17. This Stipulation may not be waived, amended or modified orally or in any other way or manner (including,

without limitation, pursuant to a plan of reorganization of the Debtors) except by a writing signed by the party to be bound, and such approval and authorization of the Bankruptcy Court or the Canadian Court as may be necessary and appropriate under the circumstances. Notice of any proposed amendment or modification of the Stipulation shall be provided by the party providing such to the Specified Parties in accordance with the Notice Procedures. This Stipulation may be supplemented from time to time by the parties hereto as circumstances require with any supplementing stipulations as approved by the Bankruptcy Court and the Canadian Court.

18. Any request for the entry of an order which is contrary to the provisions of this Stipulation must be made on notice by the proponent of the order to the Specified Parties in accordance with the Notice Procedures.

19. Each party represents and warrants to the other that its execution, delivery and performance of this Stipulation are within the power and authority of such party and have been duly authorized by such party, except that, with respect to the Debtors and the Interim Receiver, Bankruptcy Court and Canadian Court approval is required.

20. This Stipulation may be signed in any number of counterparts, each of which shall be deemed an original and all of which together shall be deemed to be one and the same

instrument, and may be signed by facsimile signature, which shall be deemed to constitute an original signature.

21. The Bankruptcy Court and the Canadian Court shall retain jurisdiction over the parties for the purpose of enforcing the terms and provisions of this Stipulation or approving any amendments or modifications thereto.

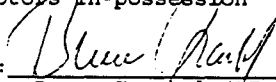
22. The parties hereto are hereby authorized to take such actions and execute such documents as may be necessary and appropriate to implement and effectuate this Stipulation.

23. This Stipulation shall be deemed effective upon its approval by the Bankruptcy Court and the Canadian Court.

IN WITNESS WHEREOF, the parties hereto have caused this stipulation to be executed either individually or by their respective attorneys or representatives hereunto authorized.

Dated: New York, New York  
December 20, 1995

ANGEL & FRANKEL, P.C.  
Counsel for Everfresh Beverages, Inc.  
and Sundance Beverages, Inc., debtors and  
debtors-in-possession

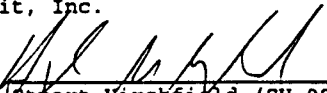
By:   
Bruce Frankel (BF 9009)  
460 Park Avenue  
New York, New York 10022  
(212) 752-8000

LANG MICHENER  
Special Counsel for Everfresh Beverages,  
Inc. and Sundance Beverages, Inc., debtors  
and debtors-in-possession

By: \_\_\_\_\_  
Joseph Marin  
BCE Place  
Suite 2500  
181 Bay Street  
Toronto, Ontario, Canada M5J 2T7

DEWEY BALLANTINE  
Counsel for The CIT Group/Business  
Credit, Inc.

By:

  
Stuart Mirshfield (SH 0099)  
Hugh M. McDonald (HM 2667)  
1301 Avenue of the Americas  
New York, New York 10019  
(212) 259-8000

CASSELS, BROCK & BLACKWELL  
Canadian Counsel for The CIT Group/Business  
Credit, Inc.

By:

Bruce Leonard  
Scotia Plaza  
Suite 2100  
40 King Street West  
Toronto, Ontario, Canada M5H 3C2

ERNST & YOUNG INC.  
As Interim Receiver of Everfresh Beverages,  
Inc., and Trustee of the Proposal

By:

Alex Morrison  
P.O. Box 251  
21st Floor  
222 Bay Street  
Toronto Dominion Center  
Toronto, Ontario, Canada M5k 137

OBERMAYER, REBMANN, MAXWELL & HIPPEL  
Counsel for the Creditors' Committee

By:

Lawrence J. Tabas  
Packard Building  
111 South 15th Street  
Philadelphia, Pennsylvania 19102-2688

STIKEMAN, ELLIOTT  
Canadian Counsel for the Creditors'  
Committee

By:

Kenneth G. Ottenbrecht (KGO \_\_\_\_\_)  
David Byer  
126 East 56th Street  
11th Floor, Tower 56  
New York, New York 10022

TESTIMONY OF HON. TINA BROZMAN BEFORE THE SENATE JUDICIARY COMMITTEE  
REGARDING PROPOSED CHAPTER 15 OF THE BANKRUPTCY CODE

Testimony of Tina L. Brozman, Chief Judge of the Bankruptcy Court for the Southern District of New York Before the Senate Judiciary Subcommittee in Connection with the Hearing on the Bankruptcy Code and International Trade

Cross-border insolvencies have confounded debtors, creditors, practitioners and jurists alike for decades. We have watched as jurisdictional battles and territorial approaches impaired the possibility of saving viable enterprises and jobs and substantially reduced the returns that creditors received on their claims. U.S. creditors have been particularly hard hit because of the frequent loss of going-concern values and because U.S. debtors in possession have been viewed with hostility in foreign venues, preventing the repatriation of assets for U.S. creditors. Private efforts by international bar associations to promote standardized insolvency laws have failed because their proponents aimed to harmonize substantive law, too weighty an undertaking for a first step. We are poised to improve dramatically the *status quo*.

In 1994, the United Nations Commission on International Trade Law, known by the acronym UNCITRAL, received a clarion call from a multinational group of bankers, judges, regulators, insolvency professionals and academics to develop a more modest solution — one that would achieve three goals: cooperation between courts, recognition of foreign proceedings and access to foreign proceedings by estate representatives. In May of this year, UNCITRAL accomplished that objective, approving a Model Law for enactment by member states of the United Nations. Three features of the Model Law are especially important to the U.S. First, the Model Law recognizes debtors in possession as proper estate representatives (an outcome which we generally have been unsuccessful in obtaining); second, the proposed law contains an automatic stay once foreign proceedings are recognized, ending the dissipation of assets by local creditors

and staying the debtor from wholesale disposition or movement of assets; and third, the Model Law expresses as one of its fundamental goals enhancing the possibility of reorganization. Adoption of the Model Law in other nations will go a long way toward furthering our national objectives.

Under the auspices of UNCITRAL and INSOL International, I have chaired the first two Multinational Judicial Colloquia On Transnational Insolvency. I appear today as the Chair of the Judicial Section of INSOL International. In addition, I am the Chief Judge of the Bankruptcy Court for the Southern District of New York, which is home to the great majority of our transnational cases, and, as such, I have firsthand experience in numerous cross-border cases.

At the first Judicial Colloquium, one theme was commonly articulated by judges from civil law jurisdictions, who have less discretion than judges from common law jurisdictions like our own; they all agreed that some form of legislation was critical to enable them to cooperate as they wish to do in transnational insolvency cases. Legislation is just as desirable for U.S. judges, because it eliminates unnecessary and costly appeals respecting the power of the bankruptcy judge to harmonize U.S. and foreign proceedings. In addition, the legislation would afford to our estate representatives the statutory authority to seek assistance in foreign courts, ending claims that they are exceeding their statutory prerogatives and adding immeasurably to our ability to repatriate assets in appropriate cases.

The second Judicial Colloquium considered an actual draft of the Model Law shortly before the final draft received UNCITRAL's approval. At the conclusion of a day and one-half of discussion, one of our evaluators, U.S. Bankruptcy Judge Leif M. Clark, from Texas, summarized the conclusions of the group respecting the importance of a legislative solution:

"At the outset all of us agree on one basic point ... and that is that this effort and cooperation is vital in the cross-border arena. In most jurisdictions judges will in the main simply not feel comfortable inventing law on a case by case basis. Our hats must be off to the pioneers who dared to try something new and pave the way for this process. But the best way to ensure that most judges follow that lead is, it seems to us, to give them the statutory authority to do so. The express provision for judicial cooperation may thus appear to be innocuous on its face but is in reality one of the most important features of the UNCITRAL effort."

Notwithstanding the clear benefits which we will receive from enactment of the Model Law domestically, there is an even more important reason for its adoption. The international community is looking to the United States for leadership. If we do not act affirmatively on this legislation, I have grave fears that it will receive no attention overseas. Just as we have led the way in creating *ad hoc* solutions for the problems of large transnational cases, we must lead the way in enacting a more comprehensive and long-lasting solution capable of governing not only the large, newsworthy cases but the smaller, less remarkable, multinational cases which, with the globalization of commercial enterprise, increasingly are becoming the bread and butter of our business bankruptcy dockets. This should substantially reduce the fear of U.S. creditors that they will lose out to creditors overseas who seize a bankrupt debtor's assets with impunity; that if a foreign enterprise fails, they will receive no notice of the right to participate in its insolvency proceedings; and that shrewd debtors can utilize technology to remove assets beyond the reach of our courts. Indeed, at the second Judicial Colloquium, one of the Norwegian judges expressed frustration about just such a case, where he was unable to follow the debtor's assets around the world as the debtor deftly moved them from nation to nation.

If, through our leadership, we convince our trading partners to enact this legislation, we will have done a great deal to maximize asset values for all creditors, rehabilitate viable

enterprises and preserve employment for our own citizens. In short, with the explosion of international commerce fostered by rapidly changing technology and initiatives such as NAFTA, we simply cannot afford *not* to enact this legislation.

I thank you for the opportunity of addressing you.

**TITLE IX—ANCILLARY AND OTHER CROSS-BORDER CASES****SEC. 901. AMENDMENT TO ADD CHAPTER 15 TO TITLE 11, UNITED STATES CODE.**

(a) *IN GENERAL.*—Title 11, United States Code, is amended by inserting after chapter 13 the following:

**“CHAPTER 15—ANCILLARY AND OTHER CROSS-BORDER CASES**

“Sec.

“1501. Purpose and scope of application.

**“SUBCHAPTER I—GENERAL PROVISIONS**

“1502. Definitions.

“1503. International obligations of the United States.

“1504. Commencement of ancillary case.

“1505. Authorization to act in a foreign country.

“1506. Public policy exception.

“1507. Additional assistance.

“1508. Interpretation.

**“SUBCHAPTER II—ACCESS OF FOREIGN REPRESENTATIVES AND CREDITORS TO THE COURT**

“1509. Right of direct access.

“1510. Limited jurisdiction.

“1511. Commencement of case under section 301 or 303.

“1512. Participation of a foreign representative in a case under this title.

“1513. Access of foreign creditors to a case under this title.

“1514. Notification to foreign creditors concerning a case under this title.

**“SUBCHAPTER III—RECOGNITION OF A FOREIGN PROCEEDING AND RELIEF**

“1515. Application for recognition of a foreign proceeding.

“1516. Presumptions concerning recognition.

“1517. Order recognizing a foreign proceeding.

“1518. Subsequent information.

“1519. Relief that may be granted upon petition for recognition of a foreign proceeding.

“1520. Effects of recognition of a foreign main proceeding.

“1521. Relief that may be granted upon recognition of a foreign proceeding.

“1522. Protection of creditors and other interested persons.

“1523. Actions to avoid acts detrimental to creditors.

“1524. Intervention by a foreign representative.

**“SUBCHAPTER IV—COOPERATION WITH FOREIGN COURTS AND FOREIGN REPRESENTATIVES**

“1525. Cooperation and direct communication between the court and foreign courts or foreign representatives.

“1526. Cooperation and direct communication between the trustee and foreign courts or foreign representatives.

“1527. Forms of cooperation.

**“SUBCHAPTER V—CONCURRENT PROCEEDINGS**

“1528. Commencement of a case under this title after recognition of a foreign main proceeding.

“1529. Coordination of a case under this title and a foreign proceeding.

“1530. Coordination of more than 1 foreign proceeding.

“1531. Presumption of insolvency based on recognition of a foreign main proceeding.

“1532. Rule of payment in concurrent proceedings.

**“§ 1501. Purpose and scope of application**

“(a) The purpose of this of chapter is to incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency with the objectives of—

“(1) cooperation between—

“(A) United States courts, United States Trustees, trustees, examiners, debtors, and debtors in possession; and

“(B) the courts and other competent authorities of foreign countries involved in cross-border insolvency cases;

“(2) greater legal certainty for trade and investment;

“(3) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor;

“(4) protection and maximization of the value of the debtor’s assets; and

“(5) facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

“(b) This chapter applies where—

“(1) assistance is sought in the United States by a foreign court or a foreign representative in connection with a foreign proceeding;

“(2) assistance is sought in a foreign country in connection with a case under this title;

“(3) a foreign proceeding and a case under this title with respect to the same debtor are taking place concurrently; or

“(4) creditors or other interested persons in a foreign country have an interest in requesting the commencement of, or participating in, a case or proceeding under this title.

“(c) This chapter does not apply to—

“(1) a proceeding concerning an entity identified by exclusion in subsection 109(b);

“(2) an individual, or to an individual and such individual’s spouse, who have debts within the limits specified in section 109(e) and who are citizens of the United States or aliens lawfully admitted for permanent residence in the United States; or

“(3) an entity subject to a proceeding under the Securities Investor Protection Act, a stockbroker subject to subchapter III of chapter 7 of this title, or a commodity broker subject to subchapter IV of chapter 7 of this title.

**“SUBCHAPTER I—GENERAL PROVISIONS****“§ 1502. Definitions**

“For the purposes of this chapter, the term—

“(1) ‘debtor’ means an entity that is the subject of a foreign proceeding;

“(2) ‘establishment’ means any place of operations where the debtor carries out a nontransitory economic activity;

"(3) 'foreign court' means a judicial or other authority competent to control or supervise a foreign proceeding;

"(4) 'foreign main proceeding' means a foreign proceeding taking place in the country where the debtor has the center of its main interests;

"(5) 'foreign nonmain proceeding' means a foreign proceeding, other than a foreign main proceeding, taking place in a country where the debtor has an establishment;

"(6) 'trustee' includes a trustee, a debtor in possession in a case under any chapter of this title, or a debtor under chapter 9 of this title; and

"(7) 'within the territorial jurisdiction of the United States' when used with reference to property of a debtor refers to tangible property located within the territory of the United States and intangible property deemed under applicable nonbankruptcy law to be located within that territory, including any property subject to attachment or garnishment that may properly be seized or garnished by an action in a Federal or State court in the United States.

**"§ 1503. International obligations of the United States**

"To the extent that this chapter conflicts with an obligation of the United States arising out of any treaty or other form of agreement to which it is a party with 1 or more other countries, the requirements of the treaty or agreement prevail.

**"§ 1504. Commencement of ancillary case**

"A case under this chapter is commenced by the filing of a petition for recognition of a foreign proceeding under section 1515.

**"§ 1505. Authorization to act in a foreign country**

"A trustee or another entity, including an examiner, may be authorized by the court to act in a foreign country on behalf of an estate created under section 541. An entity authorized to act under this section may act in any way permitted by the applicable foreign law.

**"§ 1506. Public policy exception**

"Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.

**"§ 1507. Additional assistance**

"(a) Subject to the specific limitations stated elsewhere in this chapter the court, upon recognition of a foreign proceeding, to provide additional assistance to a foreign representative under this title or under other laws of the United States.

"(b) In determining whether to provide additional assistance under this title or under other laws of the United States, the court shall consider whether such additional assistance, consistent with the principles of comity, will reasonably assure—

"(1) just treatment of all holders of claims against or interests in the debtor's property;

"(2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;

"(3) prevention of preferential or fraudulent dispositions of property of the debtor;

"(4) distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title; and

"(5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

**"§ 1508. Interpretation**

"In interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.

**"SUBCHAPTER II—ACCESS OF FOREIGN REPRESENTATIVES AND CREDITORS TO THE COURT**

**"§ 1509. Right of direct access**

"(a) A foreign representative is entitled to commence a case under section 1504 by filing a petition for recognition under section 1515, and upon recognition, to apply directly to other Federal and State courts for appropriate relief in those courts.

"(b) Upon recognition, and subject to section 1510, a foreign representative has the capacity to sue and be sued, and shall be subject to the laws of the United States of general applicability.

"(c) Subject to section 1510 of this title, a foreign representative is subject to laws of general application.

"(d) Recognition under this chapter is prerequisite to the granting of comity or cooperation to a foreign representative in any State or Federal court in the United States. Any request for comity or cooperation by a foreign representative in any court shall be accompanied by a sworn statement setting forth whether recognition under section 1515 has been sought and the status of any such petition.

"(e) Upon denial of recognition under this chapter, the court may issue appropriate orders necessary to prevent an attempt to obtain comity or cooperation from courts in the United States without such recognition.

**"§ 1510. Limited jurisdiction**

"The sole fact that a foreign representative files a petition under section 1515 does not subject the foreign representative to the jurisdiction of any court in the United States for any other purpose.

**"§ 1511. Commencement of case under section 301 or 303**

"(a) Upon recognition, a foreign representative may commence—

"(1) an involuntary case under section 303; or

"(2) a voluntary case under section 301 or 302, if the foreign proceeding is a foreign main proceeding.

"(b) The petition commencing a case under subsection (a) must be accompanied by a statement describing the petition for recognition and its current status. The court where the petition for recognition has been filed must be advised of the foreign representative's intent to commence a case under subsection (a) prior to such commencement.

**"§ 1512. Participation of a foreign representative in a case under this title**

"Upon recognition of a foreign proceeding, the foreign representative in that proceeding is entitled to participate as a party in interest in a case regarding the debtor under this title.

**"§ 1513. Access of foreign creditors to a case under this title**

"(a) Foreign creditors have the same rights regarding the commencement of, and participation in, a case under this title as domestic creditors.

"(b)(1) Subsection (a) does not change or codify present law as to the priority of claims under section 507 or 726 of this title, except that the claim of a foreign creditor under those sections shall not be given a lower priority than that of general unsecured claims without priority solely because the holder of such claim is a foreign creditor.

"(2)(A) Subsection (a) and paragraph (1) do not change or codify present law as to the allowability of foreign revenue claims or other foreign public law claims in a proceeding under this title.

"(B) Allowance and priority as to a foreign tax claim or other foreign public law claim shall be governed by any applicable tax treaty of the United States, under the conditions and circumstances specified therein.

**"§ 1514. Notification to foreign creditors concerning a case under this title**

"(a) Whenever in a case under this title notice is to be given to creditors generally or to any class or category of creditors, such notice shall also be given to the known creditors generally, or to creditors in the notified class or category, that do not have addresses in the United States. The court may order that appropriate steps be taken with a view to notifying any creditor whose address is not yet known.

"(b) Such notification to creditors with foreign addresses described in subsection (a) shall be given individually, unless the court considers that, under the circumstances, some other form of notification would be more appropriate. No letters rogatory or other similar formality is required.

"(c) When a notification of commencement of a case is to be given to foreign creditors, the notification shall—

"(1) indicate the time period for filing proofs of claim and specify the place for their filing;

"(2) indicate whether secured creditors need to file their proofs of claim; and

"(3) contain any other information required to be included in such a notification to creditors pursuant to this title and the orders of the court.

"(d) Any rule of procedure or order of the court as to notice or the filing of a claim shall provide such additional time to creditors with foreign addresses as is reasonable under the circumstances.

**"SUBCHAPTER III—RECOGNITION OF A FOREIGN PROCEEDING AND RELIEF**

**"§ 1515. Application for recognition of a foreign proceeding**

"(a) A foreign representative applies to the court for recognition of the foreign proceeding in which the foreign representative has been appointed by filing a petition for recognition.

"(b) A petition for recognition shall be accompanied by—

"(1) a certified copy of the decision commencing the foreign proceeding and appointing the foreign representative;

"(2) a certificate from the foreign court affirming the existence of the foreign proceeding and of the appointment of the foreign representative; or

"(3) in the absence of evidence referred to in paragraphs (1) and (2), any other evidence acceptable to the court of the existence of the foreign proceeding and of the appointment of the foreign representative.

"(c) A petition for recognition shall also be accompanied by a statement identifying all foreign proceedings with respect to the debtor that are known to the foreign representative.

"(d) The documents referred to in paragraphs (1) and (2) of subsection (b) must be translated into English. The court may require a translation into English of additional documents.

**"§ 1516. Presumptions concerning recognition**

"(a) If the decision or certificate referred to in section 1515(b) indicates that the foreign proceeding is a foreign proceeding as defined in section 101 and that the person or body is a foreign representative as defined in section 101, the court is entitled to so presume.

"(b) The court is entitled to presume that documents submitted in support of the petition for recognition are authentic, whether or not they have been legalized.

"(c) In the absence of evidence to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the center of the debtor's main interests.

**"§ 1517. Order recognizing a foreign proceeding**

"(a) Subject to section 1506, after notice and a hearing an order recognizing a foreign proceeding shall be entered if—

"(1) the foreign proceeding is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;

"(2) the foreign representative applying for recognition is a person or body as defined in section 101; and

"(3) the petition meets the requirements of section 1515.

"(b) The foreign proceeding shall be recognized—

"(1) as a foreign main proceeding if it is taking place in the country where the debtor has the center of its main interests; or



"(2) as a foreign nonmain proceeding if the debtor has an establishment within the meaning of section 1502 in the foreign country where the proceeding is pending.

"(c) A petition for recognition of a foreign proceeding shall be decided upon at the earliest possible time. Entry of an order recognizing a foreign proceeding shall constitute recognition under this chapter.

"(d) The provisions of this subchapter do not prevent modification or termination of recognition if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist, but in considering such action the court shall give due weight to possible prejudice to parties that have relied upon the granting of recognition. The case under this chapter may be closed in the manner prescribed for a case under section 350.

#### **"§ 1518. Subsequent information**

"From the time of filing the petition for recognition of the foreign proceeding, the foreign representative shall file with the court promptly a notice of change of status concerning—

"(1) any substantial change in the status of the foreign proceeding or the status of the foreign representative's appointment; and

"(2) any other foreign proceeding regarding the debtor that becomes known to the foreign representative.

#### **"§ 1519. Relief that may be granted upon petition for recognition of a foreign proceeding**

"(a) From the time of filing a petition for recognition until the petition is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature, including—

"(1) staying execution against the debtor's assets;

"(2) entrusting the administration or realization of all or part of the debtor's assets located in the United States to the foreign representative or another person authorized by the court, including an examiner, in order to protect and preserve the value of assets that, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy; and

"(3) any relief referred to in paragraph (3), (4), or (7) of section 1521(a).

"(b) Unless extended under section 1521(a)(6), the relief granted under this section terminates when the petition for recognition is decided upon.

"(c) It is a ground for denial of relief under this section that such relief would interfere with the administration of a foreign main proceeding.

"(d) The court may not enjoin a police or regulatory act of a governmental unit, including a criminal action or proceeding, under this section.

"(e) The standards, procedures, and limitations applicable to an injunction shall apply to relief under this section.

#### **"§ 1520. Effects of recognition of a foreign main proceeding**

"(a) Upon recognition of a foreign proceeding that is a foreign main proceeding—

"(1) section 362 applies with respect to the debtor and that property of the debtor that is within the territorial jurisdiction of the United States;

"(2) a transfer, an encumbrance, or any other disposition of an interest of the debtor in property within the territorial jurisdiction of the United States is restrained as and to the extent that is provided for property of an estate under sections 363, 549, and 552; and

"(3) unless the court orders otherwise, the foreign representative may operate the debtor's business and may exercise the powers of a trustee under section 549, subject to sections 363 and 552.

"(b) The scope, and the modification or termination, of the stay and restraints referred to in subsection (a) are subject to the exceptions and limitations provided in subsections (b), (c), and (d) of section 362, subsections (b) and (c) of section 363, and sections 552, 555 through 557, 559, and 560.

"(c) Subsection (a) does not affect the right to commence individual actions or proceedings in a foreign country to the extent necessary to preserve a claim against the debtor.

"(d) Subsection (a) does not affect the right of a foreign representative or an entity to file a petition commencing a case under this title or the right of any party to file claims or take other proper actions in such a case.

#### **"§ 1521. Relief that may be granted upon recognition of a foreign proceeding**

"(a) Upon recognition of a foreign proceeding, whether main or nonmain, where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including—

"(1) staying the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities to the extent they have not been stayed under section 1520(a);

"(2) staying execution against the debtor's assets to the extent it has not been stayed under section 1520(a);

"(3) suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under section 1520(a);

"(4) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities;

"(5) entrusting the administration or realization of all or part of the debtor's assets within the territorial jurisdiction of the United States to the foreign representative or another person, including an examiner, authorized by the court;

"(6) extending relief granted under section 1519(a); and

"(7) granting any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a).

"(b) Upon recognition of a foreign proceeding, whether main or nonmain, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in the United States to the foreign representative or another person, including an examiner, authorized by the court, provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected.

"(c) In granting relief under this section to a representative of a foreign nonmain proceeding, the court must be satisfied that the relief relates to assets that, under the law of the United States, should be administered in the foreign nonmain proceeding or concerns information required in that proceeding.

"(d) The court may not enjoin a police or regulatory act of a governmental unit, including a criminal action or proceeding, under this section.

"(e) The standards, procedures, and limitations applicable to an injunction shall apply to relief under paragraphs (1), (2), (3), and (6) of subsection (a).

**"§ 1522. Protection of creditors and other interested persons**

"(a) The court may grant relief under section 1519 or 1521, or may modify or terminate relief under subsection (c), only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected.

"(b) The court may subject relief granted under section 1519 or 1521, or the operation of the debtor's business under section 1520(a)(2) of this title, to conditions it considers appropriate, including the giving of security or the filing of a bond.

"(c) The court may, at the request of the foreign representative or an entity affected by relief granted under section 1519 or 1521, or at its own motion, modify or terminate such relief.

"(d) Section 1104(d) shall apply to the appointment of an examiner under this chapter. Any examiner shall comply with the qualification requirements imposed on a trustee by section 322.

**"§ 1523. Actions to avoid acts detrimental to creditors**

"(a) Upon recognition of a foreign proceeding, the foreign representative has standing in a case concerning the debtor pending under another chapter of this title to initiate actions under sections 522, 544, 545, 547, 548, 550, and 724(a).

"(b) When the foreign proceeding is a foreign nonmain proceeding, the court must be satisfied that an action under subsection (a) relates to assets that, under United States law, should be administered in the foreign nonmain proceeding.

**"§ 1524. Intervention by a foreign representative**

"Upon recognition of a foreign proceeding, the foreign representative may intervene in any proceedings in a State or Federal court in the United States in which the debtor is a party.

**"SUBCHAPTER IV—COOPERATION WITH FOREIGN COURTS AND FOREIGN REPRESENTATIVES**

**"§ 1525. Cooperation and direct communication between the court and foreign courts or foreign representatives**

"(a) Consistent with section 1501, the court shall cooperate to the maximum extent possible with foreign courts or foreign representatives, either directly or through the trustee.

"(b) The court is entitled to communicate directly with, or to request information or assistance directly from, foreign courts or foreign representatives, subject to the rights of parties in interest to notice and participation.

**"§ 1526. Cooperation and direct communication between the trustee and foreign courts or foreign representatives**

"(a) Consistent with section 1501, the trustee or other person, including an examiner, authorized by the court, shall, subject to the supervision of the court, cooperate to the maximum extent possible with foreign courts or foreign representatives.

"(b) The trustee or other person, including an examiner, authorized by the court is entitled, subject to the supervision of the court, to communicate directly with foreign courts or foreign representatives.

**"§ 1527. Forms of cooperation**

"Cooperation referred to in sections 1525 and 1526 may be implemented by any appropriate means, including—

"(1) appointment of a person or body, including an examiner, to act at the direction of the court;

"(2) communication of information by any means considered appropriate by the court;

"(3) coordination of the administration and supervision of the debtor's assets and affairs;

"(4) approval or implementation of agreements concerning the coordination of proceedings; and

"(5) coordination of concurrent proceedings regarding the same debtor.

**"SUBCHAPTER V—CONCURRENT PROCEEDINGS**

**"§ 1528. Commencement of a case under this title after recognition of a foreign main proceeding**

"After recognition of a foreign main proceeding, a case under another chapter of this title may be commenced only if the debtor has assets in the United States. The effects of such case shall be restricted to the assets of the debtor that are within the territorial jurisdiction of the United States and, to the extent necessary to implement cooperation and coordination under sections 1525, 1526, and 1527, to other assets of the debtor that are within the jurisdiction of the court under sections 541(a) of this title, and 1334(e) of title 28, to the extent that such other assets are not subject to the jurisdiction and control of a foreign proceeding that has been recognized under this chapter.

**"§ 1529. Coordination of a case under this title and a foreign proceeding**

"Where a foreign proceeding and a case under another chapter of this title are taking place concurrently regarding the same debtor, the court shall seek cooperation and coordination under sections 1525, 1526, and 1527, and the following shall apply:

"(1) When the case in the United States is taking place at the time the petition for recognition of the foreign proceeding is filed—

"(A) any relief granted under sections 1519 or 1521 must be consistent with the relief granted in the case in the United States; and

"(B) even if the foreign proceeding is recognized as a foreign main proceeding, section 1520 does not apply.

"(2) When a case in the United States under this title commences after recognition, or after the filing of the petition for recognition, of the foreign proceeding—

"(A) any relief in effect under sections 1519 or 1521 shall be reviewed by the court and shall be modified or terminated if inconsistent with the case in the United States; and

"(B) if the foreign proceeding is a foreign main proceeding, the stay and suspension referred to in section 1520(a) shall be modified or terminated if inconsistent with the relief granted in the case in the United States.

"(3) In granting, extending, or modifying relief granted to a representative of a foreign nonmain proceeding, the court must be satisfied that the relief relates to assets that, under the law of the United States, should be administered in the foreign nonmain proceeding or concerns information required in that proceeding.

"(4) In achieving cooperation and coordination under sections 1528 and 1529, the court may grant any of the relief authorized under section 305.

**"§ 1530. Coordination of more than 1 foreign proceeding**

"In matters referred to in section 1501, with respect to more than 1 foreign proceeding regarding the debtor, the court shall seek cooperation and coordination under sections 1525, 1526, and 1527, and the following shall apply:

"(1) Any relief granted under section 1519 or 1521 to a representative of a foreign nonmain proceeding after recognition of a foreign main proceeding must be consistent with the foreign main proceeding.

"(2) If a foreign main proceeding is recognized after recognition, or after the filing of a petition for recognition, of a foreign nonmain proceeding, any relief in effect under section 1519 or 1521 shall be reviewed by the court and shall be modified or terminated if inconsistent with the foreign main proceeding.

"(3) If, after recognition of a foreign nonmain proceeding, another foreign nonmain proceeding is recognized, the court shall grant, modify, or terminate relief for the purpose of facilitating coordination of the proceedings.

**"§ 1531. Presumption of insolvency based on recognition of a foreign main proceeding**

"In the absence of evidence to the contrary, recognition of a foreign main proceeding is for the purpose of commencing a proceeding under section 303, proof that the debtor is generally not paying its debts as such debts become due.

**"§ 1532. Rule of payment in concurrent proceedings**

"Without prejudice to secured claims or rights in rem, a creditor who has received payment with respect to its claim in a foreign proceeding pursuant to a law relating to insolvency may not receive a payment for the same claim in a case under any other chapter of this title regarding the debtor, so long as the payment to other creditors of the same class is proportionately less than the payment the creditor has already received."

(b) CLERICAL AMENDMENT.—The table of chapters for title 11, United States Code, is amended by inserting after the item relating to chapter 13 the following:

"15. Ancillary and Other Cross-Border Cases ..... 1501".

**SEC. 902. AMENDMENTS TO OTHER CHAPTERS IN TITLE 11, UNITED STATES CODE.**

(a) APPLICABILITY OF CHAPTERS.—Section 103 of title 11, United States Code, is amended—

(1) in subsection (a), by inserting before the period the following: ", and this chapter, sections 307, 304, 555 through 557, 559, and 560 apply in a case under chapter 15"; and

(2) by adding at the end the following:

"(j) Chapter 15 applies only in a case under such chapter, except that—

"(1) sections 1513 and 1514 apply in all cases under this title; and

"(2) section 1505 applies to trustees and to any other entity (including an examiner) authorized by the court under chapters 7, 11, and 12, to debtors in possession under chapters 11 and 12, and to debtors under chapter 9 who are authorized to act under section 1505."

(b) DEFINITIONS.—Paragraphs (23) and (24) of title 11, United States Code, are amended to read as follows:

"(23) 'foreign proceeding' means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation;

"(24) 'foreign representative' means a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of the foreign proceeding;".

(c) AMENDMENTS TO TITLE 28, UNITED STATES CODE.—

(1) PROCEDURES.—Section 157(b)(2) of title 28, United States Code, is amended—

(A) in subparagraph (N), by striking "and" at the end;

(B) in subparagraph (O), by striking the period at the end and inserting "; and"; and

(C) by adding at the end the following:

"(P) recognition of foreign proceedings and other matters under chapter 15 of title 11."

(2) BANKRUPTCY CASES AND PROCEEDINGS.—Section 1334(c)(1) of title 28, United States Code, is amended by striking "Nothing in" and inserting "Except with respect to a case under chapter 15 of title 11, nothing in".

(3) DUTIES OF TRUSTEES.—Section 586(a)(3) of title 28, United States Code, is amended by inserting "15," after "chapter".

**RECENT AMENDMENTS TO THE  
FEDERAL RULES OF BANKRUPTCY PROCEDURE  
*and*  
BANKRUPTCY CODE LEGISLATIVE UPDATE  
(H.R. 833 and S. 625)**

**Kenneth N. Klee  
University of California at Los Angeles School of Law  
*and*  
Klee, Tuchin & Bogdanoff, LLP  
Los Angeles, California**

**AND**

**Lawrence P. King  
New York University School of Law  
*and*  
Wachtel, Lipton, Rosen & Katz  
New York, New York**

**SECTION H**



**RECENT AMENDMENTS TO  
THE FEDERAL RULES OF BANKRUPTCY PROCEDURE  
and  
BANKRUPTCY CODE LEGISLATIVE UPDATE**

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9th Biennial Judge Joe Lee  
Bankruptcy Institute  
December 10 & 11, 1999

by  
Kenneth N. Klee  
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## **NOT SO FAST**

On December 1, 1999, sixteen amendments to the Federal Rules of Bankruptcy Procedure became effective. See House Doc. 106-53.<sup>1</sup> This paper highlights two sets of changes.

### **Rule 7001(7). Plan Injunctions.**

For years, chapter 11 plans have included injunctions of various kinds. Invariably, plan proponents have violated Rule 7001(7) which requires an injunction to be obtained by commencement of an adversary proceeding. Unlike Rule 7001(8) which allows subordination under a plan to be done without filing a complaint, before December 1, 1999 Rule 7001(7) contained no such exception. Arguably, injunctions issued in violation of the Rule were void or voidable. Effective December 1, 1999, Rule 7001(7) was amended to excuse compliance with adversary proceeding requirements when an injunction is sought under a chapter 9, 11, 12, or 13 plan. This amendment automatically applies in all bankruptcy cases commenced on or after December 1, 1999 and "insofar as just and practicable" in all cases then pending.

### **Rule 7062. Automatic Stay of Orders.**

For many years there has been confusion over the application of Rule 7062's automatic stay to certain orders, including orders confirming plans. Effective December 1, 1999, Bankruptcy Rules 7062, 3020, 3021, 4001, 6004, 6006, and 9014 were amended to specify when orders are stayed automatically. These amendments apply in all bankruptcy cases commenced on or after December 1, 1999 and "insofar as just and practicable" in all cases then pending. Rule 9014 has been amended to delete the reference to Rule 7062, so unless the court orders or the rules provide otherwise, in contested matters the default option is that orders will not be stayed but will be effective immediately on entry. Rule 7062 is amended so that it applies in adversary proceedings without reference to the former exceptions for categories of contested matters.

Specific exceptions have been adopted under Rules 4001, 6004, 6006, and Rules 3020 and 3021. Prior to December 1, 1999, orders granting relief from the

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<sup>1</sup> [http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.88&filename=hd053.pdf&directory=/diskb/wais/data/106\\_cong\\_documents](http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.88&filename=hd053.pdf&directory=/diskb/wais/data/106_cong_documents).

automatic stay were not stayed automatically. Rule 4001 now provides that unless the court orders otherwise, an order granting relief from the stay under Rule 4001(a)(1) is automatically stayed for 10 days after entry. This stay does not apply to orders granted ex parte under Rule 4001(a)(2). Nor does the stay affect the time within a notice of appeal must be filed under Rule 8002. Because foreclosure can moot an appeal, the new rule gives the estate a meaningful chance to request a stay pending appeal.

Rule 6004 has been amended to automatically stay for 10 days from entry, unless the court orders otherwise, an order authorizing the use, sale, or lease of property other than cash collateral. Prior to December 1, 1999, no order authorizing the use, sale, or lease of any property of the estate was stayed automatically. Similarly, under the amendment, an order authorizing the use of cash collateral is not stayed automatically. Careful attorneys, however, will be sure to get separate orders authorizing the use of cash collateral. If an order authorizing the use of cash collateral is part of an order authorizing the use, sale, or lease of collateral other than cash collateral, it is possible that the "plain meaning" of the Rule will stay the entire order.

Rule 6006 has been amended to automatically stay for 10 days from entry, unless the court orders otherwise, an order authorizing a trustee to assign a lease under § 365(f). Prior to December 1, 1999, orders assuming or assigning executory contracts or unexpired leases were not stayed. Now an assumption order remains unstayed, but an assignment order will be stayed in order to give the non-debtor party to the contract or lease an opportunity to request a stay pending appeal.

Prior to December 1, 1999, it was unclear whether orders confirming plans were automatically stayed under Rule 7062. See *In re Ewell*, 958 F.2d 276, 278 (9th Cir. 1992) (questioning whether previous version of Rule 7062 applied to judicial sales). Under the amendment to Rule 3020(e), effective December 1, 1999, an order confirming a chapter 9 or chapter 11 plan is stayed automatically for 10 days from entry, unless the court orders otherwise. This amendment will give parties opposing confirmation the opportunity to seek a stay pending appeal. A corresponding amendment to Rule 3021 provides that distribution under a confirmed plan may be made after confirmation except as provided in Rule 3020(e). Presumably while the order is stayed, distribution may not be made. To avoid controversy in cases commenced before December 1, 1999, confirmation orders entered on or after December 1, 1999 should specify whether it is just and practicable for the order confirming plan to be stayed under the amended rule.

**WEBSITE REFERENCE**  
**FOR SIDE-BY-SIDE COMPARISON**  
**OF PROPOSED BANKRUPTCY REFORM ACTS OF 1999**

**H.R. 833 and S. 625**

**Proposed Bankruptcy Reform Acts of 1999:  
Side-by-Side Comparison of Current House and Senate Legislation  
(H.R. 833, as passed in the House on May 5, 1999, and  
S. 625, as reported to the Senate on May 11, 1999)**

**DAVIS POLK & WARDWELL**

Posted: August 1999

**Note: This comparison is not comprehensive and does not compare all of the statutes affected by the pending bankruptcy legislation. Davis Polk & Wardwell compiled these charts to assist us in our internal analysis of the House and Senate bills. We are making them available in PDF format to visitors to this website (<http://www.dpw.com/bankruptcyreform>) with the understanding that while we have tried to be as accurate as possible in compiling this comparison, we do not warrant that the contents are accurate in every respect. Therefore, for those provisions that are particularly important to the reader, we urge the reader to consult the applicable provisions of the House and Senate bills to verify the contents of these charts. Please note that these charts may be subject to further revision by Davis Polk & Wardwell.**

**In the ensuing text, proposed new language appears in italics. Proposed deletions are shown as struck out by a line.**

**If you have any questions or corrections please contact: Pamela Arnsten (voice: 212-450-4857; email: [arnsten@dpw.com](mailto:arnsten@dpw.com)), Stephen Case (voice: 212-450-4064; email: [case@dpw.com](mailto:case@dpw.com)) or Donald Bernstein (voice: 212-450-4092; email: [bernstein@dpw.com](mailto:bernstein@dpw.com)).**





SECTION BY SECTION ANALYSIS OF H.R. 833  
AS PASSED BY THE U. S. HOUSE OF REPRESENTATIVES

-National Bankruptcy Conference -

National Bankruptcy Conference  
Section by Section Analysis of H.R. 833 as passed by the House of Representatives  
[Last Revised May 26, 1999]

**TITLE I.**

**Sec. 101. Conversion.**

This section permits a court to convert a case from chapter 7 to chapter 13 with the debtor's consent, rather than requiring that the debtor request conversion.

**Sec. 102. Dismissal or conversion.**

Courts must presume that a case is abusive if the debtor's income is sufficient to pay at least \$6,000 over 5 years after deducting the debtor's expenses, private school costs for a dependent child if less than \$10,000 per year, secured debts and priority debts. The debtor's expenses shall be determined using the IRS collection standards (excluding payments for debts). The debtor also may subtract an additional 5% of the IRS allowance for food and clothing if doing so is "reasonable and necessary." In addition, the debtor may deduct estimated administrative expenses and attorneys' fees. In determining whether to dismiss a case, the court "may not take into consideration" whether the debtor has made or continues to make charitable contributions.

All chapter 7 debtors must file a statement of "current monthly net income"<sup>1</sup> along with calculations to determine whether the case is presumptively abusive. The presumption of abuse may be rebutted only by showing extraordinary circumstances that require additional expenses or adjustment of income that makes the debtor unable to pay \$6,000 or more over 5 years. Each item must be documented and accompanied by a detailed explanation to which the debtor attests under oath.

<sup>1</sup>"Current monthly net income" includes income from all sources within the prior 180 days, excluding reparations for war crimes and crimes against humanity and excluding benefits under the Social Security Act, divided by six to obtain a monthly figure.

This means test establishes a safe harbor that precludes all parties from bringing ability to pay motions against debtors with incomes equal to or less than the regional median household income.<sup>2</sup> There is another safe harbor against creditor actions providing that only the court, United States trustee, or trustee may bring motions to dismiss or convert cases under section 707(b) if the debtor has income less than the highest national median family income for a family of equal or lesser size, with upward adjustments for families with 4 members.<sup>3</sup>

Notwithstanding these safe harbors, chapter 7 trustees are required to review all materials filed by every chapter 7 debtor and determine within 10 days after the section 341 meeting whether the debtor's case should be presumed abusive. The trustee must bring a motion in a presumptively abusive case if the debtor's income is not less than the highest national median family income for a family of equal or lesser size (with upward adjustment for families with more than 4 members, and with the household income for one earner being used for an individual with no family members).

When determining whether to dismiss or convert a case for abuse, courts also may consider whether a case has been filed in bad faith and the totality of circumstances. A totality of the circumstances analysis includes consideration of whether the debtor filed the case primarily to reject a personal services contract.

This section charges the Director of the Executive Office for United States Trustees to submit a report on the utilization of the IRS expense standards, the impact of those standards, and recommendations for amendments within 3 years after the date of enactment.

If a trustee prevails on a section 707(b) motion and the debtor's attorney is found to have violated Rule 9011 of the Federal Rules of Bankruptcy Procedure, the court shall assess damages against the counsel for the debtor, which may include reimbursing the trustee for costs and attorneys' fees. The signature of an attorney on the bankruptcy petition shall constitute a certificate that the attorney has performed a reasonable investigation into the circumstances that gave rise to the petition and determined that the papers filed by the debtor are well grounded in fact and warranted by existing law or a good faith argument for the modification of existing law and do not constitute an abuse of chapter 7.

The court may award a debtor reasonable costs if a creditor's section 707(b) motion was not substantially justified or the creditor brought the motion solely for the purpose of coercing the debtor to waive a right provided or guaranteed by the Bankruptcy Code.

Finally, this provision adds another chapter 13 plan confirmation requirement: the debtor must have acted in good faith when he filed a chapter 13 petition for relief.

<sup>2</sup> For households with more than 4 individuals, there shall be an upward adjustment of \$583 per person (this originally was a per month adjustment, but now appears to be a per year adjustment).  
<sup>3</sup>The creditor safe harbor provision refers to national median family income. The total safe harbor provision refers to regional median household income. In some instances, there will be a gap between the two.

*Comments: This means test deprives courts of sufficient discretion to identify debtors with substantial repayment ability and is based on an unrealistic repayment schedule -- 5 years -- when 3 year plans already are highly susceptible to failure. It is inefficient to require that the trustee certify every debtor's ability to pay, including those below the safe harbor income level.*

*The IRS collection allowances, which are not mandatory in the tax context, are not appropriate as a template to determine whether debtors deserve chapter 7 bankruptcy relief. The Hyde amendment would have enabled a judge to determine necessary and reasonable expenses for a debtor and the debtor's dependents to assess whether the debtor has the ability to pay. Adoption of the IRS' inflexible and rigid standards will cause many honest families to lose the benefit of a fresh start under chapter 7.*

*Some of the problems with the IRS standards can be set out briefly. Because some of the allowances are based on income as well as family size, the IRS expense standards give a higher food allowance to a single high income person than to a low income family of 6. The means test permits homeowners to deduct their entire mortgage payments regardless of the amount, in addition to the portion of the IRS housing allowance that is not attributable to the mortgage payment. However, the means test does not make clear how much of the IRS housing allowance may be claimed by homeowners for housing-related costs. In any event, this portion of the test favors homeowners with high mortgage payments over homeowners with low mortgage payments, and gives least favored status to families who rent their dwellings.*

*The transportation allowance affects similarly situated debtors differently as well. The test disfavors people without any cars who rely on public transportation and creates perverse incentives by benefitting high income debtors with one or more late-model cars. Each case will need individualized scrutiny of the extent to which the debtor is permitted to deduct "other necessary expenses" for child care, health care, dependent care of elderly, taxes, union dues, and similar expenses.*

*The required calculation of current monthly net income (a 6 month average) may overstate or understate the amount of income actually available to pay creditors. For example, if the debtor had an income of \$5,000 per month for 3 months, followed by 3 months of zero income, that debtor will be presumed to have monthly income of \$2,500 when in reality she has none. In addition, including the income of a nondebtor spouse may create a marriage penalty on debtors. The problems with including nondebtor spouse income are heightened by the exclusion of the expenses of a separated spouse.*

*All attorneys representing parties in bankruptcy cases are already subject to Rule 9011 of the Federal Rules of Bankruptcy Procedure. Like Rule 11 of the Federal Rules of Civil Procedure, Rule 9011 penalizes attorneys for sanctionable behavior. The bankruptcy system should hold lawyers answerable to the standards applicable to all lawyers who practice in federal court.*

#### **Sec. 103. Notice of alternatives.**

This section amends 11 U.S.C. § 342(b) so that an individual seeking bankruptcy relief must obtain a written notice prescribed by the United States trustee before the commencement of a

case. This written notice must contain a brief description of bankruptcy options (e.g., chapter 7 versus chapter 13) and credit counseling services approved by the United States trustee. Notice also must state that concealing assets or providing false information leads to criminal sanctions.

*Comments: Increasing consumers' awareness of alternatives to bankruptcy is desirable. In some districts, however, such as the Central District of California, a significant portion of consumer debtors are pro se filers. These pro se filers may not know to comply with the requirements imposed by this provision and section 302 of this bill (prebankruptcy counseling requirement).*

#### **Sec. 104. Debtor financial management training test program.**

This section instructs the Executive Office for United States Trustees to consult with a wide range of individuals with expertise in the field of debtor education, develop a financial management training curriculum and materials, and establish pilot programs in 6 judicial districts for a one year period beginning not later than 270 days after enactment of this Act, during which the curriculum and materials are available to individual debtors. During this one year period, the Director of the Executive Office for United States Trustees must evaluate the effectiveness of the curriculum and materials as well as other preexisting consumer education programs. Not later than three months after concluding the evaluation, the Director must submit a report to Congress.

*Comments: To maximize the benefits of a pilot program, it may take several years to assess whether the program prevents people from repeating the mistakes that led them into financial trouble and bankruptcy. In addition, because appropriations will be necessary to implement this provision, section 104 should not become effective until the later of October 1, 2000 or one year after the date of enactment of this bill.*

#### **Sec. 105. Definitions.**

This section introduces new terms into the bankruptcy lexicon such as "bankruptcy assistance," "assisted person," and "debt relief agency" for application to sections 106, 154, and 155 of this bill that impose requirements and restrictions on lawyers, bankruptcy petition preparers, and other entities falling into the definition of debt relief agency.

*Comments: These definitions seem to encompass a wide range of parties, such as bookstores, which may extend the application of the subsequent sections beyond their intended scope.*

#### **Sec. 106. Enforcement.**

Under this section, a debt relief agency must disgorge fees or waive unpaid fees if it fails to perform the promised services, misrepresents the benefits of bankruptcy, or provides inappropriate advice. This section also authorizes civil penalties and injunctive relief.

#### **Sec. 107. Sense of the congress.**

This provision states that "[i]t is the sense of the Congress that States should develop curricula relating to the subject of personal finance, designed for use in elementary and secondary schools."

#### **Sec. 108. Discouraging abusive reaffirmation practices.**

This provision amends 11 U.S.C. § 524 to provide that a debtor is entitled to a hearing regarding a reaffirmation of an unsecured debt, during which the court would decide whether "the agreement is an undue hardship, not in the debtor's best interest, and not the result of a threat by the creditor to take any action that cannot be legally taken or that is not intended to be taken." However, this requirement is waivable by debtors represented by counsel. This provision does not authorize hearings for reaffirmation of unsecured debts owed to credit unions or nominally secured debts.

*Comments: This provision does not substantially change current law, which has proven to be inadequate in screening reaffirmations of debt that the debtor cannot afford and that impede the debtor's ability to satisfy critical postbankruptcy obligations. This problem is heightened if creditors are permitted to bring section 707(b) motions and rely on additional exceptions to discharge, the threat of which may be used as leverage to extract reaffirmation agreements. If reaffirmations are not otherwise restricted, reaffirmation review should be mandatory for at least all unsecured and nominally secured debts. It would be helpful to enhance disclosures of the costs as well.*

#### **Sec. 109. Promotion of alternative dispute resolution.**

This provision does not address alternative dispute resolution as that term is generally defined, but rather attempts to induce parties to restructure debts outside of bankruptcy. It authorizes a court to reduce an unsecured consumer debt claim by up to 20% if the debtor proves by clear and convincing evidence that the creditor holding the claim refused to negotiate a reasonable alternative repayment schedule offered by the debtor at least 60 days before the filing of the petition if that repayment schedule would have resulted in the repayment of at least 60% of the debt over a reasonable period. The court's authority to reduce claims on this basis does not apply to nondischargeable debts. This provision also protects payments from avoidance as preferential transfers if the payments were part of an alternative repayment plan created by an approved credit counseling agency.

*Comments: Further study is necessary to determine whether this provision is necessary or desirable. As a technical matter, the appropriate burden of proof for bankruptcy proceedings and contested matters is by a preponderance of the evidence, not clear and convincing evidence. Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654 (1991).*

#### **Sec. 110. Enhanced disclosure for credit extensions secured by a dwelling.**

This provision authorizes the Federal Reserve to study whether consumers who obtain high loan to value mortgages receive adequate information about the income tax deductibility of interest on the unsecured portion of such loans, and whether additional disclosures are necessary.

*Comments: This provision is less direct than section 207 of H.R. 3150 as passed by the Senate last year (now S. 945), which would have required that home equity loan solicitations and applications notify potential borrowers that tax benefits of home equity lending are limited to the portion that is secured by the value of the collateral. Enhanced disclosure is critical to educating consumers and decreasing the likelihood of insolvency and bankruptcy.*

#### **Sec. 111. Dual use debit card.**

This provision authorizes a study of existing protections that limit consumers' liability for unauthorized electronic fund transfers. Not later than 2 years after enactment of this bill, the Federal Reserve must issue a report on its findings and issue regulations accordingly.

*Comments: This amendment is less proactive than section 208 of H.R. 3150 as passed by the Senate last year, which would have amended the Electronic Fund Transfer Act to delineate the circumstances in which consumers are liable for unauthorized electronic fund transfers.*

#### **Sec. 112. Enhanced disclosures under an open-end credit plan.**

This section amends the Truth in Lending Act to require disclosures, including several examples of how long it would take to pay off a debt if the consumer makes only the minimum monthly payment, the amount of the minimum payment expressed as a dollar amount and the date by which it must be paid, penalty rates, and "payment holidays." In addition, the amendment makes clear that these disclosures apply to credit card solicitations and applications on the World Wide Web. Creditors must provide a worksheet annually to help the borrower to determine his household income and debt obligations. The Federal Reserve must study whether consumers receive adequate information about borrowing, particularly in open end credit plans such as credit cards, to submit a report to Congress within two years after the date of enactment, and to require additional disclosures if necessary.

*Comments: The proposed generic disclosures may not be as useful to consumers as disclosures based on a borrower's actual balance and terms.*

#### **Sec. 113. Protection of savings earmarked for the postsecondary education of children.**

This provision exempts \$50,000 for one dependent child or \$100,000 total in an education IRA.

#### **Sec. 114. Effect of discharge.**

Under this section, a creditor's willful failure to properly credit repayment plan distributions violates the injunction automatically imposed by 11 U.S.C. § 524 when a debtor receives a discharge. If an individual debtor is injured by the failure of a creditor to comply with the reaffirmation agreement requirements in sections 524(c) and (d) or a creditor's willful violation of section 524(a)(2), the debtor may be entitled to recover costs, attorneys' fees, and damages. However, an action to recover for violations of the discharge injunction "may not be brought as a class action."

*Comments: This provision appropriately imposes sanctions on parties that willfully violate the discharge injunction and reaffirmation procedures, which has been a persistent problem under current law. See, e.g., Night of the Living Debt; Discharged Bills Come Back -- Often Illegally -- to Haunt Bankruptcy Filers, THE WASHINGTON POST p. H01 (September 13, 1998) (citing postbankruptcy collection practices of certain retailers that have admitted to such conduct). Regardless of one's views on class action lawsuits as a general matter, it is not clear why this specific type of class action is being singled out for differential treatment.*

**Sec. 115. Limiting trustee liability.**

This provision imposes statutory limitations on case trustees' liability. A trustee may not be sued unless he acted with gross negligence (defined as reckless indifference or deliberate disregard of trustee's fiduciary duty), and the plaintiff must get bankruptcy court permission before suing the trustee personally. A case trustee may not be sued in any capacity for acts taken in connection with determining a debtor's ineligibility or for disseminating statistics and information regarding a case unless trustee has actual knowledge that the information is false.

*Comments: This provision should clarify that it applies notwithstanding section 959(b) of title 28 so that its requirement to obtain leave of court is not contradictory.*

**Sec. 116. Reinforce the fresh start.**

This section amends 11 U.S.C. § 523(a)(17), the exception to discharge for court costs, but deletes a reference in earlier versions of this amendment clarifying that the exception to discharge applies only to prisoners.

*Comments: This exception to discharge was added to the Bankruptcy Code in the Prison Litigation Reform Act of 1995, Pub. L. 104-134, and the language should reflect its intended scope of application to prisoners.*

**Sec. 117. Discouraging bad faith repeat filings.**

Under this provision, the automatic stay terminates 30 days after the filing of a petition for relief under title 11 by an individual if the individual was a debtor in another case that was dismissed within the previous year. A party in interest may seek an extension of the stay by showing that the later case is in good faith. A case presumptively is not in good faith if the debtor filed more than one previous case within the year, if a prior case was dismissed after the debtor did not file the requisite documents without substantial excuse, if the debtor did not provide adequate protection, if the debtor did not perform the terms of a confirmed plan, or if the debtor's financial condition and personal affairs have not changed substantially since the last case was dismissed. In addition, a case presumptively is not in good faith as to a particular creditor if the creditor sought relief from the automatic stay in the prior case and that action was pending upon dismissal or had been resolved in the creditor's favor. A presumption that a case is not in good faith is rebuttable by clear and convincing evidence. The automatic stay does not apply to all of the case of an individual who has been a debtor in two or more dismissed cases within the previous year, although a party in interest may request that a stay be imposed by showing that the case is in good faith (with presumptions similar to those listed above).

*Comments: The National Bankruptcy Conference supports restrictions to deter abusive repeat filings, subject to some minor technical revisions. The standard for rebutting a presumption should be by a preponderance of the evidence, as is generally the standard in bankruptcy matters, not clear and convincing evidence.*

**Sec. 118. Curbing abusive filings.**

This section establishes standards for the application of *in rem* orders that make the automatic stay inapplicable to an identified property interest in future cases. This order may be issued upon a court finding that the filing of a bankruptcy petition was part of a scheme to hinder, delay, and

defraud creditors involving the transfer of an interest in real property or multiple bankruptcy filings affecting that property. An *in rem* order remains in effect for two years, although parties may obtain relief from an *in rem* order for good cause or changed circumstances. In addition, this provision makes the automatic stay inapplicable to any act to enforce a lien against property of a debtor who is ineligible for bankruptcy relief pursuant to 11 U.S.C. § 109(g) or a prior court order. A government agency that accepts notices of interests or liens in property must accept a certified copy of *in rem* order.

*Comments: The National Bankruptcy Conference supports this provision. To resolve a slight inconsistency, the reference in section 362(d)(4) should be changed so that the two-year period in that provision runs from the date of the entry of the order, not the recording. This can be accomplished by striking "not later than 2 years after that recording" and inserting "not later than 2 years after the entry of the order". The proposed automatic stay exception that permits lien enforcement against the property of individuals ineligible for bankruptcy may lead to some wrongful repossessions and foreclosures.*

**Sec. 119. Debtor retention of personal property security.**

This section prohibits the "ridethrough" of secured debt obligations in chapter 7. If a debtor does not redeem or reaffirm a debt secured by personal property within 45 days after the first meeting of creditors, the creditor may take any action against the property permitted under applicable nonbankruptcy law unless the court determines on the motion of a trustee within the 45 day period that the property is of consequential value to the bankruptcy estate. This section also clarifies that redemption requires payment in a single lump sum.

*Comments: This provision makes a substantial change to the law and practice in several circuits while it codifies the law of other circuits. If this provision is retained, some minor refinements would be helpful. For example, if the debtor is contesting the validity of, or is seeking to avoid, the security interest (similar to the proposed section 521(c) that creates an exception for voidable security interests), or if the debtor attacks a security interest as being invalid under state law, the property should not be abandoned to the creditor. With respect to redemption, it is appropriate to clarify that a debtor must provide a lump sum payment to the party holding a security interest in that property.*

**Sec. 120. Relief from the automatic stay when the debtor does not complete intended surrender of consumer debt collateral.**

This section authorizes automatic stay relief without court permission if a debtor fails to file a statement of intention or to follow through on the debtor's statement of intention (unless the statement specifies reaffirmation and the creditor refuses to reaffirm on the original contract terms), except if the court determines on the motion of a trustee that the property is of consequential value or benefit to the estate, in which case the court must order adequate protection for the creditor and the debtor must deliver the property to the trustee.

*Comments: This provision should be revised to provide that a debtor's failure to file a statement of intention or to follow through on a statement of intention triggers abandonment of the property to the debtor, and the creditor may exercise its rights except to the extent that it seeks to enforce ipso facto clauses triggered by the bankruptcy or insolvency of the debtor. The trustee may face liability for accounting and storing items delivered by the debtor. It may be preferable to require delivery only at the request of the trustee.*

#### **Sec. 121. Giving secured creditors fair treatment in chapter 13.**

According to this section, the holder of an allowed secured claim retains its lien until the debtor pays the entire debt (including the unsecured portion) or until receipt of a chapter 13 discharge.

*Comments: Current law is divided on whether a lien is released when the allowed secured claim has been paid off or when the repayment plan has been completed. See In re Johnson, 213 B.R. 552 (Bankr. N.D. Ill. 1997) (collecting cases split on question of lien retention). This provision may encourage some debtors to remain committed to their repayment plans. It may also result in a higher rate of repossessions of collateral.*

#### **Sec. 122. Restraining abusive purchases on secured credit.**

This provision amends 11 U.S.C. § 506 so that debts partially secured by personal property purchased by an individual debtor within 5 years before the filing of a bankruptcy petition are not bifurcated into secured and unsecured claims in chapter 7, 11, 12, or 13. If the allowed claim is secured only by the personal property so acquired, the value of the personal property and the amount of the allowed secured claim "shall be the sum of the unpaid principal balance of the purchase price and accrued and unpaid interest and charges at the contract rate." If the claim is secured by other property as well, the value of the security shall be "not less than the unpaid principal balance of the purchase price of the personal property and unpaid interest and charges at the contract rate." If the individual is a debtor in a subsequent case within two years after the date the original petition was filed, the value of the allowed secured claim will be calculated in the same manner as in the prior case.

*Comments: The National Bankruptcy Conference opposes this provision that eliminates the stripdown of partially secured debt and includes accrued interest and penalty charges. This provision diverts value from general unsecured creditors in favor of undersecured creditors. The Bankruptcy Code should give creditors what they otherwise would receive under state law; treating a creditor as fully secured when that creditor's interest is substantially undersecured deviates from this fundamental principle. If this provision is adopted notwithstanding these concerns, the five year period should be reduced to 90 days and should exclude retail charge card debts.*

#### **Sec. 123. Fair valuation of collateral.**

Under section 123, the allowed secured claim for a debt secured by personal property is determined by the collateral's replacement value, defined as the price a retail merchant would

charge for property of that kind, age, and condition, with no deductions for marketing or sales costs.

*Comments: In Associates Commercial Corp. v. Rash, \_\_\_ U.S. \_\_\_, 117 S. Ct. 1879 (1997), the Supreme Court held that "replacement value" is the appropriate standard. However, the Supreme Court also made clear in footnote 6 that debtors — and consequently, unsecured creditors — should not pay for attributes that they did not receive and that did not have to be expended by the creditor, such as the costs of marketing and reconditioning. Failing to deduct for those costs is inconsistent with the goal of maximizing returns to unsecured creditors. Most property acquired for personal family or household purposes do not have an easily determined replacement value as defined in this provision because retail merchants dealing in new goods rarely sell used goods as well. Second-hand stores carry a restricted range of items that may not be comparable to the item of property to be valued. If Congress chooses to legislate in this area, Congress might consider providing that the fair valuation of collateral in bankruptcy is the value of the property in the hands of a creditor following foreclosure, which reflects what the creditor realistically would receive under state law.*

#### **Sec. 124. Domiciliary requirements for exemptions.**

Under this section, to be subject to the exemption laws of a state, a debtor must be domiciled in a state for the 730 days immediately preceding the date of the filing of the petition. If the debtor did not live in any state for 730 days, the debtor must use the exemptions of the state in which he resided during the 180 days, or the majority of the 180 days, before the 730 day period.

*Comments: This amendment no longer leaves people without exemptions if they have lived in a state for less than 730 days, but does nothing to limit the ability of a debtor who has lived in a state for 730 days or more from taking advantage of unlimited exemptions, commonly identified as the largest single abuse of the bankruptcy system under current law.*

#### **Sec. 125. Restrictions on certain exempt property obtained through fraud.**

This section provides that the exemption of a debtor's equity in a homestead shall be reduced to the extent such value is attributable to any portion of property that the debtor "disposed of" within 730 days before the bankruptcy petition date with the intent to hinder, delay or defraud a creditor.

*Comments: This provision does not make a meaningful addition to the current bankruptcy laws. Current law already authorizes the avoidance of transfers, or the denial of a discharge altogether, when debtors transfer property with the actual intent to hinder, delay, or defraud within one year before the date of the filing of the petition. 11 U.S.C. §§ 548(a)(1), 727(a)(2). Trustees also may recover constructive fraudulent transfers within one year before filing for bankruptcy. Id. § 548(a)(2). In addition, using applicable state law, trustees may recover actual or constructive fraudulent conveyances transfers made within 2, 4, or in some states even 6 years before the bankruptcy filing. Id. § 544(b). This provision fails to close the loophole in current*

*bankruptcy law: fraudulent transfer laws do not protect creditors in the cases of individuals who amass considerable wealth in exempt property but do not make any transfers. To prevent debtors from discharging their debts while retaining property of high value, a cap should be imposed on all homestead exemptions.*

**Sec. 126. Rolling stock equipment.**

This section amends 11 U.S.C. §§ 1168 and 1110 to provide even greater protections to creditors secured by rolling stock equipment and aircraft and lessors of the same. These amendments require that a trustee or debtor-in-possession perform all obligations and cure all defaults in accordance with the terms of such security agreement, lease, or conditional sale contract, and required that a trustee surrender property if the vendor or lessor makes a written demand and otherwise would be entitled to take possession.

*Comments: The amendment to section 1110 of the Bankruptcy Code legislatively overrules Western Pacific Airlines, Inc. v. Gatz Capital, 221 B.R. 1 (D. Colo. 1998). These amendments expand, but do not dramatically change, the protection for aircraft and rolling stock lessors and secured creditors that the Bankruptcy Code already provides. The National Bankruptcy Conference generally opposes special interest provisions that provide preferential treatment for a particular type of creditor to the detriment of other creditors, and for this reason has recommended in the past that these provisions be deleted.*

**Sec. 127. Discharge under chapter 13.**

This section amends 11 U.S.C. § 1328 so that a debtor who completes a 3 to 5 year chapter 13 plan may not discharge debts that are nondischargeable under 11 U.S.C. §§ 523(a)(2), (3)(B), (a)(4), and (a)(6) (if resulting from a willful and malicious injury by the debtor that caused personal injury or death).

*Comments: The National Bankruptcy Conference supports this provision to the extent that it excludes from the superdischarge debts falling under section 523(a)(6) that result from a willful and malicious injury by the debtor that caused personal injury or death. However, if the scope of the discharge in chapter 7 and chapter 13 are relatively coextensive by excepting from discharge credit card debts and cash advances under section 523(a)(2), the incentive to file chapter 13 is reduced. Those debts should not be excepted from discharge in chapter 13.*

*Increased nondischargeability in chapter 13 intensifies the need to address another issue: separate classification of nondischargeable claims for purposes of a repayment plan. Courts are divided on whether chapter 13 debtors may separately classify nondischargeable debts and commit a higher amount of disposable income to those debts. Cf. Groves v. LaBarge, 39 F.3d 212 (8th Cir. 1994) (fact that a debt is nondischargeable is insufficient to warrant separate classification under section 1322(b)(1)) with In re Tucker, 159 B.R. 325 (Bankr. D. Mont. 1993) (permitting separate classification of nondischargeable debts). If a chapter 13 debtor is not permitted to commit concentrated portions of income to debts that will survive the repayment plan, a debtor who completes a repayment plan may be faced not only with the residual debt, but with substantial accrued interest as well. Thus, a restriction on nondischargeability should be*

*accompanied with a provision permitting separate classification of nondischargeable debts or a provision imposing a moratorium on interest accrual for the duration of a repayment plan.*

**Sec. 128. Bankruptcy judgeships.**

This provision authorizes temporary judgeships and requires disclosure of judges' travel expenses.

**Sec. 129. Additional amendments to title 11, United States Code.**

This section amends 11 U.S.C. § 523(a)(9) to explicitly except from discharge debts resulting from drunk boating and amends 11 U.S.C. § 507(a) to give priority status to allowed claims for death and personal injuries resulting from drunk boating or drunk driving.

*Comments: All priority debts must be repaid in full in the course of a chapter 13 plan. Hence, granting priority status to this or any other type of debt decreases the likelihood that chapter 13 debtors with a debt of this kind will be able to confirm a plan and repay any debts in chapter 13. The amendment to section 523(a)(9) duplicates an amendment made in section 1112 of this bill.*

**Sec. 130. Amendment to section 1325 of title 11, United States Code.**

Under this section, the disposable income available for distribution to unsecured creditors in a chapter 13 plan must be calculated under the new means test as set forth in section 102 of this bill. The amendment also provides for an explicit deduction of foster care, disability, and support payments for a dependent child.

*Comments: Using the IRS expense standards and the means test-calculation generally will be troublesome in chapter 13 and likely yield a lower success rate. In addition, the means test is based on a 5-year payment schedule, which will further exacerbate the failure rate. This provision is inconsistent with section 606 of the bill, which requires 5-year plans only for debtors with income above the national median. Additional problems produced by the means test may be found in the discussion of section 102 of this bill.*

**Sec. 131. <sup>133</sup>Application of the codebtor stay only when the stay protects the debtor.**

This section provides that the stay protecting codebtors in chapter 13 cases terminates 30 days after the date of the order for relief if a debtor did not receive the consideration for the claim "to the extent that the creditor proceeds against the individual that received that consideration or property not in possession of the debtor that secures that claim." The codebtor stay also is lifted postconfirmation when a debtor's plan provides for surrender or abandonment of the debtor's interest in personal property subject to a lease. These new rules are inapplicable when the debtor is primarily obligated to pay the creditor under a legally binding divorce decree or separation agreement.

**Sec. 132. Adequate protection for investors.**

This section adds another exception to the automatic stay permitting a securities self regulatory organization to commence or continue an investigation or action, other than for monetary sanctions, without first seeking court approval.

*Comments: The National Bankruptcy Conference generally opposes provisions that prefer a particular type of creditor over other creditors. The expansion of exceptions to the automatic stay for regulatory actions through this bill and section 603 of the Omnibus Consolidated and Emergency Appropriations Act, 1999, Pub. L. No. 105-277 (striking 11 U.S.C. § 362(b)(4) and (b)(5) and replacing them with a new provision), heightens the importance of imposing explicit limitations to narrowly define the police and regulatory power statutorily to exclude actions taken for purely pecuniary purposes, making the following amendment necessary:*

Section 362 of title 11, United States Code, is amended by adding at the end the following —

(i) In this section, "police and regulatory power" excludes any act, action, or proceeding that affects property of or from the estate to secure or satisfy, in whole or in part, a debt.

#### Sec. 133. Limitation on luxury goods.

This section amends 11 U.S.C. § 523(a)(2)(C) to presumptively except from discharge any debts of \$250 or more owed to a single creditor for cash advances or luxury goods or services within 90 days before the bankruptcy filing. This provision expands current section 523(a)(2)(C) in two ways. It extends the presumptive time period from 60 to 90 days and it permits a wider range of debts to be presumed nondischargeable by lowering the threshold from \$1,000 to \$250.

*Comments: The National Bankruptcy Conference generally opposes provisions that prefer one type of creditor over others. This provision limits chapter 7 debt relief for debtors of all income levels and expands nondischargeability for the benefit of credit card lenders. Three months worth of cash advances taken in reasonable amounts for necessities easily can exceed \$250. If Congress decides to amend section 523(a)(2)(C) to substantially reduce the dollar threshold (the current threshold is \$1,075) triggering a presumption of nondischargeability for credit card debts, the presumptive period should be shortened to 30 days and should exclude cash advances.*

#### Sec. 134. Allowing a debtor to retain leased personal property by assumption.

Under this section, leased personal property is not property of the estate and is not protected by the automatic stay once a lease is rejected or not timely assumed by the trustee. This section also offers a procedure by which debtors can assume leases themselves. In individual chapter 11 and chapter 13 cases, the lease is deemed rejected at the conclusion of the confirmation hearing, with similar consequences.

*Comments: Leases rejected or not timely assumed should be abandoned to the debtors, and debtors should be provided with an opportunity to cure defaults.*

#### Sec. 135. Adequate protection of lessors and purchase money secured creditors.

Under this section, a chapter 13 debtor must make cash payments at the contract rate to lessors and creditors with debts secured by personal property until the creditors start to receive plan payments. The section also authorizes a lessor or creditor to retain any property rightfully obtained prior to the bankruptcy filing until adequate protection payments are commenced, notwithstanding otherwise applicable turnover requirements.

*Comments: The Bankruptcy Code already authorizes adequate protection against the declining value of collateral. If more is necessary to insure payment of secured creditors pending confirmation of a plan, the adequate protection provision of S. 625 should be considered. That amendment provides that courts may instruct trustees to distribute payments to fully secured creditors and lessors prior to confirmation and that those payments are credited against the principal debt.*

#### Sec. 136. Automatic stay.

This section creates new exceptions to the automatic stay that expand the ability of residential landlords to take action against debtors without first seeking leave from the court. Landlords may continue eviction or unlawful detainer actions if the lease terminated prepetition, if the debtor does not paid rent after the commencement of the case, if the debtor filed a previous case within the last year and failed to pay postpetition rent during the course of that case, if the eviction action is based on "endangerment to property or person or the use of illegal drugs."

*Comments: The National Bankruptcy Conference generally opposes exceptions to the automatic stay that prefer one type of creditor to others. This provision gives wide latitude for landlords to evict individuals filing for bankruptcy even if the debtor is making rent payments postpetition. If a provision to protect landlords is thought to be necessary, this provision should be replaced with a provision authorizing landlords to receive expedited relief from the automatic stay. The following provision is an example: Section 362 of title 11, United States Code is amended by adding at the end thereof— (j) If a lessor of residential real property makes a request for relief under subsection (d) of this section and the debtor has not paid rent that first became due after the commencement of the case, the stay provided by subsection (a)(3) of this section is terminated with respect to the lessor 20 days after request is filed, unless the debtor files and serves upon such lessor a written objection to the request.*

#### Sec. 137. Extend period between bankruptcy discharges.

This section amends 11 U.S.C. § 727(a)(8) to prevent a chapter 7 debtor from receiving a discharge if he received a discharge in a prior case under chapter 7 or 11 commenced within eight years before the filing of the petition in the instant case. If a chapter 13 debtor previously received a discharge under any chapter within the prior five years before the instant case commenced, he cannot receive a discharge even if he completes a new repayment plan.

*Comments: This provision imposes a longer bar on the receipt of a discharge after a successful chapter 13 repayment plan than after the discharge in chapter 7.*

#### Sec. 138. Definition of domestic support obligation.



This provision adds a definition of "domestic support obligation" to 11 U.S.C. § 101, the general definition section of the Bankruptcy Code. The new definition includes any debt, whether accrued before or after the bankruptcy filing if: the debt is owed or recoverable to a spouse, ex-spouse, child, legal guardian, or a governmental unit; the debt is in the nature of alimony, maintenance, or support, regardless of its designation, established or subject to establishment by reason of a separation agreement, divorce decree, property settlement agreement, court order, or determination made by a governmental unit; and the debt has not been assigned to a nongovernmental unit, other than a debt collector. This definition is relevant to subsequent provisions that give certain rights to the holders of domestic support obligations and impose additional requirements on debtors who owe these obligations.

#### Sec. 139. Priorities for claims for domestic support obligations.

This section amends 11 U.S.C. § 507(a), the provision that determines priorities in distribution among expenses and debts. The amendment moves domestic support obligations from "seventh priority" to "first priority." Because the definition of domestic support obligation now includes debts owed to the government, those government debts are entitled to "first priority" as well. However, the amendment specifies that any first priority distribution should first be applied to satisfy the claims of support recipients and then to government units.

*Comments: Right now, the expenses of administering the bankruptcy estate are entitled to "first priority." See 11 U.S.C. §§ 507(a)(1), 503(b). The Bankruptcy Code gives first priority to administrative expenses to enable the trustee to incur the expenses necessary to liquidate property and make distributions to creditors, including support recipients. If a debtor has significant support obligations, and support is "first priority," the trustee will not be able to liquidate and distribute property. Instead, the trustee may have to "abandon" property— give it back to the debtor— rather than distributing the proceeds to support recipients. Thus, while it may be legally correct to say that this bill puts child support "first" under section 507 of the Bankruptcy Code, that statement is somewhat misleading. Apart from the issue related to subordination of administrative expenses moving from "seventh priority" to "first priority" makes little practical difference: the debts that have second through sixth priorities almost never appear in consumer cases. Those priorities deal with debts of grain storage facility operators, debts of fishermen, employee wage claims, retail layaway claims, and the like. Taking all factors into consideration, this amendment would have an effect in fewer than 1% of all chapter 7 cases.*

#### Sec. 140. Requirements to obtain confirmation and discharge in cases involving domestic support obligations.

This section amends 11 U.S.C. §§ 1129(a) and 1325(a), provisions that set forth the requirements for confirmation of plans of reorganization in cases under chapter 11 and chapter 13. Under this amendment, the debtor cannot confirm a plan of reorganization unless the debtor has paid all domestic support obligations that "become payable" after the bankruptcy petition is filed. In addition, this section amends 11 U.S.C. § 1328(a), the provision that determines whether a chapter 13 debtor may discharge his debts. Under this amendment, the debtor cannot obtain a

discharge after completing payments under a chapter 13 plan unless he certifies that all domestic support obligations have been paid.

*Comments: Requiring that the debtor pay all past due support owed to the government as a condition of discharge may heighten collection difficulties for a former spouse and children who are trying to collect continued support because the debtor will not have discharged his other debts. Language in this amendment regarding confirmation may be construed in certain instances to require that a debtor pay all past due support debts before confirmation of a plan; doing so may be infeasible. The amendment should refer to support obligations that "first became due" postpetition.*

#### Sec. 141. Exceptions to automatic stay in domestic support obligation proceedings.

This section adds additional exceptions to the automatic stay in 11 U.S.C. § 362(b). According to these amendments, the automatic stay does not enjoin actions to impose or enforce wage orders for domestic support obligations, the interception of tax refunds, the enforcement of medical obligations, or actions to withhold, suspend, or restrict licenses of the debtor for delinquency in support obligations.

#### Sec. 142. Nondischargeability of certain debts for alimony, maintenance, and support.

This section amends 11 U.S.C. § 523(a)(5) to exempt from discharge all domestic support obligations. This section also makes a substantial change to 11 U.S.C. § 523(a)(15). This provision currently permits a court to find that a property settlement (that is not in the nature of support) is excepted from discharge unless the court finds (1) that the debtor does not have the ability to pay the obligation or (2) that discharging the debt would result in a benefit to the debtor that outweighs the detrimental consequences to the ex-spouse or children. The amendment eliminates these two conditions so that all property settlements will be nondischargeable.

*Comments: There will be times when this change to the treatment of property settlements will work hardship on spouses and children collecting support. A custodial parent and child may file for bankruptcy after they have difficulty collecting payments from an ex-spouse and thus cannot meet their day to day obligations. As a result of this amendment, some financially troubled spouses and children who file for bankruptcy because they have not been receiving their support payments will be unable to discharge debts they may owe to their wealthier spouses as a result of a property settlement. In addition, some ex-spouses do not receive support because they are financially independent or have remarried and joined financial stable households. Another scenario that reveals the odd effects of this amendment is when a debtor has been married and divorced twice. The first former spouse may need child support from the debtor. The second former spouse may be wealthy and remarried and does not receive support from the debtor but has a property settlement with the debtor. If this amendment becomes law, the support obligation to the first spouse and the property settlement to the second spouse would both be nondischargeable and have the same status after bankruptcy; if the debtor lacks sufficient funds to pay both, the support recipient, who has fewer resources to seek collection, may suffer.*

**Sec. 143. Continued liability of property.**

This amendment permits nondischargeable domestic support obligations to be collected from property -- even property that state law makes exempt from collection or attachment -- after bankruptcy.

*Comments: This provision overrides wage exemptions, property exemptions, and state laws protecting tenancies by the entireties. It is unclear whether this provision actually will benefit families or whether it instead will benefit government agencies, particularly because overriding homestead exemptions may have the effect of removing families from their homes.*

**Sec. 144. Protection of domestic support claims against preferential transfer motions.**

This section amends 11 U.S.C. § 547, the provision that allows avoidance, and ultimately recovery, of pre-bankruptcy transfers that were "preferential." The amendment prevents a trustee from seeking recovery of a prepetition "domestic support obligation."

*Comments: With respect to actual support recipients, this amendment does not substantially change current law. A 1994 amendment protects ex-spouses and children from having to give back "preferential" support payments. See 11 U.S.C. § 547(c)(7). The amendment changes current law by insulating preferential payments made to governmental units. Insulating those payments to the government may, in some cases, hurt an ex-spouse and child of the debtor because those funds otherwise would be available for ongoing support payments and instead have been applied to old support debts preferentially paid to the government.*

**Sec. 145. Clarification of meaning of household goods.**

This amendment adds a definition of household goods to 11 U.S.C. § 101 and states that household goods includes "tangible personal property normally found in or around a residence, but does not include motorized vehicles used for transportation purposes."

*Comments: This amendment codifies the prevailing case law. See, e.g., In re McGreevy, 955 F.2d 957 (4th Cir. 1992) (defining household goods as items of personal property typically found in or around home and used by debtor or his dependents to support and facilitate day-to-day living within home, including maintenance and upkeep of home).*

**Sec. 146. Nondischargeable debts.**

This section adds an exception to discharge when the "debtor incurred the debt to pay such a nondischargeable debt with the intent to discharge in bankruptcy the newly-created debt." It makes nondischargeable all debts incurred to pay nondischargeable debts within 90 days regardless of the debtor's intent.

*Comments: The National Bankruptcy Conference opposes this expansion of the exceptions to discharge. For a credit card debt to be nondischargeable, a creditor should be required to prove each element of fraud by the preponderance of the evidence. As a technical matter, the reference in the amendment to section 727 should be deleted. Section 727 deals with objections*

*to a chapter 7 debtor receiving a discharge of debts overall, not the nondischargeability of a particular debt.*

**Sec. 147. Monetary limitation on exempt property.**

This section imposes a \$250,000 cap on larger or unlimited homestead exemptions provided by state law, but permits states to opt out from the cap, which renders the cap useless.

*Comments: The National Bankruptcy Conference supports the imposition of a cap on otherwise unlimited exemptions. Experience with the opt-out provision in the Bankruptcy Reform Act of 1978, however, has shown that the cap will not serve its purpose if an opt-out opportunity is provided. We can be confident that states with generous or unlimited exemptions will opt out of the cap. If Congress believes it is appropriate to permit unlimited exemptions, it should consider providing a modest federal floor on exemptions.*

**Sec. 148. Bankruptcy fees.**

This section authorizes courts to waive bankruptcy filing fees for indigent chapter 7 debtors.

*Comments: The National Bankruptcy Conference supports this amendment. The Judicial Conference pilot program demonstrated that fee waivers enabled the most needy individuals to obtain debt relief.*

**Sec. 149. Collection of child support.**

This section imposes duties on trustees in chapter 7 and chapter 13 cases to assist support recipient creditors of the debtors in determining how they can enforce their rights.

*Comments: This provision parallels additional domestic support obligation provisions that were added to S. 625. Authorizing support recipients to request information regarding the debtor's location from a creditor should be coupled with a requirement that the creditor produce that information.*

**Sec. 150. Excluding employee benefit plan participant contributions and other property from the estate.**

This provision excludes from the property of a business debtor's estate amounts intended to be forwarded to employee benefit plans under ERISA.

*Comments: This provision appears to duplicate protections already provided under ERISA.*

**Sec. 151. Clarification of postpetition wages and benefits.**

This provision clarifies that postpetition wages and payments for services, including employee benefits, are explicitly included among the actual and necessary costs of preserving the estate that are entitled to administrative expense priority. It also includes wages and benefits

attributable to a debtor's violation of the law, regardless of when the original unlawful act occurred or whether any services were rendered.

**Sec. 152. Exceptions to automatic stay in domestic support obligation proceedings.**

Under this provision, the automatic stay exception for withholding income applies if it is for payment of a domestic support obligation owed directly to the spouse, former spouse, or child of the debtor unless the court finds that such withholding would render a repayment plan infeasible.

**Sec. 153. Automatic stay inapplicable to certain proceedings against the debtor.**

This provision creates an automatic stay exception for actions relating to child custody, domestic violence, or dissolution of marriage.

**Sec. 154. Disclosures.**

This provision was removed by the Judiciary Committee and reinserted on the House floor. It requires that parties offering bankruptcy assistance provide certain notices and disclosures to debtors, including statements delineating the responsibilities undertaken by debt relief agencies in the bankruptcy process. The disclosures must notify the debtor that anyone providing bankruptcy assistance must provide information regarding the valuation of assets at replacement value, the determination of monthly income, and the determination of exempt property.

*Comments: Misinformation and false advertising about bankruptcy should be discouraged. This provision, however, in some respects is overbroad it appears to instruct nonattorney petition preparers to give legal advice. A more targeted approach is section 221 of S. 625, which imposes meaningful restrictions to prevent petition preparers from engaging in the unauthorized practice of law.*

**Sec. 155. Debtor's bill of rights.**

This section imposes additional requirements on parties providing bankruptcy assistance and prohibits a debt relief agency from making a untrue or misleading statement that the agency should have known was untrue or misleading.

*Comments: Again, section 221 of S. 625 provides a more targeted and effective solution to the problem of misrepresentation regarding bankruptcy.*

**TITLE II.**

**Sec. 201. Reenactment of chapter 12.**

This section reenacts chapter 12.

*Comments: The National Bankruptcy Conference has submitted a statement jointly with the Commercial Law League of America and the American College of Bankruptcy that endorses freestanding bills that make chapter 12 permanent. Ensuring the continuation of the family*

*farmer reorganization chapter of the Bankruptcy Code should not be tied to bankruptcy reform generally.*

**Sec. 202. Meetings of creditors and equity security holders.**

Under this section, the court is authorized to waive the requirement of a section 341 meeting of creditors after notice and a hearing if the debtor files a prepackaged plan of reorganization.

*Comments: The National Bankruptcy Conference supports this provision, which will enhance the efficiency of prepackaged plans of reorganization. However, the Conference recommends that the proposed section 341(e) reads in accordance with the following amendment: Section 341 of title 11, United States Code, is amended by adding at the end the following — "(e) Notwithstanding subsections (a) and (b) in a case under chapter 9 or 11 of this title in which a plan has been filed for which, before the meeting of creditors or equity security holders under this section, a hearing on confirmation has been scheduled, on the request of a party in interest and after notice and a hearing, the court may order that the United States trustee postpone the meeting pending the hearing on confirmation, and, if the plan is confirmed, order that the meeting not be held."*

**Sec. 203. Protection of retirement savings in bankruptcy.**

This provision amends 11 U.S.C. § 522 to exempt qualified retirement funds that are exempt from taxation under various provisions of the Internal Revenue Code. This provision makes the automatic stay inapplicable to wage deductions for pensions, profit sharing or other such plans to the extent that those amounts are used solely for payments relating to a loan from an ERISA qualified plan, except for debts incurred within 1 year prior to filing a bankruptcy petition. In addition, loans borrowed from retirement plans are excepted from discharge under section 523(a), except for loans made within 1 year prior to filing the bankruptcy petition. Finally, section 1322 is amended to provide that a chapter 13 plan may not "materially alter" the terms of a loans from retirement funds.

*Comments: The National Bankruptcy Conference supports this provision. It would be helpful to add the following language to the end of the section 1325 amendment: "For purposes of the plan only, any such loan shall be treated as a nonrecourse loan secured by the assets of the applicable pension, profitsharing, stock bonus, or other plan. No plan established under sections 401, 403, 408(A), 414, 457, or 501(c) of the Internal Revenue Code of 1986 or permitted under the Employment Retirement Income Security Act may be disqualified as a result of the repayment of any loan to such plan made in accordance with a confirmed plan under this chapter."*

**Sec. 204. Protection of refinancing of security interest.**

This provision amends 11 U.S.C. § 547(e)(2) so that a transfer is deemed to be made at the time such transfer takes effect between the transferor and the transferee if the transferee perfects its interest within 30 days, rather than 10 days.

*Comments: This extension of the relation-back period may harm the interests of and trap creditors who extend credit in reliance on the lack of a perfected security interest in specified collateral.*

#### **Sec. 205. Executory contracts and unexpired leases.**

Notwithstanding the title of this provision, this amendment addresses only unexpired leases of nonresidential real property, not executory contracts or other types of leases. Section 205 amends 11 U.S.C. § 365(d)(4) so that a debtor in possession or trustee must assume or reject a nonresidential real property lease within 120 days after the order for relief. On the request of the trustee/debtor in possession or lessor for cause, the court may extend the period for another 120 days. Thereafter, the court may not grant extensions unless the lessor consents. Section 217 of the bill addresses damage claim that may result when a lease is timely assumed under this provision but later events lead to rejection.

*Comments: This provision will preclude the reorganization of some businesses, particularly seasonal businesses, and will force some debtors in possession to make premature decisions regarding their leases, to the potential detriment of other creditors if the business ultimately is liquidated. See In re Klein Sleep Prods., 78 F.3d 18 (2d Cir. 1996) (obligations under assumed lease are entitled to administrative expense priority if lease is later rejected). Ideally, section 205 instead should read as follows: Section 365(d)(4) of title 11, United States Code, is amended by adding at the end the following — "The court may extend the period during which the trustee or plan proponent must elect to assume or reject a lease of nonresidential real property until no later than the date of entry of the order confirming the plan, but such assumption or rejection shall occur on or before the earlier of — (A) the effective date of the plan; (B) conversion of the case; or (C) dismissal of the case." "*

#### **Sec. 206. Creditors and equity security holders committees.**

Section 206 clarifies that courts may review appointments to creditors' and equity security holders' committees to ensure adequate representation of creditors or equity security holders. This provision also authorizes the court to expand the membership of a committee to include a creditor that is a small business if the court determines that the creditor holds claims that are disproportionately large when compared to the creditor's annual gross revenue. A committee must provide creditors access to information and the court may compel the committee to produce additional reports and disclosure.

*Comments: The National Bankruptcy Conference supports the explicit authorization of courts to review appointments to committees to ensure adequate representation, which resolves a split in the case law and recognizes that adequate representation is a question of law for which parties should have legal redress.*

#### **Sec. 207. Amendment to section 546 of title 11, United States Code.**

This section prohibits a trustee from avoiding a warehouseman's lien for storage, transportation or other costs incidental to the storage and handling of goods, notwithstanding the trustee's otherwise applicable power to avoid those liens under 11 U.S.C. § 545.

*Comments: To the extent that a statutory lien protected by this provision would be ineffective against a bona fide purchaser, the National Bankruptcy Conference opposes this amendment.*

#### **Sec. 208. Limitation.**

This section extends the period provided by 11 U.S.C. § 546(c)(1)(B) from 20 to 45 days.

*Comments: The National Bankruptcy Conference opposes the unwarranted expansion of reclamation rights that is prejudicial to the interests of other creditors and to the estate.*

#### **Sec. 209. Amendment to section 330(a) of title 11, United States Code.**

This section amends 11 U.S.C. § 330(a) so that the factors guiding courts in awarding compensation apply specifically to examiners, chapter 11 trustees, and professional persons. When determining trustees' compensation, the court "shall treat such compensation as a commission based on the results achieved."

*Comments: To more effectively fulfill the intent of this provision, 11 U.S.C. § 330 should be revised to strike the first (A) after paragraph (3) to avoid the extraneous reference (there are two paragraphs designated (A) and the first is unnecessary). Paragraph (2) of this amendment should be added as a new subparagraph (F) in section 330(a)(3) that reads "whether the compensation is reasonable compensation as a commission based on the results achieved." Paragraph (1) of this amendment then should be deleted as unnecessary. Thus, section 209 of this bill should read as follows: Section 330(a)(3) of title 11, United States Code, is amended --*

*(1) by deleting the first "(A)" that appears; (2) in subparagraph (D) by striking "; and" at the end; (3) in subparagraph (E) by inserting "and" at the end; and (4) by adding at the end the following: "(F) whether the compensation is reasonable as a commission based on the results achieved." "*

#### **Sec. 210. Postpetition disclosure and solicitation.**

This section permits postpetition solicitation of votes prior to court approval of a disclosure statement in a prepackaged plan of reorganization, but only for holders of claims solicited prior to commencement of the case in accordance with applicable nonbankruptcy law.

*Comments: The National Bankruptcy Conference supports this provision. To fulfill the intent of the amendment, it should be revised to read as follows: Section 1125 of title 11, United States Code, is amended by adding at the end the following — "(g) Notwithstanding subsection (b), an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if the solicitation began before the commencement of the case and was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with the solicitation or, if there*

*is not any such law, rule, or regulation, the solicitation occurred after disclosure of adequate information to the solicited holders."*

**Sec. 211. Preferences.**

This provision broadens the availability of the ordinary course of business defense to preference actions under 11 U.S.C. § 547(c)(2) by de-coupling the requirement that a transaction be in the ordinary course of business between the debtor and creditor and in accordance with ordinary business terms for the industry at large. This means that the recipient of a payment that was not in the ordinary course between the debtor and the creditor will not be required to return the payment for the benefit of all creditors. This section also precludes trustees from bringing preference actions to recover less than \$5,000 in aggregate transfers to noninsider creditors in cases that do not involve primarily consumer debts.

**Sec. 212. Venue of certain proceedings.**

This section amends 28 U.S.C. § 1409 so that a trustee may commence a preference action to recover a nonconsumer debt of less than \$10,000 only in the district in which the noninsider creditor resides.

**Sec. 213. Period for filing plan under chapter 11.**

This section limits the ability of a debtor in possession to obtain extensions of its exclusive right to file a chapter 11 plan to 18 or 20 months, respectively. The amendment provides no discretion for judges to permit longer periods of exclusivity under appropriate circumstances.

*Comments: The National Bankruptcy Conference opposes this provision. This amendment does not provide the requisite flexibility to permit longer periods of exclusivity under compelling circumstances. Although plans are confirmed more quickly now than in the 1980s, the exclusivity period in successful larger cases averages longer than 18 to 20 months. Inflexible limits on exclusivity will squelch negotiations long before the exclusivity periods expire, as creditors exert leverage with the threat of a competing plan. Debtors in possession may be more likely to seek confirmation of nonconsensual plans, a costly and undesirable result. Under the 1994 amendments, district courts have jurisdiction to hear appeals from orders increasing the exclusivity period, 28 U.S.C. § 158(a)(2), which should be utilized to address unwarranted extensions of exclusivity.*

**Sec. 214. Fees arising from certain ownership interests.**

Section 214 amends 11 U.S.C. § 523(a)(16) to expand this exception to discharge by encompassing condominium fees and assessments regardless of whether the debtor or a tenant continues to occupy the unit.

*Comments: The National Bankruptcy Conference opposes exceptions to discharge providing preferential treatment for certain creditors to the detriment of others without a sound policy justification. If a debtor is not using the condominium due to foreclosure or other circumstances, condominium fees for that period should not be excepted from discharge, as they are not distinguishable from obligations owed to other creditors.*

**Sec. 215. Defaults based on nonmonetary obligations.**

This section amends 11 U.S.C. § 365(b)(2) to clarify the requirements to cure non-monetary defaults on executory contracts and leases, an issue that arose in part from the line of cases culminating in *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9<sup>th</sup> Cir. 1997). According to this amendment, a trustee's requirement to cure does not apply to a penalty rate or penalty provision relating to a default arising from a failure to perform nonmonetary obligations under an executory contract or under an unexpired lease of real or personal property, but this waiver does not apply to executory contracts that transfer a right or interest under a filed or issued patent, copyright, trademark, trade dress, or trade secret. The trustee's requirement to cure also does not apply to the satisfaction of any other provision relating to a default arising from any failure to perform nonmonetary obligations under a nonresidential real property lease or executory contract, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption and, in the case of an executory contract, if the court determines based on the equities of the case that the requirements to cure should not apply with respect to such default. In addition, this section eliminates the now-defunct provisions in section 365 addressing aircraft gate and terminal leases. This section also makes a conforming change regarding nonmonetary defaults to 11 U.S.C. § 1124(2), which governs the impairment of claims and interests in chapter 11.

*Comments: The National Bankruptcy Conference supports this provision generally, but opposes the language that excludes intellectual property contracts from its scope. The intellectual property exception does not take into consideration the possibility that the debtor is the intellectual property licensor rather than the licensee. If the licensor cannot assume the contract, the nondebtor party may be deprived of rights except to the extent protected under section 365(n). Moreover, if the debtor is the licensee, there is no reason why a technical prepetition default on a nonmonetary obligation, such as going dark or a conducting a going out of business sale, should justify forfeiting the debtor's access to the intellectual property as long as any other defaults have been cured. If some additional protection is desired, the balancing test used in the provision for executory contracts should be sufficient. It is appropriate to eliminate the defunct provisions addressing aircraft gate and terminal leases, but this deletion requires renumbering and cross referencing of the remaining paragraphs of those subsections.*

**Sec. 216. Sharing of compensation.**

This section permits fee sharing in connection with a bona fide public service attorney referral program operating in accordance with nonbankruptcy law and rules of personal responsibility.

**Sec. 217. Priority for administrative expenses.**

This provision limits the priority for an administrative expense claim resulting from a lease that is assumed but subsequently rejected within the year. It should be read in conjunction with section 205 of the bill, which limits the time for assumption or rejection of a nonresidential real property lease.

*Comments: This provision limits some of the effects of section 205 of this bill, which imposes short time limitations for the assumption or rejection of nonresidential real property leases.*

*Whether it is desirable to cap damages in this context but not others is an issue that merits further study.*

**Sec. 218. Nondischargeability of certain educational benefits and loans.**

This provision applies the exception to discharge for student loans, which currently applies to government insured loans and loans made by not for profit organizations, so that it applies to all student loans, including loans made by the for-profit private sector.

*Comments: The National Bankruptcy Conference opposes this further expansion of nondischargeability. Congress just expanded the student loan exception to discharge last fall to eliminate the discharge of older student loans as an offset for other expenditures in the Higher Education Amendments. This current expansion applies to student loans made by regular commercial lenders and thus the justification behind the student loan exception to discharge - to protect government and nonprofit programs - is not applicable. Those who borrow to improve themselves should not be treated worse in bankruptcy than those who borrowed to spend on current consumption.*

**Sec. 301. Definition of disinterested person.**

This section amends the definition of disinterested person in 11 U.S.C. § 101(14) to eliminate the per se disqualification of investment bankers previously retained by the debtor.

**Sec. 302. Miscellaneous improvements.**

This provision amends 11 U.S.C. § 109 so that an individual may not be a debtor in bankruptcy unless the individual has received credit counseling within 90 days before the date of the petition. Credit counseling includes, at a minimum, participation in a briefing that outlines the opportunities for counseling and assists that individual in an initial budget analysis. Debtors must file a certificate from the credit counseling service and a copy of the debt repayment plan, if any. The prebankruptcy counseling requirement does not apply if the United States trustee determines that the approved services for that district are not reasonably able to provide adequate services to those seeking counseling as a bankruptcy prerequisite. This determination must be reviewed by the United States trustee on an annual basis. The United States trustee may approve only credit counseling agencies that satisfy the standards in regulations promulgated by the Federal Trade Commission and are accredited by the Council on Accreditation or an equivalent third party nonprofit accrediting organization. The counseling requirement also may be waived by the court if a debtor certifies that he had exigent circumstances and unsuccessfully attempted to obtain counseling services for a sequential 5 days or that exigent circumstances require filing before the expiration of that 5 day period. This exemption expires 30 days after the debtor files a petition for relief.

This section also conditions receipt of a chapter 7 and chapter 13 discharge on the completion of a financial management course. The requirement does not apply if the United States trustee determines that the approved courses are not adequate to service those individuals who are seeking education as a condition of discharge. The United States trustee may approve programs

or courses only if they satisfy regulations promulgated by the Executive Office for United States Trustees.

As an unrelated matter, this section defines the debtor's principal residence, stating that it is "a residential structure, including incidental property, without regard to whether that structure is attached to real property," and also includes multi-unit dwellings. Incidental property is defined as "property commonly conveyed with a principal residence" and "all easements, rights appurtenances, fixtures, rents, royalties, mineral rights, oil or gas rights or profits, water rights, escrow funds, or insurance proceeds" and "all replacement or additions." Moreover, a mortgage retains antimodification protection if a debtor lived in a residence within the 180 days prior to bankruptcy, even if he does not live there as of the date of the bankruptcy filing.

This provision creates an exception to the automatic stay for the postponement, continuation, or delay of a prepetition foreclosure proceeding or sale until a prepetition default is fully cured under chapter 13. It also provides that a mortgage is protected against modification in chapter 13, even if the debtor does not reside in the property at the time of filing, if the debtor used the property as a principal residence at any time within 180 days prior to the bankruptcy.

Finally, this section contains a business bankruptcy amendment. It amends 11 U.S.C. § 546(g) so that when a court authorizes the debtor to ship goods back to a creditor, the creditor's rights are subject to the prior rights of any third parties in the goods.

*Comments: Courts should retain adequate discretion to waive the prebankruptcy counseling requirement if it would be an undue hardship.*

*The implementation of a mandatory financial management course should be deferred until completion of the pilot programs established in section 104 of this bill.*

*The definition of debtor's principal residence should exclude mobile homes, which depreciate and are subject to extensions of credit priced like consumer loans instead of mortgage loans.*

**Sec. 303. Extensions.**

This provision extends the Bankruptcy Administrators' program in Alabama and North Carolina. The districts in those states therefore would not be part of the U.S. trustee program.

*Comments: The National Bankruptcy Conference opposes this amendment, which encourages nonuniformity and undermines the efficacy of the United States Trustee system. This provision gives rise to Constitutional concerns, which may affect this legislation in its entirety. See Angelo v. Victoria Farms, Inc., 38 F.3d 1525 (9<sup>th</sup> Cir. 1994) (delaying implementation of United States trustee program in North Carolina and Alabama violates United States Constitution).*

**Sec. 304. Local filing of bankruptcy cases.**

This section amends 28 U.S.C. § 1408 to provide that in the case of a corporation, the domicile and residence of the debtor are conclusively presumed to be in the location of the debtor's principal place of business. Place of incorporation would no longer be an independent basis for venue.

**Sec. 305. Permitting assumption of contracts.**

This provision amends 11 U.S.C. § 365(c) to make clear that the ability of a debtor in possession to assume a contract is not dependent on whether the debtor in possession would be permitted to assign that contract.

*Comments: This amendment sensibly changes the result of the opinions like Perlman v. Catapult Entertainment (In re Catapult Entertainment), 165 F.3d 747 (9th Cir. 1999), which held that a debtor in possession could not assume patent license that is nonassignable under federal nonbankruptcy law. It would be helpful to extend the application of this amendment to chapter 12 as well.*

**TITLE IV.<sup>4</sup>**

**Sec. 401. Flexible rules for disclosure statement and plan.**

This section permits courts to waive or modify the requirement that a small business chapter 11 debtor in possession file a disclosure statement that is approved as a prerequisite to soliciting votes on a plan of reorganization. The provision permits the court to conditionally approve disclosure statements and to combine the disclosure statement hearing with the confirmation hearing. The proposed standard for approval of disclosure statements (balancing the complexity of the case, the benefit of additional information to parties in interest, and the cost of providing additional information) is extended to all chapter 11 debtors.

*Comments: It is appropriate to apply the proposed flexible standard of disclosure statement approval to all chapter 11 debtors.*

**Sec. 402. Definitions.**

This section amends the definition of small business debtor to apply in cases involving debts of \$4 million or less and include single asset real estate debtors only if they fall within that debt cap.

*Comments: This definition incorporates approximately 85% of all chapter 11 cases.*

<sup>4</sup> The National Bankruptcy Conference and the Commercial Law League of America formulated a revised version of the small business provisions in Title IV that addresses many of the problems identified in this section by section analysis. The revised small business provisions are attached as Appendix E to the National Bankruptcy Conference March 17, 1999 testimony to the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee and also are available on request.

**Sec. 403. Standard form disclosure statement and plan.**

Section 403 orders the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to devise and adopt uniform forms for disclosure statements and plans of reorganization for debtors falling within the small business definition. The section advises that the rules should achieve a practical balance between parties' reasonable needs for complete information and economy and simplicity for debtors.

*Comments: Standard forms for disclosure statements should be developed carefully to take into account the distinctions in disclosure necessary for various types of business debtors.*

**Sec. 404. Uniform national reporting requirements.**

This provision requires that a small business debtor file periodic financial reports, including information on profitability, projected cash receipts and disbursements, comparisons of actual receipts and disbursements with prior projections, whether the debtor is in compliance with postpetition requirements and has filed tax returns and paid taxes and other administrative claims, and other matters in the best interest of all parties.

*Comments: Papers of this nature should be filed with the United States trustee, not with the court. This provision should be simplified and combined with section 406 of this bill.*

**Sec. 405. Uniform reporting rules and forms for small business cases.**

This provision gives responsibility to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to propose for adoption the establishment of rules and forms to elicit information regarding such matters as the debtor's profitability, cash receipts and disbursements, and whether the debtor is timely filing tax returns and paying taxes and administrative claims when due.

**Sec. 406. Duties in small business cases.**

Section 406 imposes duties on the small business debtor in possession to file additional information, attend through a responsible individual meetings with the United States trustee and the court, timely file all schedules and statements of financial affairs unless the court grants a limited extension due to extraordinary and compelling circumstances, file all reports, maintain insurance, timely file tax returns, pay all administrative expense tax claims, establish separate deposit accounts for taxes and deposit funds within 1 day thereafter or a responsible time set by the court (unless the court waives this requirement), and allow the United States trustee to inspect the business premises and books and records.

*Comments: This provision differs from prior versions by permitting courts to waive some requirements in compelling circumstances. "Compelling," however, imposes a high threshold to waiver. Waiver for "reasonable justification" may be an appropriate alternative. More feasible deadlines should be set for these duties, and many of the required documents should be submitted to the United States trustee, not the court. Mentioning requirements to pay taxes*

might create a negative implication regarding a debtor's other duties not mentioned in this provision, such as the duty to pay wage claims.

#### **Sec. 407. Plan filing and confirmation deadlines.**

This section requires that a small business debtor file a plan of reorganization within 90 days after filing for bankruptcy. To obtain an extension of up to 60 days, the debtor must demonstrate prior to the expiration of the deadline that there are no grounds for dismissal or conversion and that there is a reasonable likelihood of reorganization. Other extensions are possible if the debtor proves "by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable time." This provision contains an exception to these requirements for cases with active creditors' committees.

*Comments: This provision substantially limits the extent to which chapter 11 debtors can negotiate with creditors and formulate a plan of reorganization while imposing a higher standard to obtain extensions than the standard applicable to larger businesses.*

#### **Sec. 408. Plan confirmation deadline.**

Under this section, plans of small business debtors must be confirmed no later than 150 days after the date of the order for relief unless there is an active creditors' committee. Extensions are available if the debtor meets the burdens for extensions stated in section 407.

*Comments: The court should be permitted to grant an extension of the plan confirmation deadline if doing so would be in the best interests of creditors and the estate. Doing otherwise will prevent many small businesses from reorganizing even if by all accounts they are worth saving.*

#### **Sec. 409. Prohibition against extension of time.**

Section 409 amends 11 U.S.C. § 105(d) to prohibit a court from exercising its discretion to extend a deadline in a manner inconsistent with sections 407 and 408.

*Comments: By negative implication, this provision suggests that the court may override other statutory deadlines. For this reason, it might be better to delete it.*

#### **Sec. 410. Duties of the United States trustee.**

Pursuant to this provision, the U.S. trustee (or bankruptcy administrator) is vested with new statutory duties in small business debtor cases, including the duty to conduct "initial debtor interviews" during which the U.S. trustee investigates the debtor's viability and business plan. The U.S. trustee must inspect the debtor's premises, must diligently monitor the debtor's activities to identify whether the debtor will be unable to confirm a plan, and must promptly seek relief on discovering material grounds for conversion or dismissal under 11 U.S.C. § 1112, as revised by section 413 of this bill.

*Comments: Some of the duties delineated in this section are appropriate and codify some current United States trustee practices. However, the assessment of business viability should not*

*fall upon the United States trustee, who already is vested with a variety of administrative responsibilities.*

#### **Sec. 411. Scheduling conferences.**

Section 411 amends 11 U.S.C. § 105(d) to require courts to hold status conferences as necessary to further the "expeditious and economical resolution of the case."

#### **Sec. 412. Serial filer provisions.**

This provision withholds application of the automatic stay for a debtor that voluntarily files a bankruptcy petition within two years after a prior chapter 11 plan was confirmed, files within two years after the entry of a dismissal order in a prior chapter 11 case, or if the former owners of a prior debtor have transferred the business to a successor entity. To obtain protection of the automatic stay, debtor must prove by a preponderance of the evidence that the new case resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and that "it is more likely than not" that the debtor will confirm a feasible plan, but not a liquidating plan, within a reasonable time. The provision also limits damages for violations of the automatic stay based on a good faith belief that there was no stay in a subsequent bankruptcy case.

*Comments: Unlike earlier versions, this serial filing restriction applies to all chapter 11 cases. Bona fide purchasers of a debtor's assets that subsequently file for bankruptcy should not be subject to the restrictions on the automatic stay. To address this problem, the term "entity" in subsection (k)(1)(D) should be replaced with "insider." In addition, "in which a discharge is not entered" should be added to the end of (k)(1)(A); otherwise, "pending" is too ambiguous.*

#### **Sec. 413. Expanded grounds for dismissal or conversion and appointment of trustee.**

This section amends 11 U.S.C. § 1112(b) to provide that a court shall convert or dismiss a case or appoint trustee or examiner, whichever is in the best interest of creditors and the estate, when a movant establishes "cause," and to enumerate additional grounds for cause. Requests for dismissal or conversion shall not be granted if the debtor objects and establishes that "it is more likely than not" that a plan will be confirmed within a time fixed by statute or by court order; and, if "cause" is an act or omission of the debtor, that there exists a reasonable justification for the act or omission and that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion (unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances beyond the debtor's control justify an extension beyond 30 days). This version of the provision clarifies that failure to maintain insurance is "cause" only if failure posed material risk to the estate or the public, limits creditors' rights to pursue certain grounds for dismissal or conversion.

*Comments: These significant changes to 11 U.S.C. § 1112 apply to all chapter 11 debtors, not just small business debtors. Unlike the current language of section 1112, which makes dismissal or conversion discretionary, dismissal or conversion under the proposed revision are mandatory upon the presence of factors that may not be sufficiently material to warrant this response. As a*



*result, this provision makes one of the most dramatic changes to bankruptcy law as it affects business cases.*

**Sec. 414. Study of operation of title 11 of the United States code with respect to small businesses.**

This provision instructs the Small Business Administration, in consultation with other parties, to study the causes of small business bankruptcies and how the bankruptcy system can be improved to help small businesses reorganize. This study must be conducted not later than 2 years after the enactment of this bill, and a report must be submitted to the House and Senate.

**Sec. 415. Payment of interest.**

This section amends 11 U.S.C. § 362(d)(3) to provide explicitly that the debtor can make the requisite payments from rents generated by the property. The section also changes the applicable interest rate to the nondefault contract rate and amends the deadline so that payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines that the debtor is subject to these provisions to account for circumstances in which it is not immediately determined that the debtor is a single asset real estate debtor.

*Comments: The National Bankruptcy Conference supports this provision.*

**TITLE V.**

**Sec. 501. Petition and proceedings related to petition.**

This section clarifies that a chapter 9 petition constitutes an order for relief.

*Comments: To effectuate the intent of this provision and to avoid an unnecessary hearing, the text of section 501 should be replaced with the following: Section 921 of title 11, United States Code, is amended by — (1) striking subsection (d); and (2) redesignating subsection (e) as subsection (d).*

**Sec. 502. Applicability of other sections to chapter 9.**

This provision amends 11 U.S.C. § 901 to extend the application to chapter 9 of certain provisions of chapter 5 of the Bankruptcy Code that relate to the liquidation of securities contracts and the termination of swap agreements.

*Comments: The National Bankruptcy Conference supports this amendment.*

**TITLE VI.**

**Sec. 601. Creditor representation at first meeting of creditors.**

This section permits nonlawyer creditor representatives to appear and participate in section 341 meetings, and to represent more than one creditor, notwithstanding local court rules, State constitution provisions, or other laws to the contrary.

*Comments: This amendment conflicts with the laws of some states under which participation at section 341 meetings is the practice of law. See In re Maloney, 209 B.R. 844 (Bankr. M.D. Pa. 1997) (examining debtor at section 341 meeting constitutes practice of law under Pennsylvania law); but see State Unauthorized Practice of Law Committee v. Paul Mason & Assoc., 46 F.3d 469 (5th Cir. 1995) (administrative functions handled by nonlawyer creditor representatives did not constitute unauthorized practice of law under Texas law).*

**Sec. 602. Audit procedures.**

Under section 602, no fewer than 1 out of 250 individual debtor cases in each judicial district must be selected randomly for audit, with procedures to be set by the Attorney General, although the audits must be in accordance with generally accepted auditing standards and performed by accountants. Cases also must be audited if the schedules show income and expenses reflecting greater than average variances from the district norm. Material misstatements could lead to revocation or denial of discharge or criminal referrals.

*Comments: The National Bankruptcy Conference supports the implementation of an audit process. The audit system does not need to rely on accountants to conduct every audit, for most audits will not focus on books and records. To the extent that a preliminary investigation reveals the need for an accountant, one could be appointed at that time. Audits also should specifically target high end cases that vary from the statistical norm, but not cases that vary from the statistical norm on the low end (e.g., very low income and/or expenses). Cases filed by individuals under chapters 11 and 12 also should be audited. Realistically, one out of every thousand cases should be audited. To complement the auditing proposal, the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States should propose an amendment to Rule 1017 of the Federal Rules of Bankruptcy Procedure that strikes "substantial" and inserts "clear" in lieu thereof and that inserts "or 60 days following the conclusion of an audit under section 586(a)(4) of title 28 of the United States Code, whichever is later" immediately after "341(a)" each place it appears.*

**Sec. 603. Giving creditors fair notice in chapter 7 and 13 cases.**

This provision amends 11 U.S.C. § 342 to require that notice to a creditor includes account numbers and specific addresses or agents listed on the "last communication before the filing of the petition from the creditor to a debtor." This provision also creates a court filing registry for designated addresses. In addition, this provision delineates a new set of debtor duties to be added to 11 U.S.C. § 521, primarily comprised of informational requirements, such as tax returns and income statements. Creditors may request access to documents and courts must comply within 5 days of such request. This provision also directs the Administrative Office of the United States Courts to establish procedures safeguarding the confidentiality of tax information within 30 days after the date of enactment and to submit a report to Congress on this matter within a year after the date of enactment.

*Comments: The court filing registry should be the primary means of ensuring that notice is sent to creditors at the address of their choosing. The remainder of the provision dealing with notice should be deleted. The informational requirements should not come into effect until the Administrative Office of the United States Courts have implemented a procedure to safeguard the privacy of tax information.*

**Sec. 604. Dismissal for failure to timely file schedules or provide required information.**

This section amends 11 U.S.C. § 521 so that cases are dismissed automatically if individual debtors do not submit all required information within the statutory deadline. Extensions of up to 45 days may be granted if a court finds a "justification" to do so.

*Comments: The need to obtain information from the Internal Revenue Service may hinder a debtor's ability to comply in a timely fashion.*

**Sec. 605. Adequate time to prepare for hearing on confirmation of the plan.**

Under section 605, 11 U.S.C. § 1324 is amended to provide that a confirmation hearing may be held no earlier than 20 days (and no later than 45 days) after the section 341 meeting.

**Sec. 606. Chapter 13 plans to have a 5-year duration in certain cases.**

This section requires that debtors with incomes greater than or equal to the national median repay their debts in 5-year chapter 13 plans.

*Comments: Extending the duration of some chapter 13 plans is a curious and questionable policy decision when two thirds of chapter 13 cases already are not completed. This provision conflicts with section 130 of the bill that requires chapter 13 plans to be structured using the means test formula, which has the effect of making all plans 5 years.*

**Sec. 607. Sense of the Congress regarding expansion of Rule 9011 of the Federal Rules of Bankruptcy Procedure.**

This provision expresses the sense of Congress that Rule 9011 should be modified to include a requirement that all documents, including schedules, should be submitted to a court or trustee only after the debtor or the debtor's attorney has made reasonable inquiry to verify that the information is well-grounded in fact and is warranted by existing law or a good faith argument for extension, modification, or reversal of existing law.

**Sec. 608. Elimination of certain fees payable in chapter 11 bankruptcy cases.**

This section amends 28 U.S.C. § 1930(a)(6) to eliminate postconfirmation quarterly United States trustee fees when the quarterly disbursement is less than \$300,000. This amendment would take effect on October 1, 1999.

*Comments: The National Bankruptcy Conference supports this amendment.*

**Sec. 609. Study of bankruptcy impact of credit extended to dependent students.**

Section 609 directs the Comptroller General to undertake a study not later than 1 year after enactment of this bill to evaluate how the bankruptcy rate is affected by extensions of credit to postsecondary education students claimed as dependents.

**Sec. 610. Prompt relief from stay in individual cases.**

Under section 610, if courts do not rule on motions for automatic stay relief within 60 days, this section provides that the stay terminates automatically in the case of an individual debtor unless the parties agree to an extension of the deadline or the court orders an extension for "good cause."

*Comments: Efforts to establish firm time limits for courts to issue rulings have not been effective in the past. Issues of timing should be handled by the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States.*

**Sec. 611. Stopping abusive conversions from chapter 13.**

Pursuant to this amendment to 11 U.S.C. § 348, upon conversion from chapter 13 to chapter 7, claims are considered fully secured unless the claim already has been paid in full, notwithstanding any valuation or determination of the allowed secured claim in chapter 13. Prebankruptcy defaults not fully cured are given the same effect as under applicable nonbankruptcy law.

*Comments: This provision should include an additional amendment so that a debtor seeking to redeem property in a converted case may apply to the redemption price all chapter 13 plan payments and adequate protection payments. This may be accomplished by deleting subparagraph (C)(i) and by adding the following: Section 722 of title 11, United States Code is amended by adding at the end — In a case that has been converted under section 1307 of this title, the redemption price is the value of the collateral less any payments made under sections 1307A and 1326 of this title.*

**Sec. 612. Bankruptcy appeals.**

This provision authorizes direct appeal to the United States Courts of Appeals from final orders and judgments, as well as certain interlocutory orders, entered by bankruptcy courts and district courts. However, these appeals will be heard by non-Article III bankruptcy appellate panels unless a party elects otherwise. Circuits may establish joint bankruptcy appellate panels. This provision also provides procedural guidance by delineating which rules will apply until rules of practice and procedure are promulgated or amended pursuant to the Rules Enabling Act.

**Sec. 613. GAO Study.**

This provision requires that the Comptroller General of the United States conduct a study of the feasibility, effectiveness, and costs of directing trustees to provide various information to the Office of Child Support Enforcement, the subject of an amendment in this bill (see "Collection

of Child Support" above). A report on the study is due not later than 300 days after the date of enactment.

**Sec. 614. Compensating trustees.**

This amendment allows the court to award a reasonable fee for trustees' actions resulting in a case being converted from chapter 7 to chapter 13 if the trustee shows by a preponderance of the evidence that the case was converted or dismissed because of the trustee's actions. The fee will be paid monthly over the life of the chapter 13 plan. The amendment also provides that the chapter 7 trustee may collect his compensation in a chapter 13 case "even if such amount has been discharged in a prior proceeding under this title."

*Comments: If chapter 7 compensation is going to be paid monthly over the life of the plan, it should be factored into the means test that determines whether the debtor has the ability to pay his debts.*

**TITLE VII.**

**Sec. 701. Improved bankruptcy statistics.**

This section orders the clerk of each district to compile statistics in a format determined by the Administrative Office of the United States Courts, which will be collected by the Administrative Office and made publicly available and the subject of a report to Congress.

*Comments: Collecting data is advisable, but all language in this provision prescribing the method of collection and reporting should be deleted. The manner of collection and reporting should be developed by a balanced group of experts in the field of data collection and bankruptcy.*

**Sec. 702. Uniform rules for the collection of bankruptcy data.**

This section instructs the Attorney General to issue rules requiring uniform forms for final trustee reports and periodic reports by debtors in possession and trustees in chapter 11 cases.

**Sec. 703. Sense of the Congress regarding availability of bankruptcy data.**

Section 703 expresses the sense of Congress that all data held by bankruptcy clerks should be released in electronic form to the public on demand and that the bankruptcy system should use a single set of data definitions and forms to collect data nationwide.

*Comments: Before taking steps to make this data widely available, Congress should evaluate the privacy considerations and whether laws such as the Fair Credit Reporting Act impose restrictions on this activity.*

**TITLE VIII.**

**Sec. 801. Treatment of certain liens.**

This section exempts ad valorem real or personal property tax liens from subordination under 11 U.S.C. § 724(b)(2), except that ad valorem tax liens would remain subordinated to priority wage claims. Although other tax liens remain subject to subordination, section 801 requires that a trustee first exhaust unencumbered assets of the estate and surcharge collateral under section 506(c) for the reasonably necessary costs and expenses of preserving and disposing of that property. Section 801 also amends 11 U.S.C. § 505 to divest bankruptcy judges of their authority to determine the amount or legality of any ad valorem tax after expiration of the applicable period for contesting or redetermining that amount under nonbankruptcy law.

*Comments: The National Bankruptcy Conference supports this provision to the extent that it exempts ad valorem tax liens from subordination under section 724(b). However, the remainder of the provision is objectionable. References to 11 U.S.C. § 507(a) should be adjusted to reflect amendments in this bill that reorder the priorities set forth in that provision.*

**Sec. 802. Effective notice to government.**

This section sets forth extensive parameters and details for providing notice to governmental units.

*Comments: The filing registry contemplated in proposed section 342(e) may be an appropriate mechanism to ensure adequate notice. However, the remainder of the provision is unduly oppressive and make compliance difficult even if the unit receives actual notice. Form of notice is generally addressed by the Federal Rules of Bankruptcy Procedure. In light of the fact that the United States government has requested to be treated as a single unit for other purposes, such as setoff, these noticing requirements seem to go to the other extreme.*

**Sec. 803. Notice of request for a determination of taxes.**

This section amends 11 U.S.C. § 505(b) to require that any request for a determination of tax liability under that section be made in a manner designated by the governmental unit.

*Comments: This provision would be unobjectionable if the information were published in a central registry to enable compliance. Absent a central registry, this provision is troublesome because it creates a new bureaucracy that unnecessarily makes compliance extremely difficult.*

**Sec. 804. Rate of interest on tax claims.**

This provision establishes the minimum rate of interest for most tax claims as the Federal short-term rate rounded to nearest full percent, determined under Internal Revenue Code section 1274(d) for the calendar year in which a plan is confirmed, plus 3 percentage points. The interest rate on ad valorem taxes is subject to determination under applicable nonbankruptcy law.

*Comments: This provision departs from its original intent to provide a uniform rate of interest. The interest rate on ad valorem taxes in some cities is well over 20%. Section 804 should be revised to provide that the rate of interest on all tax claims, including ad valorem tax claims, is the federal tax deficiency rate under 26 U.S.C. § 6621(a)(2), as originally proposed by in the bankruptcy bill first introduced by Representative Gekas and his co-sponsors last year.*

**Sec. 805. Tolling of priority of tax claim time periods.**

Section 805 authorizes the tolling of certain time periods in 11 U.S.C. § 507(a)(8)(A). This provision also adds an extra 6 months to the tolling period under section 507(a)(8)(A)(i) and tolls the 240-day period under section 507(a)(8)(A)(ii) for the duration of an installment payment agreement, which could add years to the tolling period.

*Comments: To the extent this provision tolls the priority and nondischargeability period for the duration of a prior bankruptcy case, this provision helpfully codifies current case law. However, the additional six-month period and tolling for installment payment agreements give may go farther than necessary and may harm the interests of other creditors.*

**Sec. 806. Priority property taxes incurred.**

This provision amends 11 U.S.C. § 507(a)(8)(B) by striking "assessed" and replacing it with "incurred."

**Sec. 807. Chapter 13 discharge of fraudulent and other taxes.**

This section further restricts the scope of the chapter 13 "superdischarge" so that a debtor who has completed a repayment plan may not discharge remaining taxes falling under 11 U.S.C. § 523(a)(1).

*Comments: This provision is controversial. It may eliminate the incentive for debtors with substantial tax debts to repay some of those debts, along with other debts, in a chapter 13 plan.*

**Sec. 808. Chapter 11 discharge of fraudulent taxes.**

Section 808 amends 11 U.S.C. § 1141(d) so that chapter 11 plan confirmation does not discharge a corporate debtor (but not any other type of debtor) from tax debts on which the debtor made a fraudulent return or which the debtor willfully attempted to evade or defeat.

*Comments: The National Bankruptcy Conference urges deletion of this section. The reorganized debtor is a separate entity for other tax purposes that should not be liable for these obligations. Most chapter 11 corporate debtors are insolvent and often controlling ownership is transferred to creditors under a plan of reorganization. Creditors should not be punished for the failures of prior ownership or management.*

**Sec. 809. Stay of tax proceedings.**

This section provides an exception to the automatic stay for appeals from certain court and administrative decisions determining a tax liability of the debtor.

**Sec. 810. Periodic payment of taxes in chapter 11 cases.**

This section requires periodic payment of priority tax claims in regular installment payments in cash, "but in no case with a balloon provision and no more than three months apart, beginning no later than the effective date of the plan and ending on the earlier of five years after the petition

date or that last date payments are to be made under the plan to unsecured creditors." In addition, the petition date, not the assessment date, is the starting point for the payment period.

*Comments: Prior to the Bankruptcy Reform Act of 1978, taxing authorities exercised virtual veto power over plans of reorganization. The 1978 Code was a compromise to make reasonable accommodations for rehabilitation. If enacted, this provision may require that other creditors, such as support creditors in the chapter 11 case of an individual debtor, wait years for repayment. If retained, the provision should be redrafted to correct its problems. The provision should clarify that "regular payments" do not have to be equal. According to the plain language of the provision, tax debts may not be deferred at all if other unsecured creditors are paid in full at confirmation. This may be an unintended result.*

**Sec. 811. Avoidance of statutory tax liens prohibited.**

Section 811 amends 11 U.S.C. § 545(2) to codify that "superpriority" rights accorded to some purchasers by the Internal Revenue Code and parallel state and local law provisions may not be used by a trustee to avoid tax liens in stocks, securities, motor vehicles, inventory, certain goods purchased at retail, and certain household goods.

*Comments: There are preferable methods of clarifying the reach of a bona fide purchaser. Section 545(2) should be clarified to give the trustee the status of a hypothetical bona fide purchaser without knowledge or notice of a lien, who takes possession of the item purchased and has not relinquished possession. This status would preserve for the benefit of all creditors those items of property on which the filed tax lien does not take priority in all circumstances under nonbankruptcy law. A similar change could be made to the definition of purchaser in section 544(a).*

**Sec. 812. Payment of taxes in the conduct of business.**

This section requires that postpetition taxes be paid in the ordinary course of business, that ad valorem real property taxes be paid when due, and that administrative period tax liabilities be paid without a precipitating request from the governmental unit. This section also amends 11 U.S.C. § 506 to permit ad valorem taxes to be surcharged against collateral. This section permits deferred tax payments in the event that a chapter 7 estate is administratively insolvent or that a tax was not incurred by a properly appointed chapter 7 trustee.

*Comments: It is reasonable to require that an operating chapter 11 debtor pay taxes in the normal course as a business expense, which is why 28 U.S.C. § 960 already provides that any officers and agents conducting business under authority of a United States court shall be subject to all taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.*

**Sec. 813. Tardily filed priority tax claims.**

This section amends 11 U.S.C. § 726(a)(1) so that late filed tax claims are entitled to distribution under that subsection to the extent they are filed on or before the earlier of 10 days following the

mailing to creditors of the trustee's report summary, or the date on which the trustee commences distribution.

*Comments: The National Bankruptcy Conference supports this provision.*

**Sec. 814. Income tax returns prepared by tax authorities.**

Under this section, for purposes of 11 U.S.C. § 523(a)(1)(B), "return" includes returns filed by the governmental unit or a written stipulation to judgment entered by a nonbankruptcy tribunal.

*Comments: It is unclear why the amendment provides that the return must have been filed in a manner permitted by applicable nonbankruptcy law. This clause may cause confusion and is not necessary to effectuate the primary component of this section.*

**Sec. 815. Discharge of the estate's liability for unpaid taxes.**

This provision adds the bankruptcy estate to the list of parties protected from a tax claim once a governmental unit fails to respond to a request for a determination of taxes under 11 U.S.C. § 505(b).

*Comments: The National Bankruptcy Conference supports this provision.*

**Sec. 816. Requirement to file tax returns to confirm chapter 13 plans.**

Section 816 requires that debtors file tax returns for the three years before bankruptcy prior to the first meeting of creditors. The section makes some allowance for extensions of the applicable deadlines.

*Comments: Debtors who are not required to file tax returns under tax law should be exempted from this requirement. The standard for extensions of time should be based on the preponderance of the evidence (the standard generally applicable in bankruptcy proceedings), not clear and convincing evidence.*

**Sec. 817. Standards for tax disclosure.**

This section amends 11 U.S.C. § 1125 to require that disclosure statements contain a "full discussion" of the tax consequences of a plan of reorganization.

*Comments: To the extent that the disclosure of tax consequences is necessary to provide adequate information, this provision is unnecessary because adequate information already is required by 11 U.S.C. § 1125. In the event that the tax consequences are not necessary or relevant to the creditors' decision making, mandating disclosure may unnecessarily increase cost and delay in the plan confirmation process, contrary to the goal of expediting chapter 11. It might be preferable to replace the term "a full discussion" with "adequate information regarding".*

**Sec. 818. Setoff of tax refunds.**

Section 818 amends 11 U.S.C. § 362 to permit the government to set off uncontested income tax obligations against income tax refund rights without seeking court permission.

*Comments: The National Bankruptcy Conference opposes this provision. Absent setoff, the tax refund would be cash collateral subject to turnover and use by the estate. As long as the debtor in possession provides the taxing authority with adequate protection, this source of liquidity should remain available.*

**TITLE IX.**

**Sec. 901. Amendment to add chapter 15 to title 11, United States Code.**

This section creates a chapter 15 of the Bankruptcy Code to deal with ancillary and other cross-border cases.

*Comments: The National Bankruptcy Conference supports the establishment of a chapter to deal with ancillary and other cross border cases to the extent consistent with the statutory language developed by the United Nations Commission on International Trade Law.*

**Sec. 902. Amendments to other chapters in title 11, United States Code.**

This section amends other provisions of the Bankruptcy Code to reflect the addition of chapter 15.

*Comments: The National Bankruptcy Conference supports the adoption of conforming amendments to the extent consistent with the statutory language developed by the United Nations Commission on International Trade Law.*

**TITLE X.**

**Sec. 1001. Treatment of certain agreements by conservators or receivers of insured depository institutions; Sec. 1002. Authority of the corporation with respect to failed and failing institutions; Sec. 1003. Amendments relating to transfers of qualified financial contracts; Sec. 1004. Amendments relating to disaffirmance or repudiation of qualified financial contracts; Sec. 1005. Clarifying amendment relating to master agreements; Sec. 1006. Federal deposit insurance corporation improvement act of 1991.**

These provisions make amendments to the Federal Deposit Insurance Act regarding the definitions and treatment of various financial contracts.

**Sec. 1007. Bankruptcy code amendments.**

(a) Definitions of forward contract, repurchase agreement, securities clearing agency, swap agreement, commodity contract, and securities contract. This subsection provides revised definitions of the above listed contracts and parties.

(b) Definitions of financial institution, financial participant, and forward contract merchant.

This subsection revises the definitions of financial institution and forward contract merchant and provides a definition of financial participant.

(c) Definition of master netting agreement and master netting agreement participant.

Subsection (c) amends 11 U.S.C. § 101 to add broad definitions of master netting agreement and master netting agreement participant. The definition of master netting agreement encompasses rights of netting, setoff, liquidation, termination, or closeout not only with a variety of financial instruments, but with security agreements and credit enhancement as well.

*Comments: This provision is unobjectionable to the extent it protects single product netting and is objectionable to the extent it permits and expands cross product netting.*

(d) Swap agreements, securities contracts, commodity contracts, forward contracts, repurchase agreements, and master netting agreements under the automatic stay.

This subsection revises the exceptions to the automatic stay for setoff by financial participants of claims against payments due, and adds an additional exception to section 362(b) to permit cross product netting without violating the automatic stay.

*Comments: This provision is objectionable to the extent that it permits cross product netting.*

(e) Limitation of avoidance powers under master netting agreement.

This subsection amends 11 U.S.C. § 546 to preclude a trustee from avoiding a transfer made by or to a master netting agreement participant under or in connection with any master netting agreement, except if the transfer was made with the actual intent to hinder, delay, or defraud.

*Comments: This provision is objectionable to the extent that it limits the ability of a trustee or debtor in possession to recover cross product netting transfers under the avoiding powers.*

(f) Fraudulent transfers of master netting agreements.

This subsection amends 11 U.S.C. § 548(d)(2) to insulate certain transfers to master netting agreement participants.

*Comments: This provision is objectionable to the extent that it insulates cross product netting from fraudulent transfer avoidance actions.*

(g) - (j) Termination or acceleration of securities contracts; Termination or acceleration of commodities or forward contracts; Termination or acceleration of repurchase agreements; Liquidation, termination, or acceleration of swap agreements.

The aforementioned subsections amend 11 U.S.C. §§ 555, 556, 559, and 560 to refer to termination, acceleration, and liquidation.

(k) Liquidation, termination, acceleration, or offset under a master netting agreement and across contracts.

This subsection adds 11 U.S.C. § 561, which prohibits the application of the stay, avoidance, or any other limitations on a contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts.

*Comments: This provision is objectionable to the extent it exempts cross product netting from the avoidance powers, the automatic stay, and other otherwise applicable provisions.*

(l) Municipal bankruptcies.

This subsection applies the securities contract liquidation provisions to chapter 9 municipal bankruptcy cases.

*Comments: The National Bankruptcy Conference supports this provision.*

(m) Ancillary proceedings.

Pursuant to this subsection, cases ancillary to foreign proceedings are subject to all Bankruptcy Code provisions relating to securities contracts, commodity agreements, forward contracts, repurchase agreements, swap agreements, or master netting agreements.

*Comments: The provision seems designed to ensure that a broad section 304 injunction is not issued against holders of the listed instruments just they are exempted from the broad automatic stay under section 362 in a domestic bankruptcy case. The section as worded is far broader and may have unintended consequences. It cannot relate to the bankruptcy avoiding powers, because those powers are not available in a section 304 proceeding in any case. If it is intended as some sort of choice of law provision, it is impossible to tell what its effects are meant to be. It should be re-worded to refer solely to exemption from broad injunctive relief. In addition, it is objectionable insofar as it includes cross-product netting, as with other provisions in this title.*

(n)-(o) Commodity broker liquidations; Stockbroker liquidations.

These two subsections add 11 U.S.C. §§ 767 and 753 to address the liquidation of commodity brokers and stockbrokers. Under these provisions, the exercise of rights by a broker or participant would not affect the priority of unsecured claims held by brokers or participants after the exercise of their rights or the applicability of the commodity broker and stockbroker liquidation provisions.

(p) Setoff.

This subsection makes conforming amendments to 11 U.S.C. § 553 to reflect the exceptions to the general rules of setoff provided for financial instruments. It creates a carveout to the exception to the right to setoff in section 553(a)(3)(C) for rights arising under provisions dealing with financial contracts. This subsection also amends 553(b)(1) to add additional references to these provisions.

(q) Securities contracts, commodity contracts, and forward contracts.

This subsection clarifies the language in several Bankruptcy Code provisions by replacing references to a variety of parties with the term "financial participant."

**Sec. 1008. Recordkeeping requirements.**

This section amends the Federal Deposit Insurance Act to authorize the FDIC to prescribe regulations that require detailed recordkeeping by insured depository institutions with respect to qualified financial contracts.

**Sec. 1009. Exemptions from contemporaneous execution requirement.**

This provision amends the Federal Deposit Insurance Act section 13(e)(2) to provide that an agreement to provide for the lawful collateralization of bankruptcy estate funds pursuant to 11 U.S.C. § 345(b)(2) and other agreements is not invalid solely because the agreement was not executed contemporaneously with the acquisition of collateral or because of pledges, delivery, or substitution of collateral made in accordance with such agreement.

**Sec. 1010. Damage measure.**

This section addresses the calculation of damages following the rejection, liquidation, termination, or acceleration of certain agreements relating to financial instruments. It provides that damages shall be measured as of the earlier of the date of rejection or the date of liquidation, termination or acceleration. The resulting damage claim is treated as a prepetition claim, consistent with other claims arising from rejection.

**Sec. 1011. SIPC stay.**

This provision adds a new paragraph to section 5(b)(2) of the Securities Investor Protection Act of 1970 which states that nothing in the Bankruptcy Code stays the contractual rights of a creditor to liquidate, terminate, or accelerate a securities contract, but that a court order may operate as a stay of the foreclosure on securities collateral pledged by the debtor.

**Sec. 1012. Asset-backed securitizations.**

This section explicitly excludes from "property of the estate" cash, receivables, securities, and other financial assets transferred by the debtor in connection with an asset securitization under which investment grade rated securities have been issued. The debtor is considered to have transferred assets prepetition if the assets were transferred pursuant to a written agreement that states that the assets were conveyed with the intention of removing them from the estate of the debtor, regardless of whether the debtor holds an interest in the issuer or securities held by the issuer, whether the debtor has continuing obligations to repurchase, service, or supervise the servicing of eligible assets, and the characterization of the transfer for other purposes.

*Comments: The National Bankruptcy Conference opposes this provision. Transactions that are not sales under state law should not be treated as sales by federal bankruptcy law. This provision may undercut the ability of a business to reorganize by leaving it with no cash collateral, to the detriment of employees and suppliers.*

**Sec. 1013. Federal reserve collateral requirements.**

This section changes the statutory references in section 16 of the Federal Reserve Act.

**Sec. 1014. Severability; effective date; application of amendments.**

This section provides that these amendments remain in effect if provisions are found to be unconstitutional. The Act takes effect on the date of enactment, and the amendments made by the Act apply to cases commenced or appointments made after the date of enactment.

**TITLE XI.**

**Sec. 1101. Definitions.**

This section makes a nontechnical change by amending the definition of single asset real estate to lift the \$4 million debt cap and to exclude family farmers. This section also clarifies that a transfer includes the creation of a lien, addressing issues raised in the line of cases culminating in *In re McConville*, 110 F.3d 47 (9<sup>th</sup> Cir. 1997).

*Comments: The National Bankruptcy Conference opposes the removal of the cap on the definition of single asset real estate, the effect of which is to make the streamlined single asset procedure applicable to a wide range of cases for which it was not intended. The National Bankruptcy Conference supports the statutory clarification that a transfer of property includes the creation of a lien. The word "each" should be deleted and replaced with "every" in proposed 11 U.S.C. § 101(54)(D).*

**Sec. 1102. Adjustment of dollar amounts.**

This section ensures that the dollar amounts in section 522(f)(3) (lien on tools of the trade exceeding \$5,000 cannot be avoided) and the proposed section 707(b)(5) (safe harbor against creditor actions) are indexed for inflation.

**Sec. 1103. Extension of time.**

This section corrects a reference error.

**Sec. 1104. Technical amendments.**

This section pluralizes a reference in 11 U.S.C. § 522(b)(1), makes a technical change to 11 U.S.C. § 541(b)(4), and slightly broadens the reference to a subsection of the Small Business Investment Act of 1958, which likely has the effect of making more debtors ineligible to file.

**Sec. 1105. Penalty for persons who negligently or fraudulently prepare bankruptcy petitions.**

This section makes a grammatical change, changing the reference to "attorney's" in section 110(j)(3) from singular possessive to plural possessive.

**Sec. 1106. Limitation on compensation of professional persons.**

Section 1106 amends 11 U.S.C. § 328(a) to provide that a trustee or committee may employ professional persons on a fixed or percentage fee basis.

**Sec. 1107. Special tax provisions.**

This amendment eliminates a reference to a tax provision that has been repealed.

**Sec. 1108. Effect of conversion.**

This section changes a reference to "property" in 11 U.S.C. § 348(f)(2) to "property of the estate" to conform to other references in that provision.

**Sec. 1109. Allowance of administrative expenses.**

This section limits the types of compensable professional services rendered by an attorney or accountant that may qualify as administrative expenses. In particular, expenses for attorneys or accountants incurred by individual members of creditors' or equity committees are not recoverable as administrative expenses.

**Sec. 1110. Priorities.**

This provision makes punctuation changes to 11 U.S.C. § 507 and changes "allowed claim" to "allowed unsecured claim" in section 507(a)(7).

**Sec. 1111. Exemptions.**

This section makes slight grammatical changes to 11 U.S.C. § 522(f) and (g).

**Sec. 1112. Exceptions to discharge.**

This section corrects the inadvertent omission of a reference to section 523(a)(15) in section 523(a)(3). Section 523(a)(15) is amended to limit the scope of the exception by requiring that the debt must be owed to a spouse, former spouse, or child of the debtor. This section also amends section 523(a)(9) to specifically exclude from discharge debts arising from drunken boating.

**Sec. 1113. Effect of discharge.**

This section makes technical corrections to 11 U.S.C. § 524(a)(3).

*Comments: This provision does not appear to change the existing text of section 524(a)(3).*

**Sec. 1114. Protection against discriminatory treatment.**

Under this provision, 11 U.S.C. § 525(c) is amended to clarify section 525(c)(1) applies to student grants, not all grants.

**Sec. 1115. Property of the estate.**

This section amends section 541(b)(4)(B)(ii) (dealing with liquid or gaseous hydrocarbons) to add a reference to 11 U.S.C. § 365, to clarify Congressional intent to exclude production payments from the debtor's estate.

**Sec. 1116. Preferences.**

This section amends 11 U.S.C. § 547(b) so that in the event of an avoided security interest given by a debtor between 90 days and 1 year before bankruptcy to a noninsider for the benefit of an

insider, the security interest shall be considered to be avoided as a preference only with respect to the insider.

*Comments: The National Bankruptcy Conference supports this amendment.*

**Sec. 1117. Postpetition transactions.**

This section makes several clarifying changes to 11 U.S.C. § 549(c) to work in conjunction with the change to the definition of transfer, discussed above.

*Comments: The National Bankruptcy Conference supports this provision.*

**Sec. 1118. Disposition of property of the estate.**

This section eliminates a reference to 11 U.S.C. § 1009, a provision in an earlier version of the 1994 amendments that never came into effect.

**Sec. 1119. General provisions.**

This provision amends 11 U.S.C. § 901(a) to add an omitted reference to 11 U.S.C. § 1123(d).

**Sec. 1120. Appointment of elected trustee.**

This section clarifies the procedure for the election of a private trustee in a chapter 11 case. The United States trustee must file a report certifying the election, which terminates the service of a previously-appointed trustee. Courts are authorized to resolve disputes arising out of an election.

*Comments: The National Bankruptcy Conference supports this provision, but recommends that proposed section 1104(b)(2)(B) be revised to read as follows: "The court shall resolve any dispute arising out of an election under subparagraph (A)."*

**Sec. 1121. Abandonment of railroad line.**

This section amends 11 U.S.C. § 1170(e)(1) to eliminate a reference to a repealed provision in Title 49 and to replace it with a correct reference.

**Sec. 1122. Contents of plan.**

This section amends 11 U.S.C. § 1172(c)(1) to eliminate a reference to a repealed provision in Title 49 and to replace it with a correct reference.

**Sec. 1123. Discharge under chapter 12.**

This section corrects erroneous references in 11 U.S.C. § 1228(a) and (c).

**Sec. 1124. Bankruptcy cases and proceedings.**

This section corrects erroneous references in 28 U.S.C. § 1334(d).

**Sec. 1125. Knowing disregard of bankruptcy law or rule.**



This section amends 18 U.S.C. § 156(a) to make stylistic changes and to clarify a reference to Title 11.

**Sec. 1126. Transfers made by nonprofit charitable corporations.**

This section makes a nontechnical change. It amends 11 U.S.C. §§ 363 and 1129(a) to require that all transfers of property in the bankruptcy case of a corporation or trust (that is not a moneyed, business, or commercial corporation or trust) are in complete accordance with all laws governing the transfer of property. This section also amends 11 U.S.C. § 541 to provide that property held by a corporation exempt from taxation under 26 U.S.C. § 501(c)(3) may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply had the debtor not filed a bankruptcy case. These amendments, if adopted, would apply to pending cases. However, a court would consider whether the application of these amendments to pending cases would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor postpetition.

*Comments: The National Bankruptcy Conference opposes these amendments, which will be relevant to cases involving hospitals and other nonprofit organizations. By negative implication, these amendments might suggest that other types of debtors do not need to follow otherwise applicable nonbankruptcy law. Subsection (e), which clarifies that the bankruptcy court need not remand or refer the matter of a transfer of property to a nonbankruptcy court, creates an ambiguity regarding the jurisdiction of the bankruptcy court and state court in the sale of the assets of a not for profit debtor. The provision is also ambiguous when it requires that the court consider whether these amendments "would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor" postpetition.*

*If this provision is adopted, the following technical comments should be considered. References to "corporation or trust" are not necessary because the definition of corporation includes trust. See 11 U.S.C. § 101(9). Paragraph (1) of section 363(d) should begin with the following clause: "if the debtor is a corporation that is not a moneyed, business, or commercial corporation." Similarly, paragraph (15) of section 1129(a) should begin with the same clause and the phrase "of the plan" should be deleted and replaced with "under the plan".*

*The amendment made by subsection (c) should be made to 11 U.S.C. § 363 (as new subsection (p)), not to 11 U.S.C. § 541. The latter portion of subsection (d) of the amendment, which begins with "The parties who may appear," should be a statutory amendment that should read as follows: (e) Standing. - Section 1109 of title 11, United States Code, is amended by adding at the end: "(e) The attorney general of the State in which the debtor is incorporated, was formed, or does business may appear and be heard in any proceeding under section 363(p) or 1129(a)(15) of this title."*

**Sec. 1127. Prohibition on certain actions for failure to incur finance charges.**

This section makes a nontechnical change and amends section 127 of the Truth and Lending Act to prevent a creditor from terminating a credit card account prior to its expiration solely because

a customer has not incurred finance charges on the account. The lender may terminate on account of 3 months' inactivity.

**Sec. 1128. Protection of valid purchase money security interests.**

This section makes a nontechnical change and amends 11 U.S.C. 547(c)(3)(B) to give a creditor 30 days, rather than 20 days, to perfect its interest for an enabling loan.

*Comments: The perfection period was just increased from 10 to 20 days in the Bankruptcy Reform Act of 1994. The period should not be further extended without a demonstration that the longer period is necessary. If this provision is retained, it should permit the lesser of the time allowed by state law or 30 days.*

**Sec. 1129. Trustees.**

This provision makes a nontechnical change and generally incorporates the provisions of the Private Trustee Reform Act of 1997, H.R. 2792, which authorizes district court judicial review of U.S. trustee decisions to remove trustees from the panel or to stop assigning cases to a particular private trustee or to resolve disputes over trustee expenses. Trustees first must exhaust administrative remedies before seeking federal court review. The failure of the agency to act within 90 days satisfies the exhaustion requirement. Trustees then may commence an action in the district court. The legislation also offers a standard of review for the district court: the district court shall affirm the agency decision unless it is "unreasonable and without cause based on the administrative record before the agency."

**TITLE XII.**

**Sec. 1201. Effective date; application of amendments.**

Except as otherwise provided in this Act, the Act and its amendments take effect 180 days after the date of enactment. The amendments made by the Act do not apply to cases commenced before the effective date.

*Comments: Like the Bankruptcy Reform Act of 1978, the effective date of this bill should be deferred for one year.*

**SECTION BY SECTION ANALYSIS OF S. 625**  
**AS PASSED BY THE U. S. SENATE COMMITTEE ON THE JUDICIARY**

**-National Bankruptcy Conference -**

National Bankruptcy Conference  
Section by section analysis of S. 625 as passed by the Committee on the Judiciary  
[Last Revised May 26, 1999]

**Title I - Needs based bankruptcy**

**Sec. 101. Conversion.**

This section permits a court to convert a case from chapter 7 to chapter 13 with the debtor's consent, rather than requiring that the debtor request conversion.

**Sec. 102. Dismissal or conversion.**

According to this provision that amends section 707(b) of the Bankruptcy Code, a chapter 7 case is presumed to be abusive if the debtor's "current monthly net income"<sup>1</sup> is sufficient to pay over 5 years the lesser of 25% of general unsecured debts or \$15,000. The debtor's expenses are determined using the IRS collection standards (excluding payments for debts). Priority debts and secured debts coming due in the following 5 years are also deducted. All chapter 7 debtors must file statements calculating their current monthly net income and ability to pay under the means test. The presumption of abuse may be rebutted only by showing "special circumstances" that require additional expenses or adjustment of income making the debtor unable to pay the lesser of \$15,000 or 25% of general unsecured debts over 5 years. Each item must be documented and accompanied by a detailed explanation to which the debtor attests under oath.

This provision includes a safe harbor against creditor section 707(b) actions for debtors with below-median incomes. Only the court, United States trustee, or trustee may bring motions to dismiss or convert cases under section 707(b) if the debtor has income less than the highest national or State median family income for a family of equal or lesser size (but the safe harbor is not adjusted upward for families with more than 4 members). Trustees, U.S. trustees and courts may challenge all cases on ability to pay grounds as well as bad faith and the totality of circumstances, including whether the case was filed to reject a personal services contract.

Debtors will be entitled to reasonable costs if a creditor unsuccessfully brings a motion to dismiss or convert that was not substantially justified or that was brought to coerce the debtor to waive a right. However, this fee shifting provision is inapplicable if the creditor's claim is less than \$1,000. Trustees who prevail in getting a debtor's case dismissed or converted may get costs and attorneys' fees against the debtor's attorney if the attorney's action in filing chapter 7 for client was "not substantially justified." The provision also imposes mandatory sanctions on debtors' attorneys who violate Fed. R. Bankr. P. 9011 (Rule 11 sanctions).

*Comments: This means test deprives courts of sufficient discretion to identify debtors with substantial repayment ability and is based on an unrealistic repayment schedule -- 5 years --*

<sup>1</sup>"Current monthly net income" includes income received from all sources within the prior 180 days, divided by 6.

*when 3 year plans already are highly susceptible to failure. It is inefficient to require that the trustee certify ability to pay for every chapter 7 debtor, including those below the median income level who have less repayment ability.*

*The IRS collection allowances, which are not mandatory in the tax context, are not appropriate as a template to determine whether debtors deserve chapter 7 bankruptcy relief. The Hyde amendment unsuccessfully offered in the House would enable a judge to determine necessary and reasonable expenses for a debtor and the debtor's dependents to assess whether the debtor has the ability to pay. Adoption of the IRS' inflexible and rigid standards will cause many honest families to lose the benefit of a fresh start under chapter 7.*

*Some of the problems with the IRS standards can be set out briefly. Because some of the allowances are based on income as well as family size, the IRS expense standards give a higher food allowance to a single high income person than to a low income family with 6 members. The means test permits homeowners to deduct their entire mortgage payments, regardless of the amount, in addition to the portion of the IRS housing allowance that is not attributable to the mortgage payment. However, the means test does not make clear how much of the IRS housing allowance may be claimed by homeowners for housing-related costs. In any event, this portion of the test favors homeowners with high mortgage payments over homeowners with low mortgage payments, and gives least favored status to families who rent their dwellings.*

*The transportation allowance affects similarly situated debtors differently as well. The test disfavors people without any cars who rely on public transportation and creates perverse incentives by benefitting high income debtors with one or more late-model cars. Each case will need individualized scrutiny of the extent to which the debtor is permitted to deduct "other necessary expenses" for child care, health care, dependent care of elderly, taxes, union dues, and similar expenses.*

*The required calculation of current monthly net income (a 6 month average) may overstate or understate the amount of income actually available to pay creditors. For example, if the debtor had an income of \$5,000 per month for 3 months, followed by 3 months of zero income, that debtor will be presumed to have monthly income of \$2,500 when in reality she has none. In addition, including the income of a nondebtor spouse may create a marriage penalty. The problems with including nondebtor spouse income are heightened by the exclusion of the expenses of a separated spouse.*

*All attorneys representing parties in bankruptcy cases are already subject to Rule 9011 of the Federal Rules of Bankruptcy Procedure. Like Rule 11 of the Federal Rules of Civil Procedure, Rule 9011 penalizes attorneys for sanctionable behavior. The bankruptcy system should hold lawyers answerable to the standards applicable to all lawyers who practice in federal court.*

**Sec. 103. Notice of alternatives.**

This section amends 11 U.S.C. § 342(b) so that an individual seeking bankruptcy relief must obtain a written notice, prescribed by the United States trustee before the commencement of a

case. This written notice must contain a brief description of bankruptcy options (e.g., chapter 7 versus chapter 13) and credit counseling services approved by the United States trustee.

*Comments: Increasing consumers' awareness of alternatives to bankruptcy is desirable. In some districts, however, such as the Central District of California, a significant portion of consumer debtors are pro se filers. These pro se filers may not know to comply with the requirements imposed by this provision and the proposed prebankruptcy counseling requirement.*

#### **Sec. 104. Debtor financial management training test program.**

This section instructs the Executive Office for United States Trustees to consult with a wide range of individuals with expertise in the field of debtor education and to develop a financial management training curriculum and materials. Pilot programs must be established in 6 judicial districts for a one-year period beginning not later than 270 days after enactment of this Act. During this one-year period, the Director of the Executive Office for United States Trustees must evaluate the effectiveness of the curriculum and materials as well as other preexisting consumer education programs. Not later than three months after concluding the evaluation, the Director must submit a report to Congress.

*Comments: To maximize the benefits of a pilot program, it may take several years to assess whether the program prevents people from repeating the mistakes that led them into financial trouble and bankruptcy. In addition, because appropriations will be necessary to implement this provision, section 104 should not become effective until the later of October 1, 2000 or one year after the date of enactment of this bill.*

#### **Sec. 105. Credit counseling.**

This provision amends 11 U.S.C. § 109 so that an individual may not be a debtor in bankruptcy unless the individual has received credit counseling within 180 days before filing for bankruptcy. Credit counseling includes, at a minimum, participation in a briefing that outlines the opportunities for counseling and assists that individual in an initial budget analysis. Individuals filing for bankruptcy must submit a certificate from the credit counseling service and a copy of the debt repayment plan, if any. The prebankruptcy counseling requirement is inapplicable if the United States trustee determines that the approved programs for that district are not reasonably able to provide adequate services to those seeking counseling as a bankruptcy prerequisite. This determination must be reviewed by the United States trustee on an annual basis. The counseling requirement also may be waived by the court if a debtor certifies the existence of exigent circumstances and the debtor requested counseling services but was unable to obtain services for a five day period. This exemption expires 30 days after the debtor files a petition for relief. This provision also offers a rebuttal to the proposed presumptions of bad faith repeat filings if the prior case was dismissed due to the creation of a debt repayment plan.

This section conditions a discharge on the completion of an instructional course on personal financial management, notwithstanding the fact that the pilot program established in section 104 of this bill is not yet completed. Although the requirement may be waived for a chapter 13

debtor if there are no appropriate services available, the requirement may not be waived for a chapter 7 debtor.

*Comments: Courts should retain adequate discretion to waive the prebankruptcy counseling requirement if it imposes an undue hardship. The implementation of a mandatory financial management course should be deferred until completion of the pilot programs established in section 104 of this bill.*

## **Title II - Enhanced consumer protection**

### **Subtitle A. Penalties for abusive creditor practices**

#### **Sec. 201. Promotion of alternative dispute resolution.**

This provision does not address alternative dispute resolution as that term is generally defined, but rather attempts to induce parties to restructure debts outside of bankruptcy. It authorizes a court to reduce an unsecured consumer debt claim by up to 20% if the debtor proves by clear and convincing evidence that the creditor holding the claim refused to negotiate a reasonable alternative repayment schedule offered by the debtor at least 60 days before bankruptcy if that repayment schedule would have satisfied at least 60% of the debt over a reasonable period. The court's authority to reduce claims on this basis does not apply to nondischargeable debts. This provision also protects payments from avoidance as preferential transfers if the payments were part of an alternative repayment plan created by an approved credit counseling agency.

*Comments: Further study is necessary to determine whether this provision is necessary or desirable. As a technical matter, the appropriate burden of proof for bankruptcy proceedings and contested matters is by a preponderance of the evidence, not clear and convincing evidence. Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654 (1991).*

#### **Sec. 202. Effect of discharge.**

Under this section, a creditor's willful failure to properly credit repayment plan distributions violates the injunction automatically imposed by 11 U.S.C. § 524 when a debtor receives a discharge.

*Comments: The provision does not amplify the scope of the discharge injunction in other important areas (e.g., illegal reaffirmations) and thus is less protective of the discharge injunction than the parallel provision in last year's Senate bill (section 203). This provision should apply to plans under chapter 12 for family farmers as well as chapter 13 and chapter 11; a reference should be added to "sections 1129, 1225, and 1325 of title 11."*

#### **Sec. 203. Violations of the automatic stay.**

This provision makes it a violation of the automatic stay to threaten a debtor of an intention to bring a complaint declaring a debt nondischargeable or to dismiss or convert the debtor's case if such threats are made for the purpose of coercing the debtor to sign a reaffirmation agreement. However, creditors are not enjoined from a "recitation of the creditor's legal rights."

*Comments: To prevent coercive activities, the "recitation of rights" exception should be deleted.*

#### Sec. 204. Discouraging abuse of reaffirmation practices.

This provision amends 11 U.S.C. § 524 to provide that a debtor is entitled to a hearing regarding a reaffirmation of an unsecured debt, during which the court would decide whether “the agreement is an undue hardship, not in the debtor’s best interest, and not the result of a threat by the creditor to take any action that cannot be legally taken or that is not intended to be taken.” However, this requirement is waivable by debtors represented by counsel. This provision does not authorize hearings for reaffirmation of nominally secured debts. The provision also authorizes greater law enforcement on the state and federal levels to address illegal reaffirmation agreements.

*Comments: The law enforcement provisions may help to address illegal reaffirmations. However, the amendment to section 524 of the Bankruptcy Code does not substantially change the procedures for legal reaffirmations. Current law has proven to be inadequate in screening reaffirmations of debt that the debtor cannot afford and that impede the debtor’s ability to satisfy critical postbankruptcy obligations. This problem is heightened if creditors are permitted to bring section 707(b) motions and rely on additional exceptions to discharge, the threat of which may be used as leverage to extract reaffirmation agreements. If reaffirmations are not otherwise restricted, reaffirmation review should be mandatory for at least all unsecured and nominally secured debts. It would be helpful to enhance disclosures of the costs as well.*

#### Subtitle B - Priority Child Support

#### Sec. 211. Priorities for claims for domestic support obligations.

This section amends 11 U.S.C. § 507(a), the provision that determines priorities in distribution among expenses and debts. The amendment moves domestic support obligations from “seventh priority” to “first priority.” Because the definition of domestic support obligation now includes debts owed to the government, those government debts are entitled to “first priority” as well. However, the amendment specifies that any first priority distribution should first be applied to satisfy the claims of support recipients and then to government units.

*Comments: Right now, the expenses of administering the bankruptcy estate are entitled to “first priority.” See 11 U.S.C. §§ 507(a)(1), 503(b). Administrative expenses have first priority so the trustee may incur the expenses necessary to liquidate property and make distributions to creditors. If a debtor has significant support obligations, and support is “first priority,” the trustee will not be able to liquidate and distribute property. Instead, the trustee may have to “abandon” property— give it back to the debtor— rather than distributing the proceeds. Thus, while it may be legally correct to say that this bill puts child support “first” under section 507 of the Bankruptcy Code, that statement is somewhat misleading. Apart from the issue related to subordination of administrative expenses moving from “seventh priority” to “first priority” makes little practical difference: the debts that have second through sixth priorities almost never appear in consumer cases. Those priorities deal with debts of grain storage facility operators, debts of fishermen, employee wage claims, retail layaway claims, and the like. Taking all*

factors into consideration, this amendment would have an effect in fewer than 1% of all chapter 7 cases.

#### Sec. 212. Requirements to obtain confirmation and discharge in cases involving domestic support obligations.

This section provides that the debtor cannot obtain a discharge after completing payments under a chapter 13 plan unless he certifies that domestic support obligations have been paid, but the details continue to be under discussion.

#### Sec. 213. Exceptions to automatic stay in domestic support obligation proceedings.

This section adds additional exceptions to the automatic stay in 11 U.S.C. § 362(b). According to these amendments, the automatic stay does not enjoin actions to impose or enforce wage orders for domestic support obligations, the interception of tax refunds, the enforcement of medical obligations, or actions to withhold, suspend, or restrict licenses of the debtor for delinquency in support obligations.

#### Sec. 214. Nondischargeability of certain debts for alimony, maintenance, and support.

This section amends 11 U.S.C. § 523(a)(5) to except from discharge all domestic support obligations. This section also makes a substantial change to 11 U.S.C. § 523(a)(15). This provision currently permits a court to find that a property settlement (that is not in the nature of support) is excepted from discharge unless the court finds (1) that the debtor does not have the ability to pay the obligation or (2) that discharging the debt would result in a benefit to the debtor that outweighs the detrimental consequences to the ex-spouse or children. The amendment eliminates these two conditions so that all property settlements will be nondischargeable.

*Comments: There will be times when this change to the treatment of property settlements will work hardship on spouses and children collecting support. A custodial parent and child may file for bankruptcy after they have difficulty collecting payments from an ex-spouse and thus cannot meet their day to day obligations. As a result of this amendment, some financially troubled spouses and children who file for bankruptcy because they have not been receiving their support payments will be unable to discharge debts they may owe to their wealthier spouses as a result of a property settlement. In addition, some ex-spouses do not receive support because they are financially independent or have remarried and joined financial stable households. Another scenario that reveals the odd effects of this amendment is when a debtor has been married and divorced twice. The first former spouse may need child support from the debtor. The second former spouse may be wealthy and remarried and does not receive support from the debtor but has a property settlement with the debtor. If this amendment becomes law, the support obligation to the first spouse and the property settlement to the second spouse would both be nondischargeable and have the same status after bankruptcy; if the debtor lacks sufficient funds to pay both, the support recipient, who has fewer resources to seek collection, may suffer.*

#### Sec. 215. Continued liability of property.

This amendment permits nondischargeable domestic support obligations to be collected from property -- even property that state law makes exempt from collection or attachment -- after bankruptcy.

*Comments: This provision overrides wage exemptions, property exemptions, and state laws protecting tenancies by the entirety. It is unclear whether this provision actually will benefit families or whether it instead will benefit government agencies, particularly because overriding homestead exemptions may have the effect of removing families from their homes.*

#### **Sec. 216. Protection of domestic support claims against preferential transfer motions.**

This section amends 11 U.S.C. § 547, the provision that allows avoidance, and ultimately recovery, of pre-bankruptcy transfers that were "preferential." The amendment prevents a trustee from seeking recovery of a prepetition "domestic support obligation."

*Comments: With respect to actual support recipients, this amendment does not substantially change current law. A 1994 amendment protects ex-spouses and children from having to give back "preferential" support payments received prepetition. See 11 U.S.C. § 547(c)(7). The amendment changes current law by insulating preferential payments made to governmental units. Insulating those payments to the government may, in some cases, hurt an ex-spouse and child of the debtor because those funds otherwise would be available for ongoing support payments and instead have been applied to old support debts preferentially paid to the government.*

**Sec. 217. Amendment to section 1325 of title 11, United States Code.** Under this section, when calculating the disposable income available for payment of nonpriority unsecured claims, one must account for reasonable child support payments, foster care payments, or disability payments for a dependent child.

#### **Sec. 218. Definition of domestic support obligation.**

This provision adds a definition of "domestic support obligation" to 11 U.S.C. § 101, the general definition section of the Bankruptcy Code. The new definition includes any debt, whether accrued before or after the bankruptcy filing if: the debt is owed or recoverable to a spouse, ex-spouse, child, legal guardian, or a governmental unit; the debt is in the nature of alimony, maintenance, or support, regardless of its designation, established or subject to establishment by reason of a separation agreement, divorce decree, property settlement agreement, court order, or determination made by a governmental unit; and the debt has not been assigned to a nongovernmental unit, other than a debt collector. This definition is relevant to subsequent provisions that give certain rights to the holders of domestic support obligations and impose additional requirements on debtors who owe these obligations.

#### **Sec. 219. Collection of child support.**

This section imposes duties on trustees in chapter 7 and chapter 13 cases to assist support recipient creditors of the debtors in determining how they can enforce their rights.

*Comments: Authorizing support recipients to request information regarding the debtor's location from a creditor should be coupled with a requirement that the creditor produce that information.*

### **Subtitle C - Other Consumer Protections**

#### **Sec. 221. Amendments to discourage abusive bankruptcy filings.**

This provision amends 11 U.S.C. § 110 to bolster the requirements and penalties for nonlawyer petition preparers, including those employed by lawyers, to ensure that they do not offer legal advice. In particular, the provision delineates the components of a mandatory written notice to debtors regarding what they can and cannot expect from petition preparers. In addition, the provision authorizes the promulgation of rules or guidelines establishing the maximum fee that a petition preparer may charge for services. The provision also authorizes the court, "as part of its contempt power," to enjoin a bankruptcy petition preparer who has failed to comply with a prior order under section 110 and may impose treble damages under certain circumstances. Any fines collected are to be given to the United States trustee to be used for nationwide enforcement of restrictions on nonlawyer petition preparers.

#### **Sec. 225. Sense of the Congress.**

This provision states that "[i]t is the sense of the Congress that States should develop curricula relating to the subject of personal finance, designed for use in elementary and secondary schools."

#### **Sec. 226. Additional amendments to title 11, United States Code.**

This section amends 11 U.S.C. § 523(a)(9) to explicitly except from discharge debts resulting from drunk boating and amends 11 U.S.C. § 507(a) to give priority status to allowed claims for death and personal injuries resulting from drunk boating or drunk driving.

*Comments: All priority debts must be repaid in full in the course of a chapter 13 plan. Hence, granting priority status to this or any other type of debt decreases the likelihood that chapter 13 debtors with a debt of this kind will be able to confirm a plan and repay any debts in chapter 13.*

#### **Sec. 227. Protection of retirement savings in bankruptcy.**

This provision amends 11 U.S.C. § 522 to exempt qualified retirement funds that are exempt from taxation under various provisions of the Internal Revenue Code. This provision makes the automatic stay inapplicable to wage deductions for pensions, profit sharing or other such plans to the extent that those amounts are used solely for payments relating to a loan from an ERISA qualified plan, except for debts incurred within 1 year prior to filing a bankruptcy petition. In addition, loans borrowed from retirement plans are excepted from discharge under section 523(a), except for loans made within 1 year prior to filing the bankruptcy petition. Finally, section 1322 is amended to provide that a chapter 13 plan may not "materially alter" the terms of a loans from retirement funds.

**Comments:** The National Bankruptcy Conference supports this provision. It would be helpful to add the following language to the end of the amendment to section 1325: "For purposes of the plan only, any such loan shall be treated as a nonrecourse loan secured by the assets of the applicable pension, profitsharing, stock bonus, or other plan. No plan established under sections 401, 403, 408(A), 414, 457, or 501(c) of the Internal Revenue Code of 1986 or permitted under the Employment Retirement Income Security Act may be disqualified as a result of the repayment of any loan to such plan made in accordance with a confirmed plan under this chapter."

### **Title III - Discouraging Bankruptcy Abuse**

#### **Sec. 301. Reinforce the fresh start.**

This section clarifies that the exception to discharge for court costs applies only to prisoners.

*Comments: The National Bankruptcy Conference supports this amendment.*

#### **Sec. 302. Discouraging bad faith repeat filings.**

Under this provision, the automatic stay terminates 30 days after the filing of a petition for relief under title 11 by an individual if the individual was a debtor in another case that was dismissed within the previous year. A party in interest may seek an extension of the stay by showing that the later case is in good faith. A case presumptively is not in good faith if the debtor filed more than one previous case within the year, if a prior case was dismissed after the debtor did not file the requisite documents without substantial excuse, if the debtor did not provide adequate protection, if the debtor did not perform the terms of a confirmed plan, or if the debtor's financial condition and personal affairs have not changed substantially since the last case was dismissed. In addition, a case presumptively is not in good faith as to a particular creditor if the creditor sought relief from the automatic stay in the prior case and that action was pending upon dismissal or had been resolved in the creditor's favor. A presumption that a case is not in good faith is rebuttable by clear and convincing evidence. The automatic stay does not apply at all to the case of an individual who has been a debtor in two or more dismissed cases within the previous year, although a party in interest may request that a stay be imposed by showing that the case is in good faith (with presumptions similar to those listed above).

*Comments: The National Bankruptcy Conference supports restrictions to deter abusive repeat filings, subject to some minor technical revisions. The standard for rebutting a presumption should be by a preponderance of the evidence, as is generally the standard in bankruptcy matters, not clear and convincing evidence.*

#### **Sec. 303. Curbing abusive filings.**

This section establishes standards for the application of *in rem* orders that make the automatic stay inapplicable to an identified property interest in future cases. This order may be issued upon a court finding that the filing of a bankruptcy petition was part of a scheme to hinder, delay, and defraud creditors involving the transfer of an interest in real property or multiple bankruptcy filings affecting that property. An *in rem* order remains in effect for two years, although parties may obtain relief from an *in rem* order for good cause or changed circumstances. In addition,

this provision makes the automatic stay inapplicable to any act to enforce a lien against property of a debtor who is ineligible for bankruptcy relief pursuant to 11 U.S.C. § 109(g) or a prior court order. A government agency that accepts notices of interests or liens in property must accept a certified copy of *in rem* order.

*Comments: The National Bankruptcy Conference supports this provision. To resolve a slight inconsistency, the reference in section 362(d)(4) should be changed so that the two-year period in that provision runs from the date of the entry of the order, not the recording. This can be accomplished by striking "not later than 2 years after that recording" and inserting "not later than 2 years after the entry of the order". The proposed automatic stay exception that permits lien enforcement against the property of individuals ineligible for bankruptcy may lead to some wrongful repossessions and foreclosures.*

#### **Sec. 304. Debtor retention of personal property security.**

This section prohibits the "ridethrough" of secured debt obligations in chapter 7. If a debtor does not redeem or reaffirm a debt secured by personal property within 45 days after the first meeting of creditors, the creditor may take any action against the property permitted under applicable nonbankruptcy law unless the court determines on the motion of a trustee within the 45 day period that the property is of consequential value to the bankruptcy estate. This section also clarifies that redemption requires payment in a single lump sum.

*Comments: This provision makes a substantial change to the law and practice in several circuits while it codifies the law of other circuits. If this provision is retained, some minor refinements would be helpful. For example, if the debtor is contesting the validity of, or is seeking to avoid, the security interest (similar to the proposed section 521(c) that creates an exception for voidable security interests), or if the debtor attacks a security interest as being invalid under state law, the property should not be abandoned to the creditor. With respect to redemption, it is appropriate to clarify that a debtor must provide a lump sum payment to the party holding a security interest in that property.*

#### **Sec. 305. Relief from the automatic stay when the debtor does not complete intended surrender of consumer debt collateral.**

This section authorizes automatic stay relief without court permission if a debtor fails to file a statement of intention or to follow through on the debtor's statement of intention (unless the statement specifies reaffirmation and the creditor refuses to reaffirm on the original contract terms), except if the court determines on the motion of a trustee that the property is of consequential value or benefit to the estate, in which case the court must order adequate protection for the creditor and the debtor must deliver the property to the trustee.

*Comments: The trustee may face liability for accounting and storing items delivered by the debtor. It may be preferable to require delivery only at the request of the trustee. This provision should be revised to provide that a debtor's failure to file a statement of intention or to follow through on a statement of intention triggers abandonment of the property to the debtor, and the*

creditor may exercise its rights except to the extent that it seeks to enforce ipso facto clauses triggered by the bankruptcy or insolvency of the debtor.

#### Sec. 306. Giving secured creditors fair treatment in chapter 13.

According to subsection (a), the holder of an allowed secured claim retains its lien until the debtor pays the entire debt (including the unsecured portion) or until receipt of a chapter 13 discharge. Under subsection (b), debts secured by cars incurred within 5 years before bankruptcy shall be treated as fully secured, regardless of the value of the car. Debts secured by other items incurred within 6 months before bankruptcy shall be treated as fully secured, regardless of the value of the collateral. Subsection (c) adds a definition of debtor's principal residence, providing that it is "a residential structure, including incidental property, without regard to whether that structure is attached to real property." This means that debts partially secured by depreciating mobile homes may not be modified in chapter 13 repayment plans.

*Comments: Current law is divided on whether a lien is released when the allowed secured claim has been paid off or when the repayment plan has been completed. See In re Johnson, 213 B.R. 552 (Bank. N.D. Ill. 1997) (collecting cases split on question of lien retention). This provision may encourage some debtors to remain committed to their repayment plans. It may also result in a higher rate of repossessions of collateral.*

*The National Bankruptcy Conference opposes the provision that eliminates the stripdown of partially secured debt and includes accrued interest and penalty charges. This provision diverts value from general unsecured creditors in favor of undersecured creditors. The Bankruptcy Code should give creditors what they otherwise would receive under state law; treating a creditor as fully secured when that creditor's interest is substantially undersecured deviates from this fundamental principle. If this provision is adopted notwithstanding these concerns, the five year period should be reduced to 90 days, should exclude retail charge card debts, and should exclude nonpurchase money security interests.*

*The definition of debtor's principal residence should exclude mobile homes, which depreciate and are security for extensions of credit priced like consumer loans instead of mortgage loans.*

#### Sec. 307. Exemptions.

To be subject to the exemption laws of a state, a debtor must be domiciled in a state for the 730 days immediately preceding bankruptcy, not just the greater portion of that period.

*Comments: This provision leaves ambiguous the rights of debtors who have not lived in a state for 730 days prior to filing for bankruptcy. An additional clause should be added to clarify that a debtor who has not lived in a state for 730 days may use federal exemptions. This can be accomplished by adding at the end of section 522(b)(2)(A), as amended by this provision, the following: ", but if the debtor's domicile has not been located in one place for the 730 days preceding the date of the filing of the petition, the debtor may exempt from property of the estate the property listed in subsection (d) of this section."*

#### Sec. 308. Residency requirement for homestead exemption.

This section provides that the exemption of a debtor's equity in a homestead shall be reduced to the extent such value is attributable to any portion of property that the debtor "disposed of" within 730 days before the bankruptcy petition date with the intent to hinder, delay or defraud a creditor.

*Comments: Current law already authorizes the avoidance of transfers, or the denial of a discharge altogether, when debtors transfer property with the actual intent to hinder, delay, or defraud within one year before the date of the filing of the petition. 11 U.S.C. §§ 548(a)(1), 727(a)(2). Trustees also may recover constructive fraudulent transfers within one year before filing for bankruptcy. Id. § 548(a)(2). In addition, using applicable state law, trustees may recover actual or constructive fraudulent conveyances transfers made within 2, 4, or in some states even 6 years before the bankruptcy filing. Id. § 544(b). This provision fails to close the loophole in current bankruptcy law: fraudulent transfer laws do not protect creditors in the cases of individuals who amass considerable wealth in exempt property but do not make any transfers. To prevent debtors from discharging their debts while retaining property of high value, a cap should be imposed on all homestead exemptions.*

#### Sec. 309. Protecting secured creditors in chapter 13 cases.

Under subsection (a), upon conversion from chapter 13 to chapter 7, claims are considered fully secured unless the claim already has been paid in full, notwithstanding any valuation or determination of the allowed secured claim in chapter 13. Prebankruptcy defaults not fully cured are given the same effect as under applicable nonbankruptcy law. Under subsection (b), leased personal property is not protected once a lease is rejected or not timely assumed by the trustee. A procedure is offered by which debtors can assume leases themselves. In individual chapter 11 and chapter 13 cases, the lease is deemed rejected at the conclusion of the confirmation hearing. Under subsection (c), the chapter 13 trustee is authorized to make preconfirmation distributions to secured creditors as "adequate protection" payments, the amount of which may be modified by the court on notice and hearing.

*Comments: Subsection (a) should permit a debtor seeking to redeem property in a converted case to apply to the redemption price all chapter 13 plan payments and adequate protection payments. Subsection (b) should be revised to state that leases rejected or not timely assumed are abandoned to the debtors, with an opportunity to cure defaults.*

#### Sec. 310. Limitation on luxury goods.

Credit card cash advances aggregating more than \$750 within 70 days before bankruptcy will be presumed nondischargeable. Debts to a single creditor aggregating more than \$250 for "luxury goods or services" incurred within 90 days before bankruptcy will be presumed nondischargeable.

*Comments: The National Bankruptcy Conference generally opposes provisions that prefer one type of creditor over others. This provision limits chapter 7 debt relief for debtors of all income levels and expands nondischargeability for the benefit of credit card lenders. If Congress decides to amend section 523(a)(2)(C) to substantially reduce the dollar threshold (the current*

threshold is \$1,075) triggering a presumption of nondischargeability for credit card debts, the presumptive period should be shortened to 30 days and should exclude cash advances.

#### Sec. 311. Automatic stay.

This section creates new exceptions to the automatic stay that expand the ability of residential landlords to take action against debtors without first seeking leave from the court. Landlords may continue eviction or unlawful detainer actions if the lease terminated prepetition, if the debtor does not paid rent after the commencement of the case, if the debtor filed a previous case within the last year and failed to pay postpetition rent during the course of that case, if the eviction action is based on "endangerment to property or person or the use of illegal drugs."

*Comments: The National Bankruptcy Conference generally opposes exceptions to the automatic stay that prefer one type of creditor to others. This provision gives wide latitude for landlords to evict individuals filing for bankruptcy even if the debtor is making rent payments postpetition. If a provision to protect landlords is thought to be necessary, this provision should be replaced with a provision authorizing landlords to receive expedited relief from the automatic stay. The following provision is an example: Section 362 of title 11, United States Code is amended by adding at the end thereof— "(j) If a lessor of residential real property makes a request for relief under subsection (d) of this section and the debtor has not paid rent that first became due after the commencement of the case, the stay provided by subsection (a)(3) of this section is terminated with respect to the lessor 20 days after request is filed, unless the debtor files and serves upon such lessor a written objection to the request."*

#### Sec. 312. Extend period between bankruptcy discharges.

This section amends 11 U.S.C. § 727(a)(8) to prevent a chapter 7 debtor from receiving a discharge if he received a discharge in a prior case under chapter 7 or 11 commenced within eight years before the filing of the petition in the instant case. If a chapter 13 debtor previously received a discharge under any chapter within the prior five years before the instant case commenced, he cannot receive a discharge even if he completes a new repayment plan.

*Comments: This provision imposes a longer bar on the receipt of a subsequent discharge following a successful chapter 13 repayment plan than after receiving a discharge in chapter 7.*

#### Sec. 313. Definition of household goods and antiques.

This section contains an exclusive list of what items (and how many) are household goods for purposes of lien avoidance under 11 U.S.C. § 522(f). According to this list, a piece of electronic entertainment equipment is not a household good except for "one television, one radio, and one VCR." A computer is a household good only if it is used primarily for the education or entertainment of minor children.

*Comments: It is nearly impossible to construct an exhaustive list of goods that appropriately accounts for all types of families and circumstances. If statutory guidance is thought to be necessary, the Senate should consider deleting this provision and replacing it with section 145 of H.R. 833 as passed by the House.*

#### Sec. 314. Debts incurred to pay nondischargeable debts.

This section adds an exception to discharge when the "debtor incurred the debt to pay such a nondischargeable debt with the intent to discharge in bankruptcy the newly-created debt." It makes nondischargeable all debts incurred to pay nondischargeable debts within 70 days regardless of the debtor's intent (except for debtors owing domestic support obligations for which there are filed claims). Subsection (b) amends 11 U.S.C. § 1328 so that a debtor who completes a 3 to 5 year chapter 13 plan may not discharge debts that are nondischargeable under 11 U.S.C. §§ 523(a)(2), (3)(B), (a)(4), and (a)(6) (if resulting from a willful and malicious injury by the debtor that caused personal injury or death), including credit card debts and cash advances under section 523(a)(2).

*Comments: The National Bankruptcy Conference opposes this expansion of the exceptions to discharge. For a credit card debt to be nondischargeable, a creditor should be required to prove each element of fraud by the preponderance of the evidence. The domestic support obligation exception creates a preference for divorced families over intact families but would not work in most cases because it is triggered by the timely filing of a domestic support obligation claim; over 95% of all nonbusiness chapter 7 cases are no-asset cases and creditors are directed not to file proofs of claim. If this provision is retained, it should be referenced in 11 U.S.C. § 523(c), like other exceptions to discharge that should be litigated during the course of the bankruptcy case. As a technical matter, the reference in the amendment to section 727 should be deleted. Section 727 deals with objections to a chapter 7 debtor receiving a discharge of debts overall, not the nondischargeability of a particular debt.*

*The National Bankruptcy Conference supports subsection (b) to the extent that it excludes from the superdischarge debts falling under section 523(a)(6) that result from a willful and malicious injury by the debtor that caused personal injury or death. However, if the scope of the discharge in chapter 7 and chapter 13 are relatively coextensive by excepting from discharge credit card debts and cash advances under section 523(a)(2), the incentive to file chapter 13 is reduced.*

#### Sec. 315. Giving creditors fair notice in chapters 7 and 13 cases.

This provision permits creditors to identify their preferred address for notices from the court and from the debtor. Failure to give notice to the designated address and to include the debtor's name, address, and taxpayer identification number will invalidate the legal effect of the notice. This provision also amplifies debtors' duties under 11 U.S.C. § 521. The additional duties primarily are informational requirements, such as tax returns and income statements. Creditors may request access to documents and courts must comply within 5 days of such request. This provision also directs the Administrative Office of the United States Courts to establish procedures safeguarding the confidentiality of tax information within 30 days after the date of enactment and to submit a report to Congress on this matter within a year after the date of enactment.

*Comments: The court filing registry is a desirable method of ensuring that creditors receive notice, although it may be infeasible to constantly update the registry. Quarterly or bi-annually*



should be sufficient. Failure to include the taxpayer identification number on notices should not invalidate the legal effect of notice. The informational requirements should not come into effect until the Administrative Office of the United States Courts has implemented a procedure to safeguard the privacy of tax information.

**Sec. 316. Dismissal for failure to timely file schedules or provide required information.**

This section amends 11 U.S.C. § 521 so that cases are dismissed automatically if individual debtors do not submit all required information within the statutory deadline. Extensions of up to 45 days may be granted if a court finds a "justification" to do so.

*Comments: The need to obtain information from the Internal Revenue Service may hinder a debtor's ability to comply in a timely fashion, particularly if the debtor has filed electronically and thus does not have copies of his or her tax returns.*

**Sec. 317. Adequate time to prepare for hearing on confirmation of the plan.**

Under this section, 11 U.S.C. § 1324 is amended to provide that a confirmation hearing may be held no later than 45 days after the section 341 meeting of creditors. In addition, this provision requires that a plan be filed not later than 90 days after the order of relief, with extensions available due to circumstances for which the debtor should not be held accountable.

*Comments: The provisions of this amendment, taken together, appear to require that the confirmation hearing precedes the filing of the plan. NOT consistent with Rule 3015(b)*

**Sec. 318. Chapter 13 plans to have a 5-year duration in certain cases.**

This section requires 5-year chapter 13 plans for cases converted from chapter 7.

*Comments:* Given the fact that two thirds of confirmed chapter 13 plans already are not completed, it is not sensible to increase the length of repayment plans, during which debtors must dedicate all disposable income. If this provision is retained, it should be redrafted to require that the plan is the shorter of 5 years or the time necessary to repay 100% of debts.

**Sec. 319. Sense of the Congress regarding expansion of rule 9011 of the Federal Rules of Bankruptcy Procedure.**

This provision expresses the sense of Congress that Rule 9011 should be modified to include a requirement that all documents, including schedules, should be submitted to a court or trustee only after the debtor or the debtor's attorney has made reasonable inquiry to verify that the information is well-grounded in fact and is warranted by existing law or a good faith argument for extension, modification, or reversal of existing law.

**Sec. 320. Prompt relief from stay in individual cases.**

If courts do not rule on motions for automatic stay relief within 60 days, this section provides that the stay terminates automatically in the case of an individual debtor unless the parties agree to an extension of the deadline or the court orders an extension for "good cause."

*Comments: Efforts to establish firm time limits for courts to issue rulings have not been effective in the past. Issues of timing should be handled by the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States.*

**Sec. 321. Treatment of certain earnings of an individual debtor who files a voluntary case under chapter 11.**

This provision amends 11 U.S.C. § 541(a)(6) so that future income of an individual debtor in chapter 11 is property of the estate, except in involuntary cases.

*Comments: The National Bankruptcy Conference opposes this amendment. Postpetition earnings are property of the estate in a chapter 13 case, but there are many substantial differences between chapter 11 and chapter 13 that should be explored thoroughly before taking this significant step. Capping unlimited homestead exemptions would go a long way toward increasing creditors' entitlements in the cases of wealthy individuals, as it would require that chapter 11 debtors pay their creditors the amount of equity that exceeded the exemption cap. This amendment does not take into consideration how the debtor's living expenses will be provided, since some courts have found that they are not administrative expenses. If there are concerns about the ways in which these provisions operate in the case of an individual debtor, those specific concerns should be explored and addressed directly. This amendment could be scaled back to apply only to the earnings generated by the debtor's business, as opposed to earnings from the debtor's human capital that is necessary to cover basic necessities.*

*To the extent that this amendment is perceived to be necessary to control "super-rich" individuals who use chapter 11 to hide from criminal sanctions, it may be helpful to consider that the Bankruptcy Code contains provisions intended to prevent criminals from using bankruptcy as a shield. For example, the automatic stay does not protect a debtor against police and regulatory actions, and that exception was recently broadened significantly in the Omnibus Appropriations bill last fall. See 11 U.S.C. § 362(b)(4). In addition, criminal fines and restitution orders are not dischargeable. Id., § 523(a)(7), (13).*

**Title IV - General and Small Business Bankruptcy Provisions.**

**Subtitle A- General Business Bankruptcy Provisions.**

**Sec. 401. Rolling stock equipment.**

This section amends 11 U.S.C. §§ 1168 and 1110 to provide even greater protections to creditors secured by rolling stock equipment and aircraft and lessors of the same. These amendments require that a trustee or debtor-in-possession perform all obligations and cure all defaults in accordance with the terms of such security agreement, lease, or conditional sale contract, and

required that a trustee surrender property if the vendor or lessor makes a written demand and otherwise would be entitled to take possession.

*Comments: The amendment to section 1110 of the Bankruptcy Code legislatively overrules Western Pacific Airlines, Inc. v. Gatz Capital, 221 B.R. 1 (D. Colo. 1998). These amendments expand, but do not dramatically change, the protection for aircraft and rolling stock lessors and secured creditors that the Bankruptcy Code already provides. The National Bankruptcy Conference generally opposes special interest provisions that provide preferential treatment for a particular type of creditor to the detriment of other creditors, and for this reason has recommended in the past that these provisions be deleted.*

#### Sec. 402. Adequate protection for investors.

This section adds another exception to the automatic stay permitting a securities self regulatory organization to commence or continue an investigation or action, other than for monetary sanctions, without first seeking court approval.

*Comments: The National Bankruptcy Conference generally opposes provisions that prefer a particular type of creditor over other creditors. The expansion of exceptions to the automatic stay for regulatory actions through this bill and section 603 of the Omnibus Consolidated and Emergency Appropriations Act, 1999, Pub. L. No. 105-277 (striking 11 U.S.C. § 362(b)(4) and (b)(5) and replacing them with a new provision), heightens the importance of imposing explicit limitations to narrowly define the police and regulatory power statutorily to exclude actions taken for purely pecuniary purposes, making the following amendment necessary:*

Section 362 of title 11, United States Code, is amended by adding at the end the following --

(i) In this section, "police and regulatory power" excludes any act, action, or proceeding that affects property of or from the estate to secure or satisfy, in whole or in part, a debt.

#### Sec. 403. Meetings of creditors and equity security holders.

Under this section, the court is authorized to waive the requirement of a section 341 meeting of creditors after notice and a hearing if the debtor files a prepackaged plan of reorganization.

*Comments: The National Bankruptcy Conference supports this provision, which will enhance the efficiency of prepackaged plans of reorganization. However, the Conference recommends that the proposed section 341(e) reads in accordance with the following amendment: Section 341 of title 11, United States Code, is amended by adding at the end the following -- "(e) Notwithstanding subsections (a) and (b) in a case under chapter 9 or 11 of this title in which a plan has been filed for which, before the meeting of creditors or equity security holders under this section, a hearing on confirmation has been scheduled, on the request of a party in interest and after notice and a hearing, the court may order that the United States trustee postpone the meeting pending the hearing on confirmation, and, if the plan is confirmed, order that the meeting not be held."*

#### Sec. 404. Protection of refinance of security interest.

This provision amends 11 U.S.C. § 547(e)(2) so that a transfer is deemed to be made at the time such transfer takes effect between the transferor and the transferee if the transferee perfects its interest within 30 days, rather than 10 days.

*Comments: This extension of the relation-back period may trap and harm the interests of creditors who extend credit in reliance on the lack of a perfected security interest in specified collateral.*

#### Sec. 405. Executory contracts and unexpired leases.

This section amends 11 U.S.C. § 365(d)(4) to replace the 60-day period with a 120-day period to assume or reject a nonresidential real property lease. After 120 days, the court may extend the deadline only on the motion of the lessor, unlike current law that permits extensions for cause.

*Comments: This provision will preclude the reorganization of some businesses, particularly seasonal businesses, and will force some debtors in possession to make premature decisions regarding their leases, to the potential detriment of other creditors if the business ultimately is liquidated. See In re Klein Sleep Prods., 78 F.3d 18 (2d Cir. 1996) (obligations under assumed lease are entitled to administrative expense priority if lease is later rejected). Ideally, section 405 instead should read as follows: Section 365(d)(4) of title 11, United States Code, is amended by adding at the end the following -- "The court may extend the period during which the trustee or plan proponent must elect to assume or reject a lease of nonresidential real property until no later than the date of entry of the order confirming the plan, but such assumption or rejection shall occur on or before the earlier of -- (A) the effective date of the plan; (B) conversion of the case; or (C) dismissal of the case." "*

#### Sec. 406. Creditors and equity security holders committees.

This section clarifies that courts may review appointments to creditors' and equity security holders' committees to ensure adequate representation of creditors or equity security holders.

*Comments: The National Bankruptcy Conference supports the explicit authorization of courts to review appointments to committees to ensure adequate representation, which resolves a split in the case law and recognizes that adequate representation is a question of law for which parties should have legal redress.*

#### Sec. 407. Amendment to section 546 of title 11, United States Code.

This section prohibits a trustee from avoiding a warehouseman's lien for storage, transportation or other costs incidental to the storage and handling of goods, notwithstanding the trustee's otherwise applicable power to avoid those liens under 11 U.S.C. § 545.

*Comments: To the extent that a statutory lien protected by this provision would be ineffective against a bona fide purchaser, the National Bankruptcy Conference opposes this amendment.*

**Sec. 408. Limitation.**

This section extends the period provided by 11 U.S.C. § 546(c)(1)(B) from 20 to 45 days.

*Comments: The National Bankruptcy Conference opposes the unwarranted expansion of reclamation rights that is prejudicial to the interests of other creditors and to the estate.*

**Sec. 409. Amendment to section 330(a) of title 11, United States Code.**

This provision amends 11 U.S.C. § 330(a) so that the factors guiding courts in awarding compensation apply specifically to examiners, chapter 11 trustees, and professional persons. When determining trustees' compensation, the court "shall treat such compensation as a commission based on the results achieved." In addition, this provision re-labels the subparagraphs to cure a technical problem.

**Sec. 410. Postpetition disclosure and solicitation.**

This section permits postpetition solicitation of votes prior to court approval of a disclosure statement in a prepackaged plan of reorganization, but only for holders of claims solicited prior to commencement of the case in accordance with applicable nonbankruptcy law.

*Comments: The National Bankruptcy Conference supports this provision. To fulfill the intent of the amendment, it should be revised to read as follows: Section 1125 of title 11, United States Code, is amended by adding at the end the following — "(g) Notwithstanding subsection (b), an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if the solicitation began before the commencement of the case and was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with the solicitation or, if there is not any such law, rule, or regulation, the solicitation occurred after disclosure of adequate information to the solicited holders."*

**Sec. 411. Preferences.**

This provision broadens the availability of the ordinary course of business defense to preference actions under 11 U.S.C. § 547(c)(2) by de-coupling the requirement that a transaction be in the ordinary course of business between the debtor and creditor and in accordance with ordinary business terms for the industry at large. This means that the recipient of a payment that was not in the ordinary course between the debtor and the creditor will not be required to return the payment for the benefit of all creditors. This section also precludes trustees from bringing preference actions to recover less than \$5,000 in aggregate transfers to noninsider creditors in cases that do not involve primarily consumer debts.

**Sec. 412. Venue of certain proceedings.**

This section amends 28 U.S.C. § 1409 so that a trustee may commence a preference action to recover a nonconsumer debt of less than \$10,000 only in the district in which the noninsider creditor resides.

**Sec. 413. Period for filing plan under chapter 11.**

This section limits the ability of a debtor in possession to obtain extensions of its exclusive right to file a chapter 11 plan to 18 or 20 months, respectively. The amendment provides no discretion for judges to permit longer periods of exclusivity under appropriate circumstances.

*Comments: The National Bankruptcy Conference opposes this provision. This amendment does not provide the requisite flexibility to permit longer periods of exclusivity under compelling circumstances. Although plans are confirmed more quickly now than in the 1980s, the exclusivity period in successful larger cases averages longer than 18 to 20 months. Inflexible limits on exclusivity will squelch negotiations long before the exclusivity periods expire, as creditors exert leverage with the threat of a competing plan. Debtors in possession may be more likely to seek confirmation of nonconsensual plans, a costly and undesirable result. Under the 1994 amendments, district courts have jurisdiction to hear appeals from orders increasing the exclusivity period, 28 U.S.C. § 158(a)(2), which should be utilized to address unwarranted extensions of exclusivity.*

**Sec. 414. Fees arising from certain ownership interests.**

Section 414 amends 11 U.S.C. § 523(a)(16) to expand this exception to discharge by encompassing condominium fees and assessments regardless of whether the debtor or a tenant continues to occupy the unit.

*Comments: The National Bankruptcy Conference opposes exceptions to discharge providing preferential treatment for certain creditors to the detriment of others without a sound policy justification. If a debtor is not using the condominium due to foreclosure or other circumstances, condominium fees for that period should not be excepted from discharge, as they are not distinguishable from obligations owed to other creditors.*

**Sec. 415. Creditor representation at first meeting of creditors.**

This section permits nonlawyer creditor representatives to appear and participate in section 341 meetings, and to represent more than one creditor, notwithstanding local court rules, State constitution provisions, or other laws to the contrary.

*Comments: This amendment conflicts with the laws of some states under which participation at section 341 meetings is the practice of law. See In re Maloney, 209 B.R. 844 (Bank. M.D. Pa. 1997) (examining debtor at section 341 meeting constitutes practice of law under Pennsylvania law); but see State Unauthorized Practice of Law Committee v. Paul Mason & Assoc., 46 F.3d 469 (5th Cir. 1995) (administrative functions handled by nonlawyer creditor representatives did not constitute unauthorized practice of law under Texas law).*

**Sec. 416. Definition of disinterested person.**

This section amends the definition of disinterested person in 11 U.S.C. § 101(14) to eliminate the per se disqualification of investment bankers previously retained by the debtor.

**Sec. 417. Factors for compensation of professional persons.**

This provision includes as consideration for compensation whether a professional is "board certified" or otherwise has demonstrated skill and experience. In addition to official certification that may be necessary to practice in certain jurisdictions, this provision encompasses non-mandatory certification that is offered by a variety of private organizations.

*Comments: The National Bankruptcy Conference is opposed to this provision. In determining the compensation of professionals who assist in a bankruptcy case, judges must be vigilant to ensure that fees are commensurate with the quality of services actually provided. Current law does not preclude courts from considering certification credentials or other recognition of expertise or experience to the extent that those factors are relevant and, therefore, current law is sufficient to accommodate the concerns of those seeking to ensure that certification is considered. Moreover, the fact that a professional is certified by a private organization does not guarantee competency of services in a particular case any more than prestigious degrees, publications or other honors, and thus it is key to retain court discretion to weigh these factors.*

*The proposed amendment poses additional issues for attorneys seeking fees; explicitly providing benefits for private certification may run afoul of states' prerogatives to regulate the practice of law. Certification of attorneys is generally a function of state supreme courts as part of their obligations and duties to regulate the practice of law in their respective jurisdictions, and some states specifically prohibit the listing of specialties or certifications by attorneys. In fact, less than a majority of states specifically authorize those specialized listings. To avoid these issues, it may be preferable for this amendment to speak more generically in terms of recognition for expertise or experience as opposed to "certification" per se.*

#### **Sec. 418. Appointment of elected trustee.**

This section clarifies the procedure for the election of a private trustee in a chapter 11 case. The United States trustee must file a report certifying the election, which terminates the service of a previously-appointed trustee. Courts are authorized to resolve disputes arising out of an election.

*Comments: The National Bankruptcy Conference supports this provision, but recommends that proposed section 1104(b)(2)(B) be revised to read as follows: "The court shall resolve any dispute arising out of an election under subparagraph (A)."*

#### **Sec. 419. Utility service.**

This provision amends 11 U.S.C. § 366 to further define "adequate assurance" (e.g., cash deposit, letter of credit, prepayment of utility consumption, another form of security agreeable to the utility) and permits a utility to discontinue service if it does not receive security in a form satisfactory to the utility within 20 days after the filing. The provision also permits a utility to recover or setoff obligations against a prepetition security deposit, but does not specify whether the debt being set off is a prepetition or postpetition obligation. The amendment is supposed to apply to chapter 11 cases only, but a literal interpretation of the amendment may lead some readers to conclude that the exclusive definition of adequate assurance applies to all cases.

*Comments. The National Bankruptcy Conference generally opposes special interest amendments that enhance the entitlements of one type of creditor to the detriment of other types*

*of creditors and to the detriment of reorganization. This amendment divests courts of discretion and goes much farther than necessary to provide sufficient protection for utilities. For example the provision contains a clause requiring adequate assurance to be in a form that is satisfactory to the utility, even if the court determines that another form of assurance is sufficient. In addition, the definition of "utility" is a subject of dispute, calling into question the scope of this amendment unclear. Since this amendment gives strong preferential treatment to utilities, more parties may seek to be treated as a utility instead of as a party to an executory contract under section 365 of the Bankruptcy Code. Finally, if the amendment is intended to apply to only chapter 11 cases, that should be clarified to avoid any misinterpretation.*

#### **Subtitle B - Small Business Bankruptcy Provisions<sup>2</sup>**

##### **Sec. 421. Flexible rules for disclosure statement and plan.**

This section permits courts to waive or modify the requirement that a small business chapter 11 debtor in possession file a disclosure statement that is approved as a prerequisite to soliciting votes on a plan of reorganization. The provision permits the court to conditionally approve disclosure statements and to combine the disclosure statement hearing with the confirmation hearing.

##### **Sec. 422. Definitions; effect of discharge.**

This section amends the definition of small business debtor to apply in cases involving debts of \$4 million or less. In addition, this provision apparently intends to exclude businesses with active creditors' committees. Due to a drafting error, however, the provision applies only to cases with active creditors' committees. The inclusion in the title of "effect of discharge" also appears to be an error, as this provision does not deal with that issue.

*Comments: This provision contains a drafting error that makes the small business definition apply only to cases with active creditors' committees, which is the opposite of what was intended. The word "not" should be added before "sufficiently active and representative" in the proposed definition of small business.*

##### **Sec. 423. Standard form disclosure statement and plan.**

This section orders the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to devise and adopt uniform forms for disclosure statements and plans of reorganization for debtors falling within the small business definition. The section advises that the rules should achieve a practical balance between parties' reasonable needs for complete information and economy and simplicity for debtors.

<sup>2</sup>Proposed alternative provisions have been submitted by the National Bankruptcy Conference and Commercial Law League of America.

*Comments: Standard forms for disclosure statements should be developed carefully to take into account the distinctions in disclosure necessary for various types of business debtors.*

**Sec. 424. Uniform national reporting requirements.**

This provision requires that a small business debtor file periodic financial reports, including information on profitability, projected cash receipts and disbursements, comparisons of actual receipts and disbursements with prior projections, whether the debtor is in compliance with postpetition requirements and has filed tax returns and paid taxes and other administrative claims, and other matters in the best interest of all parties.

*Comments: Papers of this nature should be filed with the United States trustee, not with the court. This provision should be simplified and combined with section 426 of this bill.*

**Sec. 425. Uniform reporting rules and forms for small business cases.**

This provision gives responsibility to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to propose for adoption the establishment of rules and forms to elicit information regarding such matters as the debtor's profitability, cash receipts and disbursements, and whether the debtor is timely filing tax returns and paying taxes and administrative claims when due.

**Sec. 426. Duties in small business cases.**

This section imposes duties on the small business debtor in possession to file additional information, attend through a responsible individual meetings with the United States trustee and the court, timely file all schedules and statements of financial affairs unless the court grants a limited extension due to extraordinary and compelling circumstances, file all reports, maintain insurance, timely file tax returns, pay all administrative expense tax claims, establish separate deposit accounts for taxes and deposit funds within 1 day thereafter or a responsible time set by the court (unless the court waives this requirement), and allow the United States trustee to inspect the business premises and books and records.

*Comments: Waiver of these requirements for "reasonable justification" may be a preferable standard to "extraordinary and compelling circumstances." More feasible deadlines should be set for these duties, and many of the required documents should be submitted to the United States trustee, not the court. Mentioning requirements to pay taxes might create a negative implication regarding a debtor's other duties not mentioned in this provision, such as the duty to pay employees.*

**Sec. 427. Plan filing and confirmation deadlines.**

This section requires that the small business debtor file a plan of reorganization within 90 days after filing for bankruptcy. This period may be shortened on request of a party in interest. To obtain an extension of the plan filing and exclusivity period, the debtor must demonstrate prior to the expiration of the deadline "by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable time."

*Comments: This provision substantially limits the extent to which chapter 11 debtors can negotiate with creditors and formulate a plan of reorganization while imposing a higher standard to obtain extensions than the standard applicable to larger businesses.*

**Sec. 428. Plan confirmation deadline.**

Under this section, plans of small business debtors must be confirmed no later than 150 days after the date of the order for relief. Extensions are available only if the debtor meets the burden for an extension stated in the previous section.

*Comments: The court should be permitted to grant an extension of the plan confirmation deadline if doing so would be in the best interests of creditors and the estate. Doing otherwise will prevent many small businesses from reorganizing even if by all accounts they are worth saving.*

**Sec. 429. Prohibition against extension of time.**

This section amends 11 U.S.C. § 105(d) to prohibit a court from exercising its discretion to extend a deadline in a manner inconsistent with sections 407 and 408.

*Comments: By negative implication, this provision suggests that the court may override other statutory deadlines. For this reason, it might be better to delete it.*

**Sec. 430. Duties of the United States trustee.**

Pursuant to this provision, the U.S. trustee (or bankruptcy administrator) is vested with new statutory duties in small business debtor cases, including the duty to conduct "initial debtor interviews" during which the U.S. trustee investigates the debtor's viability and business plan. The U.S. trustee must inspect the debtor's premises, must diligently monitor the debtor's activities to identify whether the debtor will be unable to confirm a plan, and must promptly seek relief on discovering material grounds for conversion or dismissal under 11 U.S.C. § 1112.

*Comments: Some duties delineated in this section are appropriate and codify current United States trustee practices. However, the assessment of business viability should not fall upon the United States trustee, who already is vested with a variety of administrative responsibilities.*

**Sec. 431. Scheduling conferences.**

This provision amends 11 U.S.C. § 105(d) to require courts to hold status conferences as necessary to further the "expeditious and economical resolution of the case."

**Sec. 432. Serial filer provisions.**

This provision is designed to withhold application of the automatic stay for a small business that files a bankruptcy petition within two years after a prior chapter 11 plan was confirmed, or within two years after the entry of a dismissal order in a prior chapter 11 case. If the owners of a small business that went through bankruptcy have transferred the business to a successor entity, the automatic stay is inapplicable unless the debtor can prove by a preponderance of the evidence that the new case resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and that "it is more likely than not" that the debtor will confirm a feasible plan, but not a liquidating plan, within a reasonable time. The provision also limits

damages for violations of the automatic stay based on a good faith belief that there was no stay in a subsequent small business bankruptcy case.

*Comments: Due to a drafting error, the provision withholds application of the automatic stay in all chapter 11 cases – consumer, business and otherwise – except when an involuntary bankruptcy petition is filed against a small business debtor and the debtor or a predecessor has been in bankruptcy recently. To address this problem, proposed subsection (j) to section 362 should be revised to state that “The filing of a petition under chapter 11 of this title does not operate as a stay in a case in which the debtor –”. Bona fide purchasers of a debtor’s assets that subsequently file for bankruptcy should not be subject to the restrictions on the automatic stay. To address this problem, the term “entity” in subparagraph (k)(1)(D) should be replaced with “insider.” In addition, “in which a discharge is not entered” should be added to the end of subparagraph (k)(1)(A) to avoid ambiguity.*

#### **Sec. 433. Expanded grounds for dismissal or conversion and appointment of trustee.**

This section amends 11 U.S.C. § 1112(b) to provide that a court shall convert or dismiss a case, whichever is in the best interest of creditors and the estate, when a movant establishes “cause,” and to enumerate additional grounds for cause. Requests for dismissal or conversion shall not be granted if the debtor objects and establishes that “it is more likely than not” that a plan will be confirmed within a time fixed by statute or by court order; and, if “cause” is an act or omission of the debtor, that there exists a reasonable justification for the act or omission and that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion (unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances beyond the debtor’s control justify an extension beyond 30 days). This section also authorizes the appointment of a trustee instead of conversion or dismissal if the court determined this would be in the best interest of the estate.

*Comments: These significant changes to 11 U.S.C. § 1112 apply to all chapter 11 debtors, not just small business debtors. Unlike the current language of section 1112, which makes dismissal or conversion discretionary, dismissal or conversion under the proposed revision are mandatory upon the presence of factors that may not be sufficiently material to warrant this response. As a result, this provision makes one of the most dramatic changes to bankruptcy law as it affects business cases.*

#### **Sec. 434. Study of operation of title 11, United States Code, with respect to small businesses.**

This provision instructs the Small Business Administration, in consultation with other parties, to study the causes of small business bankruptcies and how the bankruptcy system can be improved to help small businesses reorganize. This study must be conducted not later than 2 years after the enactment of this bill, and a report must be submitted to the House and Senate.

#### **Sec. 435. Payment of interest.**

This section amends 11 U.S.C. § 362(d)(3) to provide explicitly that the debtor can make the requisite payments from rents generated by the property. The section also changes the applicable

interest rate to the nondefault contract rate and amends the deadline so that payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines that the debtor is subject to these provisions to account for circumstances in which it is not immediately determined that the debtor is a single asset real estate debtor.

*Comments: The National Bankruptcy Conference supports this provision.*

### **Title V - Municipal Bankruptcy Provisions.**

#### **Sec. 501. Petition and proceedings related to petition.**

This section clarifies that a chapter 9 petition constitutes an order for relief.

*Comments: To effectuate the intent of this provision and to avoid an unnecessary hearing, the text of section 501 should be replaced with the following: Section 921 of title 11, United States Code, is amended by — (1) striking subsection (d); and (2) redesignating subsection (e) as subsection (d).*

#### **Sec. 502. Applicability of other sections to chapter 9.**

This provision amends 11 U.S.C. § 901 to extend the application to chapter 9 of certain provisions of chapter 5 of the Bankruptcy Code that relate to the liquidation of securities contracts and the termination of swap agreements.

*Comments: The National Bankruptcy Conference supports this amendment.*

### **Title VI - Improved Bankruptcy Statistics and Data**

#### **Sec. 601. Audit procedures.**

No fewer than 1 out of 250 individual debtor cases in each judicial district must be selected randomly for audit, with procedures to be set by the Attorney General, although the audits must be in accordance with generally accepted auditing standards and performed by accountants. Cases also must be audited if the schedules show income and expenses reflecting greater than average variances from the district norm. Material misstatements could lead to revocation or denial of discharge or criminal referrals.

*Comments: The National Bankruptcy Conference supports the implementation of an audit process. The audit system does not need to rely on accountants to conduct every audit, for most audits will not focus on books and records. To the extent that a preliminary investigation reveals the need for an accountant, one could be appointed at that time. Audits also should specifically target high end cases that vary from the statistical norm, but not cases that vary from the statistical norm on the low end (e.g., very low income and/or expenses). Cases filed by individuals under chapters 11 and 12 also should be audited. Realistically, one out of every thousand cases should be audited. To complement the auditing proposal, the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States should propose an amendment to Rule 1017 of the Federal Rules of Bankruptcy Procedure that strikes*

"substantial" and inserts "clear" in lieu thereof and that inserts "or 60 days following the conclusion of an audit under section 586(a)(4) of title 28 of the United States Code, whichever is later" immediately after "341(a)" each place it appears.

#### **Sec. 602. Improved bankruptcy statistics.**

This section orders the clerk of each district to compile statistics in a format determined by the Administrative Office of the United States Courts, which will be collected by the Administrative Office and made publicly available and the subject of a report to Congress.

*Comments:* Collecting data is advisable, but all language in this provision prescribing the method of collection and reporting should be deleted. The manner of collection and reporting should be developed by a balanced group of experts in the field of data collection and bankruptcy.

#### **Sec. 603. Uniform rules for the collection of bankruptcy data.**

This section instructs the Attorney General to issue rules requiring uniform forms for final trustee reports and periodic reports by debtors in possession and trustees in chapter 11 cases.

#### **Sec. 604. Sense of Congress regarding availability of bankruptcy data.**

This provision expresses the sense of Congress that all data held by bankruptcy clerks should be released in electronic form to the public on demand and that the bankruptcy system should use a single set of data definitions and forms to collect data nationwide.

*Comments:* Before taking steps to make this data widely available, Congress should evaluate the privacy considerations and whether laws such as the Fair Credit Reporting Act impose restrictions on this activity.

### **Title VII - Bankruptcy Tax Provisions**

#### **Sec. 701. Treatment of certain liens.**

This section exempts ad valorem real or personal property tax liens from subordination under 11 U.S.C. § 724(b)(2), except that ad valorem tax liens would remain subordinated to priority wage claims. Although other tax liens remain subject to subordination, this section requires that a trustee first exhaust unencumbered assets of the estate and surcharge collateral under section 506(c) for the reasonably necessary costs and expenses of preserving and disposing of that property. This section also divests bankruptcy judges of their authority to determine the amount or legality of any ad valorem tax under section 505 of the Bankruptcy Code after expiration of the applicable period for contesting or redetermining that amount under nonbankruptcy law.

*Comments:* The National Bankruptcy Conference supports this provision to the extent that it exempts ad valorem tax liens from subordination under section 724(b). However, the remainder of the provision is objectionable. References to 11 U.S.C. § 507(a) should be adjusted to reflect amendments in this bill that reorder the priorities set forth in that provision.

#### **Sec. 702. Effective notice to government.**

This section sets forth extensive parameters for providing notice to governmental units.

*Comments:* The filing registry contemplated in proposed section 342(e) may be an appropriate mechanism to ensure adequate notice. However, the remainder of the provision is unduly oppressive and make compliance difficult even if the unit receives actual notice. Form of notice is generally addressed by the Federal Rules of Bankruptcy Procedure. In light of the fact that the United States government has requested to be treated as a single unit for other purposes, such as setoff, these noticing requirements seem to go to the other extreme.

#### **Sec. 703. Notice of request for a determination of taxes.**

This section amends 11 U.S.C. § 505(b) to require that any request for a determination of tax liability under that section be made in a manner designated by the governmental unit.

*Comments:* This provision would be unobjectionable if the information were published in a central registry to enable compliance. Absent a central registry, this provision is troublesome because it creates a new bureaucracy that unnecessarily makes compliance extremely difficult.

#### **Sec. 704. Rate of interest on tax claims.**

This provision establishes the minimum rate of interest on most tax claims as the Federal short-term rate rounded to nearest full percent, determined under Internal Revenue Code section 1274(d) for the calendar year in which a plan is confirmed, plus 3 percentage points. The interest rate on ad valorem taxes is subject to determination under applicable nonbankruptcy law.

*Comments:* This provision departs from its original intent to provide a uniform rate of interest. The interest rate on ad valorem taxes in some cities is well over 20%. Section 804 should be revised to provide that the rate of interest on all tax claims, including ad valorem tax claims, is the federal tax deficiency rate under 26 U.S.C. § 6621(a)(2), as originally proposed by in the bankruptcy bill first introduced by Representative Gekas and his co-sponsors last year.

#### **Sec. 705. Tolling of priority of tax claim time periods.**

This section authorizes the tolling of certain time periods in 11 U.S.C. § 507(a)(8)(A). This provision also adds an extra 6 months to the tolling period under section 507(a)(8)(A)(i) and tolls the 240-day period under section 507(a)(8)(A)(ii) for the duration of an installment payment agreement, which could add years to the tolling period.

*Comments:* To the extent this provision tolls the priority and nondischargeability period for the duration of a prior bankruptcy case, this provision helpfully codifies current case law. However, the additional six-month period and tolling for installment payment agreements give may go farther than necessary and may harm the interests of other creditors.

#### **Sec. 706. Priority property taxes incurred.**

This provision amends 11 U.S.C. § 507(a)(8)(B) by striking "assessed" and replacing it with "incurred."

**Sec. 707. Chapter 13 discharge of fraudulent and other taxes.**

This section further restricts the chapter 13 "superdischarge" so that a debtor who has completed a repayment plan may not discharge remaining taxes falling under 11 U.S.C. § 523(a)(1).

*Comments: This provision is controversial. It may eliminate the incentive for debtors with substantial tax debts to repay some of those debts, along with other debts, in a chapter 13 plan.*

**Sec. 708. Chapter 11 discharge of fraudulent taxes.**

This section amends 11 U.S.C. § 1141(d) so that chapter 11 plan confirmation does not discharge a corporate debtor (but not any other type of debtor) from tax debts on which the debtor made a fraudulent return or which the debtor willfully attempted to evade or defeat.

*Comments: The National Bankruptcy Conference urges deletion of this section. The reorganized debtor is a separate entity for other tax purposes that should not be liable for these obligations. Most chapter 11 corporate debtors are insolvent and often controlling ownership is transferred to creditors under a plan of reorganization. Creditors should not be punished for the failures of prior ownership or management.*

**Sec. 709. Stay of tax proceedings.**

This section provides an exception to the automatic stay for appeals from certain court and administrative decisions determining a tax liability of the debtor.

**Sec. 710. Periodic payment of taxes in chapter 11 cases.**

This section requires periodic payment of priority tax claims in regular installment payments in cash, "but in no case with a balloon provision and no more than three months apart, beginning no later than the effective date of the plan and ending on the earlier of five years after the petition date or that last date payments are to be made under the plan to unsecured creditors." In addition, the petition date, not the assessment date, is the starting point for the payment period.

*Comments: Prior to the Bankruptcy Reform Act of 1978, taxing authorities exercised virtual veto power over plans of reorganization. The 1978 Code was a compromise to make reasonable accommodations for rehabilitation. If enacted, this provision may require that other creditors, such as support creditors in the chapter 11 case of an individual debtor, wait years for repayment. If retained, the provision should be redrafted to correct its problems. The provision should clarify that "regular payments" do not have to be equal. According to the plain language of the provision, tax debts may not be deferred at all if other unsecured creditors are paid in full at confirmation. This may be an unintended result.*

**Sec. 711. Avoidance of statutory tax liens prohibited.**

Section 711 amends 11 U.S.C. § 545(2) to codify that "superpriority" rights accorded to some purchasers by the Internal Revenue Code and parallel state and local law provisions may not be

used by a trustee to avoid tax liens in stocks, securities, motor vehicles, inventory, certain goods purchased at retail, and certain household goods.

*Comments: There are preferable methods of clarifying the reach of a bona fide purchaser. Section 545(2) should be clarified to give the trustee the status of a hypothetical bona fide purchaser without knowledge or notice of a lien, who takes possession of the item purchased and has not relinquished possession. This status would preserve for the benefit of all creditors those items of property on which the filed tax lien does not take priority in all circumstances under nonbankruptcy law. A similar change could be made to the definition of purchaser in section 544(a).*

**Sec. 712. Payment of taxes in the conduct of business.**

This section requires that postpetition taxes be paid in the ordinary course of business, that ad valorem real property taxes be paid when due, and that administrative period tax liabilities be paid without a precipitating request from the governmental unit. This section also amends 11 U.S.C. § 506 to permit ad valorem taxes to be surcharged against collateral. This section permits deferred tax payments in the event that a chapter 7 estate is administratively insolvent or that a tax was not incurred by a properly appointed chapter 7 trustee.

*Comments: It is reasonable to require that an operating chapter 11 debtor pay taxes in the normal course as a business expense, which is why 28 U.S.C. § 960 already provides that any officers and agents conducting business under authority of a United States court shall be subject to all taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.*

**Sec. 713. Tardily filed priority tax claims.**

This section amends 11 U.S.C. § 726(a)(1) so that late filed tax claims are entitled to distribution under that subsection to the extent they are filed on or before the earlier of 10 days following the mailing to creditors of the trustee's report summary, or the date on which the trustee commences distribution.

*Comments: The National Bankruptcy Conference supports this provision.*

**Sec. 714. Income tax returns prepared by tax authorities.**

Under this section, for purposes of 11 U.S.C. § 523(a)(1)(B), "return" includes returns filed by the governmental unit or a written stipulation to judgment entered by a nonbankruptcy tribunal.

*Comments: It is unclear why the amendment provides that the return must have been filed in a manner permitted by applicable nonbankruptcy law. This clause may cause confusion and is not necessary to effectuate the primary component of this section.*

**Sec. 715. Discharge of the estate's liability for unpaid taxes.**



This provision adds the bankruptcy estate to the list of parties protected from a tax claim once a governmental unit fails to respond to a request for a determination of taxes.

*Comments: The National Bankruptcy Conference supports this provision.*

#### Sec. 716. Requirement to file tax returns to confirm chapter 13 plans.

This amendment requires that debtors file tax returns for the three years before bankruptcy prior to the first meeting of creditors. The section makes some allowance for extensions of the applicable deadlines.

*Comments: Debtors who are not required to file tax returns under tax law should be exempted from this requirement. The standard for extensions of time should be based on the preponderance of the evidence (the standard generally applicable in bankruptcy proceedings), not clear and convincing evidence.*

#### Sec. 717. Standards for tax disclosure.

This section amends 11 U.S.C. § 1125 to require that disclosure statements contain a "full discussion" of the tax consequences of a plan of reorganization.

*Comments: To the extent that the disclosure of tax consequences is necessary to provide adequate information, this provision is unnecessary because adequate information already is required by 11 U.S.C. § 1125. In the event that the tax consequences are not necessary or relevant to the creditors' decision making, mandating disclosure may unnecessarily increase cost and delay in the plan confirmation process, contrary to the goal of expediting chapter 11. It might be preferable to replace the term "a full discussion" with "adequate information regarding".*

#### Sec. 718. Setoff of tax refunds.

This provision permits the government to set off uncontested income tax obligations against income tax refund rights without seeking court permission.

*Comments: The National Bankruptcy Conference opposes this provision. Absent setoff, the tax refund would be cash collateral subject to turnover and use by the estate. As long as the debtor in possession provides the taxing authority with adequate protection, this source of liquidity should remain available.*

### Title VIII - Ancillary and Other Cross Border Cases

#### Sec. 801. Amendment to add chapter 15 to title 11, United States Code.

This section creates a chapter 15 of the Bankruptcy Code to deal with ancillary and other cross border cases.

*Comments: The National Bankruptcy Conference supports the establishment of a chapter to deal with ancillary and other cross border cases to the extent consistent with the statutory language developed by the United Nations Commission on International Trade Law.*

#### Sec. 802. Amendments to other chapters in title 11, United States Code.

This section amends other provisions of the Bankruptcy Code to reflect the addition of chapter 15.

*Comments: The National Bankruptcy Conference supports the adoption of conforming amendments to the extent consistent with the statutory language developed by the United Nations Commission on International Trade Law.*

#### Sec. 803. Claims relating to insurance deposits in cases ancillary to foreign proceedings.

This section amends 11 U.S.C. § 304 to provide that the court may not grant relief under the new transnational chapter with respect to any deposit, escrow, trust funds, or other security required or permitted under any applicable State insurance law or regulation for the benefit of claim holders in the United States.

### Title IX - Financial Contract Provisions

#### Sec. 901. Bankruptcy Code amendments.

##### (a) - (c) Definitions.

This subsection provides revised and new definitions, including definitions of master netting agreement and master netting participant. The definition of master netting agreement encompasses rights of netting, setoff, liquidation, termination, or closeout, not only with a variety of financial instruments, but with security agreements and credit enhancement as well.

(d) Swap agreements, securities contracts, commodity contracts, forward contracts, repurchase agreements, and master netting agreements under the automatic stay.

This subsection revises the exceptions to the automatic stay for setoff by financial participants of claims against payments due, and adds an additional exception to section 362(b) to permit cross product netting without violating the automatic stay.

*Comments: This provision is objectionable to the extent that it permits cross product netting.*

##### (e) Limitation of avoidance powers under master netting agreement.

This subsection amends 11 U.S.C. § 546 to preclude a trustee from avoiding a transfer made by or to a master netting agreement participant under or in connection with any master netting agreement, except if the transfer was made with the actual intent to hinder, delay, or defraud.

*Comments: This provision is objectionable to the extent that it limits the ability of a trustee or debtor in possession to recover cross product netting transfers under the avoiding powers.*

(f) **Fraudulent transfers of master netting agreements.**

This subsection would amend 11 U.S.C. § 548(d)(2) to insulate certain transfers to master netting agreement participants.

*Comments: This provision is objectionable to the extent that it insulates cross product netting from fraudulent transfer avoidance actions.*

(g) - (j) Termination or acceleration of securities contracts; termination or acceleration of commodities or forward contracts; termination or acceleration of repurchase agreements; Liquidation, termination, or acceleration of swap agreements..

These subsections amend 11 U.S.C. §§ 555, 556, 559, and 560 to refer to termination, acceleration, and liquidation.

(k) Liquidation, termination, acceleration, or offset under a master netting agreement and across contracts.

This subsection adds 11 U.S.C. § 561, which prohibits the application of the stay, avoidance, or any other limitations on a contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts.

*Comments: This provision is objectionable to the extent it exempts cross product netting from the avoidance powers, the automatic stay, and other otherwise applicable provisions.*

(l) **Ancillary proceedings.**

Pursuant to this subsection, cases ancillary to foreign proceedings are subject to all Bankruptcy Code provisions relating to securities contracts, commodity agreements, forward contracts, repurchase agreements, swap agreements, or master netting agreements.

*Comments: The provision seems designed to ensure that a broad section 304 injunction is not issued against holders of the listed instruments just they are exempted from the broad automatic stay under section 362 in a domestic bankruptcy case. The section as worded is far broader and may have unintended consequences. It cannot relate to the bankruptcy avoiding powers, because those powers are not available in a section 304 proceeding in any case. If it is intended as some sort of choice of law provision, it is impossible to tell what its effects are meant to be. It should be re-worded to refer solely to exemption from broad injunctive relief. In addition, it is objectionable insofar as it includes cross-product netting, as with other provisions in this title.*

(m) -(n) Commodity broker liquidations; Stockbroker liquidations.

These two subsections add 11 U.S.C. §§ 767 and 753 to address the liquidation of commodity brokers and stockbrokers. The exercise of rights by a broker or participant will not affect the priority of unsecured claims held by brokers or participants after the exercise of their rights or the applicability of the commodity broker and stockbroker liquidation provisions.

(o) **Setoff.**

This subsection makes conforming amendments to 11 U.S.C. § 553 to reflect the exceptions to the general rules of setoff provided for financial instruments. It creates a carveout to the exception to the right to setoff in section 553(a)(3)(C) for rights arising under provisions dealing with financial contracts. This subsection also amends 553(b)(1) to add additional references to these provisions.

(p) **Securities contracts, commodity contracts, and forward contracts.**

This subsection clarifies the language in several Bankruptcy Code provisions by replacing references to a variety of parties with the term "financial participant."

**Sec. 902. Damage measure.**

This section addresses the calculation of damages following the rejection, liquidation, termination, or acceleration of certain agreements relating to financial instruments. It provides that damages shall be measured as of the earlier of the date of rejection or the date of liquidation, termination or acceleration. The resulting damage claim is treated as a prepetition claim, consistent with other claims arising from rejection.

**Sec. 903. Asset-backed securitizations.**

This section explicitly excludes from "property of the estate" cash, receivables, securities, and other financial assets transferred by the debtor in connection with an asset securitization under which investment grade rated securities have been issued. The debtor is considered to have transferred assets prepetition if the assets were transferred pursuant to a written agreement that states that the assets were conveyed with the intention of removing them from the estate of the debtor, regardless of whether the debtor holds an interest in the issuer or securities held by the issuer, whether the debtor has continuing obligations to repurchase, service, or supervise the servicing of eligible assets, and the characterization of the transfer for other purposes.

*Comments: The National Bankruptcy Conference opposes this provision. Transactions that are not sales under state law should not be treated as sales by federal bankruptcy law. This provision may undercut the ability of a business to reorganize by leaving it with no cash collateral, to the detriment of employees and suppliers.*

**Sec. 904. Effective date; application of amendments.**

The amendments made by title IX apply to cases commenced or appointments made after the date of enactment.

**Title X - Protection of Family Farmers**

**Sec. 1001 - Reenactment of chapter 12.**

This provision re-enacts chapter 12 and makes it permanent.

*Comments: The National Bankruptcy Conference supports this amendment.*

**Sec. 1002 - Debt limit increase.**

This provision ensures that the debt limit for chapter 12 family farmer eligibility is indexed for inflation like other dollar amounts in the Bankruptcy Code, beginning on April 1, 2001.

*Comments: The National Bankruptcy Conference supports this amendment.*

**Sec. 1003. Elimination of requirement that family farmer and spouse receive over 50 [sic.] percent of income from farming operation in year prior to bankruptcy.**

This section amends the definition of family farmer so that debtors can be considered family farmers if farming operations provide more than the requisite percentage of their gross income in at least one of the three calendar years preceding bankruptcy.

*Comments: Under current law, farming operations must provide more than 80% of an individual's gross income in the taxable year preceding the taxable year in which the farmer files for bankruptcy. The title of this amendment makes it unclear whether there is an intention to change that percentage to 50%.*

**Sec. 1004. Certain claims owed to governmental units.**

This section provides an exception to the general rule that all priority claims be paid in full over the life of a repayment plan. Claims owed to governmental units arising as a result of sale, transfer, exchange, or other disposition of any farm asset shall be treated as an unsecured claim that is not entitled to priority. This section permits a family farmer to request a determination of the tax effects of the plan from the IRS, in addition to state and local taxing authorities.

*Comments: The National Bankruptcy Conference supports this amendment.*

**Title XI - Technical amendments****Sec. 1101. Definitions.**

This section makes a nontechnical change by amending the definition of single asset real estate to lift the \$4 million debt cap and to exclude family farmers. This section also clarifies that a transfer includes the creation of a lien, addressing issues raised in the line of cases culminating in *In re McConville*, 110 F.3d 47 (9<sup>th</sup> Cir. 1997).

*Comments: The National Bankruptcy Conference opposes the removal of the cap on the definition of single asset real estate, the effect of which is to make the streamlined single asset procedure applicable to a wide range of cases for which it was not intended. The National Bankruptcy Conference supports the statutory clarification that a transfer of property includes the creation of a lien. The word "each" should be deleted and replaced with "every" in proposed 11 U.S.C. § 101(54)(D).*

**Sec. 1102. Adjustment of dollar amounts.**

This provision ensures that the dollar amounts in section 522(f)(3) (lien on tools of the trade exceeding \$5,000 cannot be avoided) and the proposed section 707(b)(5) (safe harbor against creditor actions) are indexed for inflation like other dollar amounts in the Bankruptcy Code.

**Sec. 1103. Extension of time.**

This section corrects a reference error.

**Sec. 1104. Technical amendments.**

This section pluralizes a reference in 11 U.S.C. § 522(b)(1), makes a technical change to 11 U.S.C. § 541(b)(4), and slightly broadens the reference to a subsection of the Small Business Investment Act of 1958, which likely has the effect of making more debtors ineligible to file.

**Sec. 1105. Penalty for persons who negligently or fraudulently prepare bankruptcy petitions.**

This section makes a grammatical change, changing the reference to "attorney's" in section 110(j)(3) from singular possessive to plural possessive.

**Sec. 1106. Limitation on compensation of professional persons.**

This section permits a trustee or committee to employ professional persons on a fixed or percentage fee basis, in addition to an hourly and contingent fee basis.

**Sec. 1107. Special tax provisions.**

This amendment eliminates a reference to a tax provision that has been repealed.

**Sec. 1108. Effect of conversion.**

This section changes a reference to "property" in 11 U.S.C. § 348(f)(2) to "property of the estate" to conform to other references in that provision.

**Sec. 1109. Allowance of administrative expenses.**

This section limits the types of compensable professional services rendered by an attorney or accountant that may qualify as administrative expenses. In particular, expenses for attorneys or accountants incurred by individual members of creditors' or equity committees are not recoverable as administrative expenses.

**Sec. 1110. Exceptions to discharge.**

This section corrects the inadvertent omission of a reference to section 523(a)(15) in section 523(a)(3), amends section 523(a)(15) to limit the scope of the exception by requiring that the debt must be owed to a spouse, former spouse, or child of the debtor, and amends section 523(a)(9) to specifically exclude from discharge debts arising from drunken boating.

**Sec. 1111. Effect of discharge.**

This section makes a technical correction in 11 U.S.C. § 524(a)(3).

**Sec. 1112. Protection against discriminatory treatment.**

This provision clarifies that 11 U.S.C. § 525(c)(1) applies to student grants, not all grants.

**Sec. 1113. Property of the estate.**

This section amends section 541(b)(4)(B)(ii) (dealing with liquid or gaseous hydrocarbons) to add a reference to 11 U.S.C. § 365, clarifying Congressional intent to exclude production payments from the debtor's estate.

**Sec. 1114. Preferences.**

This section amends 11 U.S.C. § 547(b) so that in the event of an avoided security interest given by a debtor between 90 days and 1 year before bankruptcy to a noninsider for the benefit of an insider, the security interest shall be considered to be avoided as a preference only with respect to the insider.

*Comments: This amendment could be improved by referring to transfers rather than security interests, like in H.R. 833. In particular, "a security interest given" should be replaced with "a transfer made" and "such security interest shall be considered to" should be replaced with "such transfer may be avoided."*

**Sec. 1115. Postpetition transactions.**

This section makes several clarifying changes to 11 U.S.C. § 549(c) to work in conjunction with the amended definition of transfer.

**Sec. 1116. Disposition of property of the estate.**

This section eliminates a reference to 11 U.S.C. § 1009, a provision in an earlier version of the 1994 amendments that never came into effect.

**Sec. 1117. General provisions.**

This provision amends 11 U.S.C. § 901(a) to add an omitted reference to 11 U.S.C. § 1123(d).

**Sec. 1118. Abandonment of railroad line.**

This section amends 11 U.S.C. § 1170(e)(1) to eliminate a reference to a repealed provision in Title 49 and to replace it with a correct reference.

**Sec. 1119. Contents of plan.**

This section amends 11 U.S.C. § 1172(c)(1) to eliminate a reference to a repealed provision in Title 49 and to replace it with a correct reference.

**Sec. 1120. Discharge under chapter 12.**

This provision corrects erroneous references in 11 U.S.C. § 1228(a) and (c).

**Sec. 1121. Bankruptcy cases and proceedings.**

This section corrects erroneous references in 28 U.S.C. § 1334(d).

**Sec. 1122. Knowing disregard of bankruptcy law or rule.**

This section amends 18 U.S.C. § 156(a) to make stylistic changes and to clarify a reference to Title 11.

**Sec. 1123. Transfers made by nonprofit charitable corporations.**

This section amends 11 U.S.C. §§ 363 and 1129(a) to require that all transfers of property in the bankruptcy case of a corporation or trust (that is not a moneyed, business, or commercial corporation or trust) are in complete accordance with all laws governing the transfer of property. This section also amends 11 U.S.C. § 541 to provide that property held by a corporation exempt from taxation under 26 U.S.C. § 501(c)(3) may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply had the debtor not filed a bankruptcy case. These amendments, if adopted, would apply to pending cases. However, a court would consider whether the application of these amendments to pending cases would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor postpetition.

*Comments: The National Bankruptcy Conference opposes these amendments, which will be relevant to cases involving hospitals and other nonprofit organizations. By negative implication, these amendments might suggest that other types of debtors do not need to follow otherwise applicable nonbankruptcy law. Subsection (e), which clarifies that the bankruptcy court need not remand or refer the matter of a transfer of property to a nonbankruptcy court, creates an ambiguity regarding the jurisdiction of the bankruptcy court and state court in the sale of the assets of a not for profit debtor. The provision is also ambiguous when it requires that the court consider whether these amendments "would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor" postpetition.*

*Some technical comments are in order as well. References to "corporation or trust" are not necessary because the definition of corporation includes trust. See 11 U.S.C. § 101(9). Paragraph (1) of section 363(d) should begin with the following clause: "if the debtor is a corporation that is not a moneyed, business, or commercial corporation.". Similarly, paragraph (15) of section 1129(a) should begin with the same clause and the phrase "of the plan" should be deleted and replaced with "under the plan".*

*The amendment made by subsection (c) should be made to 11 U.S.C. § 363 (as new subsection (p)), not to 11 U.S.C. § 541. The latter portion of subsection (d) of the amendment, which begins with "The parties who may appear," should be a statutory amendment that should read as follows: (e) Standing. - Section 1109 of title 11, United States Code, is amended by adding at the end: "(c)The attorney general of the State in which the debtor is incorporated, was formed, or does business may appear and be heard in any proceeding under section 363(p) or 1129(a)(15) of this title."*

**Sec. 1124. Protection of valid purchase money security interests.**

This section makes a nontechnical change and amends 11 U.S.C. 547(c)(3)(B) to give a creditor 30 days, rather than 20 days, to perfect its interest for an enabling loan.

*Comments: The perfection period was increased from 10 to 20 days in the Bankruptcy Reform Act of 1994. The period should not be extended further without a demonstration that the longer period is necessary. If this provision is retained, it should permit the lesser of the time allowed by state law or 30 days.*

**Sec. 1125. Extensions.**

This provision extends the Bankruptcy Administrators' program in Alabama and North Carolina.

The districts in those states therefore would not be part of the U.S. trustee program.

*Comments: The National Bankruptcy Conference opposes this amendment, which encourages nonuniformity and undermines the efficacy of the United States Trustee system. This provision gives rise to Constitutional concerns, which may affect this legislation in its entirety. See Angelo v. Victoria Farms, Inc., 38 F.3d 1525 (9<sup>th</sup> Cir. 1994) (delaying implementation of United States trustee program in North Carolina and Alabama violates United States Constitution).*

**Sec. 1126. Bankruptcy judgeships.**

This provision authorizes temporary judgeships and requires disclosure of judges' travel expenses.

**Title XII - General Effective Date; Application of Amendments.**

**Sec. 1201. Effective date; application of amendments.**

This provisions makes the bill and its amendments effective 180 days after the date of enactment, except as otherwise provided. The amendments will not apply to cases commenced before the effective date.

*Comments: Like the Bankruptcy Reform Act of 1978, the effective date of this bill should be deferred for one year.*

**PROFESSIONAL COMPENSATION  
AND DISCLOSURE ISSUES**

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**COMPENSATION:  
IT CAN BE DANGEROUS TO YOUR POCKETBOOK**

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**Taft A. McKinstry  
Fowler, Measle & Bell, LLP  
Lexington, Kentucky**

**and**

**Joan Lloyd Cooper  
Wyatt, Tarrant & Combs  
Louisville, Kentucky**

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**SECTION I**

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# PROFESSIONAL COMPENSATION AND DISCLOSURE ISSUES

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## **PROFESSIONAL COMPENSATION AND DISCLOSURE ISSUES**

### **"COMPENSATION: IT CAN BE DANGEROUS TO YOUR POCKETBOOK"**

#### **I. INTRODUCTION**

Accepting a bankruptcy related employment has always had its elements of risk, but with the passage of time, the risks have multiplied. Most bankruptcy lawyers are well-aware of the dangers of the administratively insolvent estate and the frustration of the failure to close a deal necessary to pay creditors in a case. Bankruptcy lawyers are now expected to bear even greater risks, including disgorgement [a hateful thought and once mostly academic] and possibly jail time, as courts begin to explore the outer reaches of the strict conflict rules attendant to bankruptcy cases.

#### **II. THE REPRESENTATION**

The incredible prosperity of the 1990's has left many bankruptcy lawyers wondering about the volume and sources of their cases in the 21st century. Many of us have retooled to staff the endless stream of "workouts", which have replaced what used to be viable Chapter 11's, while others have continued to represent clients in court-assisted workouts. Whatever the choice of playing field, the analysis of the representation early on will help avoid some of the serious concerns in getting paid and keeping payment.

- A. Who will be your client- The most elemental, but important, consideration is who will be your client. Confusion over whose interest you will represent is not unique to bankruptcy actions but can be particularly troublesome if the "workout" becomes a court process. Until a matter arrives in the bankruptcy court clerk's office, the lines of representation may be blurred or conflicts addressed within the spirit of the Canons of Ethics. Perhaps you represent a closely-held corporate entity or sole proprietorship. Representation of the owner and the entity may have certain ethical considerations prior to bankruptcy and may require disclosure and a waiver, but after bankruptcy you will likely be prohibited from representing both parties which will result in disqualification and possibly disgorgement of fees paid pre-petition and maybe post-petition.
- B. Scope of the Representation- If a matter begins as a "workout", you will likely desire to complete the representation if it progresses to a bankruptcy. Certainly you should only continue the representation if you are experienced in bankruptcy law and can overcome any of the obstacles to employment and payment.

- C. Who runs the show and gives you instructions- This is especially important given a case that might end up in bankruptcy court. Knowing the chain of command in your client could highlight early in a case whether you will run into serious conflict issues over who you represent.
- D. Who will foot the bill- If payment of the fees for your services is coming from a source other than the direct client, you can bet that full disclosure down the road could result in challenges to your employment on the basis of conflict or perhaps even disinterestedness. Anytime a fee or retainer is to be paid by a source other than the entity you represent, serious potential conflicts can result.

### III EMPLOYMENT OF PROFESSIONAL PERSONS

- A. The Retention Agreement- The employment of a professional person by the estate should be written and should outline all of the expectations of the parties, including the scope of the representation, the payment of fees, timing of payment and any issues relating to potential conflicts of interest.
  - 1. Professional Persons- 11 U.S.C. Section 327(a) requires the trustee to seek court approval before hiring professional persons before they can perform services for the trustee. The term "professional persons" is not defined in the Bankruptcy Code but there is a non-exclusive list of those who are considered professionals and must be employed under an order of court.
    - a. This nonexclusive list includes attorneys, accountants, appraisers, auctioneers and any other professional persons hired to represent or assist the trustee in carrying out the trustee's or Debtor in Possession's duties under title 11.
    - b. Section 327(a) and Bankruptcy Rule 2014 require that an application to employ a professional person be filed with the Court before services are provided. Failure to adhere to this requirement may result in a denial of fees to the professional despite the bankruptcy court's latitude in granting *nunc pro tunc* applications. In fact, Judge Lee of the Bankruptcy Court for the Eastern District of Kentucky has made clear that he will rarely, if ever, grant *nunc pro tunc* applications of employment. See e.g., In re Calumet Farm, Inc., No. 91-51414, Order and Memorandum Opinion (Bankr. E.D. Ky., Nov. 25, 1992).
    - c. An application to employ a professional person must contain a showing that the employment is "reasonably necessary" to the proper and efficient administration of the estate.

- d. Professionals cannot be employed or compensated for performing tasks that fall within the category of duties outlined in the Bankruptcy Code as administrative duties of the trustee or debtor in possession's counsel. For example, in Cle-Ware Indus., Inc. v. Sokolsky, 493 F.2d 863 (6<sup>th</sup> Cir. 1974), the Court held that under the Bankruptcy Act, separate counsel for the debtor and the debtor in possession should no longer be appointed and attorneys cannot be compensated for overlapping services.
2. The retention agreement between the estate and the professional person may become the subject of great interest in the future. It should be drafted extremely carefully, avoiding ambiguities and other sources of future misunderstandings.
3. Bankruptcy Code Section 327(a) requires that the professional person to be employed not hold or represent an interest adverse to the estate, and must be a disinterested person. This subject is discussed below in section IIIB of these materials.
4. A person is not disqualified from employment as a professional person in a Chapter 7, 12 or 11 solely because of their employment by or representation of a creditor, unless another creditor or the United States trustee objects. The Court will disallow the employment if there is an actual conflict of interest. See Section 327(c).
5. The trustee may
  - a. employ himself as attorney or accountant for the estate if it is in the best interests of the estate. See Section 327(d).
  - b. employ the debtor's attorney, with court approval and for a specified purpose, other than to represent the trustee in conducting the case, as long as the attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which he is employed, if it is in the best interests of the estate. See Section 327(e). Note that Section 327(e), intended to govern the employment of an attorney who has represented the debtor, is a less restrictive standard than Section 327(c), but limits such employment to a "specified special purpose."
  - c. not employ a person that has served as an examiner in the case. See Section 327(f).

B. Disinterestedness

1. A disinterested person is defined by Bankruptcy Code Section 101(14) as a person that:
  - (A) is not a creditor, an equity security holder, or an insider<sup>1</sup>;
  - (B) is not and was not an investment banker for any outstanding security of the debtor;
  - (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
  - (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor<sup>2</sup> or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
  - (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.
2. It is Section 101(14)(E) that seems to be the downfall of many chapter 11 practitioners recently. While disinterestedness is a requirement for appointment, conflicts and/or the existence of an interest materially adverse to the estate which destroy disinterestedness are often not disclosed, or if disclosed, not recognized in an attorney's initial (and sometimes subsequent)

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<sup>1</sup> Bankruptcy Code Section 101(31) defines "insider" as including, when the debtor is a corporation, a director or officer of the debtor, a person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor or a relative of a general partner, director, officer or person in control of the debtor.

<sup>2</sup> In a brief opinion, Judge Lee denied debtor's application to retain the attorney of its choice because such attorney had, within two years prior, served as secretary of the debtor, although he had resigned such position prior to the commencement of the case. Although attorney had not received compensation as an officer of the corporation and did not attend board meetings or perform any actual duties, the Court, citing the "mechanical application of the disinterestedness standard" denied the application. In re Doverspike Bros. Coal Co., No. 98-52194, Order (Bankr. E.D. Ky. Nov. 18, 1998).

disclosures. Instead, such issues sometimes arise upon the motion of a creditor, the United States Trustee, or even competitor of the debtor, after the attorney has rendered substantial services. Many courts are taking a hard line on not only disqualifying and ordering disgorgement for attorneys who have a conflict, but also for attorneys who fail to fully disclose potential conflicts, sometimes without ever addressing the underlying issue of whether a conflict exists or the attorney is not disinterested.

3. The Sixth Circuit trilogy of cases relevant to the compensation of professionals<sup>3</sup> together hold that if a professional is not disinterested as defined in 11 U.S.C. § 101(14), then that professional cannot be validly employed under 11 U.S.C. § 327. Without being validly employed under 11 U.S.C. § 327, a professional is not entitled to compensation under 11 U.S.C. § 330. In other words, the Sixth Circuit has held that “a valid appointment under § 327(a) is a condition precedent to the decision to grant or deny compensation under § 330(a) or § 328(c).” In re Federated, at 1320.
4. In an opinion allowing counsel for the DIP to accept a mortgage on property the DIP used, but did not own, over the objection of the United States Trustee that such would turn counsel into a stakeholder, Judge Bucki of the Bankruptcy Court for the Western District of New York, captured the problematic nature of disinterestedness:

The concept of disinterestedness ... is a goal that professionals can only achieve in an imperfect form. Much like the concept of absolute zero in physics, attorneys are unlikely to ever attain a state of absolute disinterestedness. Indeed, the mere expectation of compensation will necessarily create some degree of self interest. Except possibly in the context of pro bono representation, the employment of counsel will always create a relationship that is potentially adverse as to the issue of compensation. ... Disinterestedness requires not perfection, but the absence of such adverse interests as might preclude counsel from generally exercising independent judgment.

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<sup>3</sup> See In re: Federated Dept. Stores, Inc., 44 F.3d 1310 (6<sup>th</sup> Cir. 1995) (if professional is not disinterested, he cannot be validly employed; if not validly employed under section 327, he is not entitled to receive compensation under section 330); In re: Eagle-Picher Industries, Inc., 999 F.2d 969 (6<sup>th</sup> Cir. 1993) (if professional is not disinterested, he cannot be employed; there does not need to be a showing of an actual conflict); and In re: Middleton Arms, 934 F.2d 723 (6<sup>th</sup> Cir. 1991) (if professional is not disinterested, professional cannot be employed and the exception contained in section 1107(b) applies only to those professionals determined to be disinterested solely because of former employment).

The adequate assurance of reasonable compensation is a vital safeguard of a professional's independent judgment. Without such assurance, the professional becomes a potential creditor for whom the risk of nonpayment creates an inevitable proclivity for diminished enthusiasm.

In re City Mattress, Inc., 163 B.R. 687, 688 (Bankr. W.D. N.Y. 1994).

5. The source and timing of payments of fees is a potential minefield attorneys must wade through in showing their disinterested status. While the payment of fees by third parties is allowed with certain procedural safeguards by the Kentucky Rules of Professional Conduct, See, SCR 3.130 (M.R. 1.8(f)), courts recognize the risk to the attorney's duty of loyalty and independent judgment such payments present.
6. In the bankruptcy arena, some courts have allowed a debtor's stockholders to individually pay or guaranty the debtor's attorney's fees. For example, In re Lotus Properties LP, 200 B.R. 388 (Bankr. C.D. Cal. 1996), involved the payment of legal fees by the general partner of debtor in a single asset chapter 11. It was clear from the outset that the secured creditor would object to the use of cash collateral for counsel fees and there was no other source from which the attorney could get paid. The attorney fully disclosed the arrangement to the court in initial disclosures and included a statement from the general partner that counsel "will owe its sole legal duty to [debtor] and will act solely in the interests of [debtor] regardless of whether such action is in the best interest of [partner]." The U.S. Trustee argued payment by the general partner was a per se impermissible conflict, but the bankruptcy court disagreed, discussing the "restrictive" versus "analytical" approaches in addressing the payment of fees by a third party/insider.
7. It appears, however, that bankruptcy courts in Kentucky take a much more restrictive approach. An example is In re BBO Resources, Inc., Case No. 99-70103, Memorandum Opinion (Bankr. E.D. Ky., Aug. 13, 1999). In In re BBO, counsel for debtor had received an initial retainer from an entity that was a creditor of the debtor and the lessor of equipment used by debtor. The arrangement was disclosed to the court and employment was initially approved. Thereafter, a creditor and the United States Trustee objected and Judge Howard disqualified the attorney from representing the DIP. After being disqualified, the attorney applied for compensation for the services provided between the time he was initially employed and the date of the order setting aside the employment, arguing he had proceeded in good faith and should not be denied compensation when it is later determined a conflict existed. Judge Howard held that there was a conflict ab initio and although

the denial of all compensation is a harsh remedy, it is the only appropriate one for an attorney who is not validly appointed due to a conflict. "Simply put, the attorney takes the risk that the court will finally determine that a conflict exists and deny the employment of the attorney by the debtor and, consequently, deny any compensation for services already provided." Id. at p. 7. Judge Howard went on to state that the Sixth Circuit had made clear that professionals should be disqualified when there is even an appearance of a conflict and that the court had no discretion to award fees under section 330(a) when the professional has not met the requirements of section 327(a).

8. Such fee arrangements present the appearance of a conflict and a potential for conflict to an extent that some courts flatly prohibit them. Other courts have held that the payment of fees by a third party constitutes an actual conflict which disqualifies the attorney from representing the debtor. In re National Distributors Warehouse Co., Inc., 148 B.R. 558 (Bankr. E.D. Ark. 1992).
9. Compare this reasoning to the case of In re First Jersey Securities, Inc., 180 F.3d 504, 509 (3<sup>rd</sup> Cir. 1999): "In summary, § 327 (a) mandates disqualification when there is an actual conflict of interest, allows for it when there is a potential conflict, and precludes it based solely on an appearance of conflict."
10. Bankruptcy Code Section 328(c) provides:

Except as provided in section 327(c), 327 (e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under Section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed. (Emphasis added)
11. The denial or even disgorgement of fees is now not the only penalty bankruptcy practitioners face. In July, 1999, the Seventh Circuit affirmed the district court's conviction of John Gellene, a partner in a prestigious New York law firm, and sentence of 15 months of imprisonment and a \$15,000.00 fine for failing to disclose his law firm's connection with a creditor of the debtor he was representing. See United States v. Gellene, 182 F.3d 578 (7<sup>th</sup> Cir. 1999).



C. The Use of Cash Collateral

1. In single-asset real estate cases and in attempts to reorganize a debtor that deals with inventory, bankruptcy practitioners are in a quandry. Taking a retainer from "cash collateral" is a very sticky situation. While in In re Addison Properties Ltd. Partnership, 185 B.R. 766 (Bankr. N.D. Ill. 1995), the court stated that in a single asset case, a security retainer paid from cash collateral and held until the end of the case might be appropriate, in In re Woodfield Gardens, 1998 Bankr. LEXIS 734 (Bankr. N.D. Ill. 1998), the court held that a real estate appraiser and professional engineering firm for the debtor who held court approved retainers of pre-petition rents collected by debtor could not be paid out of such retainers on their final fee applications because these funds constituted cash collateral of the principal secured creditor.
2. While there are a wealth of cases that are all over the board on the use of cash collateral, one of the most alarming ones is In re Creekstone Apartments Associates, L.P., 1995 WL 588904 (M.D. Tenn. 1995), where the court held that mortgagee could maintain a conversion action against counsel for the debtor and the general partner of the debtor who both received post-default transfers of rent.
3. The problem counsel faces is the wording of the language in many of the security agreements debtor executes to lender. Postpetition, the parties often agree to a "carve-out" wherein lender allows the use of its cash collateral, but receives added protection. Such a situation raises complicated questions regarding the debtor's favoring of that creditor, from simply different treatment to agreements not to sue the creditor. Another issue is the extent of disclosures debtor must make regarding creditor's treatment and debtor's use of cash collateral. Implicated are Sections 363 and 364 and Bankruptcy Rule 4001.

D. Professionals as Prepetition Creditors of Debtor

1. In re First Jersey Securities, Inc., 180 F. 3d 504 (3<sup>rd</sup> Cir. 1999): In this case, the Third Circuit reversed the district court and the bankruptcy court by determining debtor's transfer of restricted securities to counsel on the eve of bankruptcy was a preference and did not fall into the "ordinary course of business" exception to the statute. The Court emphasized that legal fees become a claim when the services are rendered, not when the invoice is prepared or sent. Further, in this case, debtor had never paid counsel, or any other creditor, with securities. The timing of the payment led to even more suspicion. As much as this case answers, however, it raises questions as to

under what circumstances a debtor's payment of prepetition legal fees will fall into the "ordinary course of business" exception to the preference statute.

2. In re Backer, No. 98-50956 (Bankr. E.D. Ky., 1998) and In re Advanced Technologies Intl. Inc., No. 99-50868 (Bankr. E.D. Ky., 1999) are two presently pending cases in which the court ordered counsel for the debtor to disgorge and waive prepetition fees. The Office of the United States Trustee has made it clear it does not approve of such curative efforts being used in the future and takes the stand that the only remedy for the acceptance of prepetition fees that are arguably preferential is voluntary disgorgement or disqualification.

E. The Duty of Honesty

In Kentucky and across the country, attorneys' failures to conduct themselves with full candor before the court is resulting in increasingly severe penalties. No longer are attorneys pocketbooks only being hurt, they are being disciplined by bar associations and, in the most dire case, serving jail time. Making national news last year was the fate of John Gellene. Even more recently was the very public disqualification of Hale & Dorr, LLP and PricewaterhouseCoopers, LLP in the Filene's Basement, Inc. bankruptcy. These and other interesting cases of note include:

1. United States v. Gellene, 182 F.3d 578 (7<sup>th</sup> Cir. 1999): John Gellene, counsel for debtor, failed to disclose that his firm represented the individual who owned debtor's primary secured creditor. Further, counsel took affirmative steps in a course of action to avoid discovery of his failure to disclose. Gellene was charged with two counts of knowing and fraudulently making a false material declaration, in violation of 18 U.S.C. § 152 and a violation of 18 U.S.C. § 1623, using a document under oath with knowledge it contained false information. Counsel was sentenced to 15 months of imprisonment and a \$15,000.00 fine. The sentence of the district court was affirmed by the Seventh Circuit.
2. In re Filene's Basement, Inc., 1999 Bankr. LEXIS 1293 and 1301: Two opinions from the Massachusetts Bankruptcy Court granting a motion to reconsider, vacating prior employment orders and denying applications to employ Hale & Dorr as attorneys and PricewaterhouseCoopers as financial advisor and consultant to debtor. This conflict and failure to disclose came up when a competitor of the debtor filed a motion for reconsideration of the appointment of the debtor's counsel and financial consultant. Both firms were disqualified because of their failure to fully disclose.

3. In re BBO Resources, Inc., Case No. 99-70103 (Bankr. E.D. Ky 1999): Counsel for debtor had agreed to be compensated by an entity that was a creditor of the debtor and the lessor of equipment used by debtor. The arrangement was disclosed to the court and employment was approved. Thereafter, a creditor and the United States Trustee objected and Judge Howard disqualified the attorney from representing the DIP.
4. In re The Leslie Fay Companies, Inc., 175 B.R. 525 (Bankr. S.D. N.Y. 1994): The Court granted the United States Trustee's motion to disqualify debtor's counsel and denied a portion of requested fees due to counsel's failure to disclose certain connections which rendered counsel not disinterested. The Court imposed this sanction while recognizing counsel rendered competent services despite counsel's failure to disclose. The Court expressed concern for harm to the debtor in losing its chosen counsel after almost two years into the reorganization.
5. In re Carlton House of Brockton, 28 BCD 777 (Bankr. D. Mass. 1996): Counsel for creditor's committee suspended from bankruptcy practice for one year due to false representations of disinterestedness.
6. Kentucky Bar Ass'n v. Wharton, 810 S.W.2d 510 (Ky. 1991): Attorney suspended for six months for violating Bankruptcy Rule 1006(b)(3) by receiving attorney fee before paying filing fee for debtor's petition and then failing to pay fee after a subsequent check was returned for insufficient funds, even though additional time was allowed by the court.
7. Roberts v. Kentucky Bar Ass'n, 771 S.W.2d 46 (Ky. 1989): Attorney allowed to resign and surrender license for six months where he accepted stock in a corporation owned by the debtor and prepared numerous deeds from the debtor to the corporation where the bankruptcy judge found the transfers were made without adequate consideration and set aside some of the transfers.

F. Specific Disclosure Rules

1. Bankruptcy Rule 2014- An order approving employment can be entered only upon application of the debtor or trustee. The application must state
  - a. the specific facts showing the necessity for the employment,
  - b. the name of the person to be employed,
  - c. the reasons for the selection,
  - d. the professional services to be rendered,
  - e. any proposed arrangement for compensation, and

- f. to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.
- g. If the employed person is a partnership or corporation, or if a named professional is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant, without further order of court.

2. Bankruptcy Code Section 329 disclosures- Any attorney for the debtor in connection with the case, whether or not they seek compensation from the court must file a statement specifying

- a. the compensation paid or agreed to be paid,
- b. if the payment or agreement was made after one year before the date of the filing of the petition
- c. whether the services were rendered or to be rendered in contemplation of or in connection with the case by such attorney, and
- d. the source of the compensation.

If the compensation exceeds the reasonable value for the services, the court can cancel the agreement or order return of the excessive payment

- a. to the estate if the property transferred
  - i. would have been property of the estate; or
  - ii. was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of title 11; or
- b. to the entity that made the payment.

3. Bankruptcy Rule 2019- Unless the Court orders otherwise, every entity or committee, except creditors, equity security holders and retiree committees, representing more than one creditor and every indenture trustee must file a verified statement setting forth

- a. the name and address of the creditor or equity security holder,
- b. the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition,
- c. a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee and in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act, and

- d. with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the member of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.

The statement must include a copy of the instrument under which the entity, committee or indenture trustee is empowered to act on behalf of creditors or equity security holders. There is a continuing duty to supplement the statement. If there is a failure to comply, the court may hold invalid the authority, acceptance, rejection or objection made by the entity or committee who has not complied with this disclosure or Bankruptcy Code Section 1125(b).

4. Bankruptcy Rule 2016(b)- Within 15 days after entry of the order for relief, **every** attorney for a debtor (whether or not such attorney applies for compensation) must file the statement under Section 329 of the Bankruptcy Code including any agreement regarding the sharing of the compensation with any other entity, except a member or regular associate of the attorney's law firm. The statement must contain the particulars of the agreement, including disclosures as to the compensation paid or agreed to be paid and the source of such compensation. There is a continuing duty to supplement this disclosure in the future within 15 days after any payment or agreement not previously disclosed.
5. A willful failure to disclose fee arrangements pursuant to Rule 2016 has been held by the Sixth Circuit to mandate a denial of all requested compensation. See In re Downs, 103 F.3d 472 (6<sup>th</sup> Cir. 1996). In re Downs held that if an attorney receives compensation from a debtor's creditor, the attorney has a pecuniary interest materially adverse to the interests of the estate — "a conflict of interest that requires a denial of all compensation to debtor's counsel." Id. at 479 (quoting In re Crimson Investments, 109 B.R. 397 (Bankr. D. Az. 1989)). Faced with such a situation, the Court "should deny all compensation to an attorney who exhibits a willful disregard of his fiduciary obligations to fully disclose the nature and circumstances of his fee arrangement under § 329 and Rule 2016." Id. The Sixth Circuit denied all fees and required disgorgement of previously received fees, stating same was "the only appropriate sanction" in the case.
6. Nevertheless, an unresolved question remains regarding whether disgorgement is an appropriate remedy when a third party pays the DIP attorney's fees, and such payment creates an impermissible conflict. If

disgorgement is the proper remedy, who receives the funds, the third party or the estate? Section 329 perhaps provides some guidance on this issue, giving a choice of parties to whom the court may order the return of compensation when such compensation exceeds the reasonable value of services. (See note 2, above). Further, in In re Land, 943 F.2d 1265 (10<sup>th</sup> Cir. 1991), the Tenth Circuit affirmed the bankruptcy court's order for debtor's counsel to return a retainer to the third party, not because the compensation exceeded the reasonable value of services, but because the attorney had never obtained court approval of employment.

7. Failure to adequately disclose information on a fee application can itself result in disgorgement, reduced fees or disqualification. The majority of courts agree that orders regarding the interim compensation of fees, as well as the appointment or disqualification of counsel, are interlocutory and not immediately appealable. For an excellent look at this issue, see In re Firstmark Corp., 46 F.3d 653 (7<sup>th</sup> Cir. 1995).

#### IV. COMPENSATION

A. Background- If all a professional person had to worry about is preparing an invoice for presentation to and payment by their client, this business would be far easier. Unfortunately, the road to compensation is a quest, paved with the sweat and tears of our brethren.

1. Limitations on Compensation-

- a. While a professional person may be employed on any reasonable terms and conditions of employment, including a retainer, on an hourly basis or on a contingent fee basis, the Court may allow compensation different from the compensation provided in the order after the conclusion of the employment, if the original terms of employment turn out to have been improvident in light of unforeseeable developments. See Section 328(a).
- b. If the trustee acts as his own attorney or accountant, he or she may only recover compensation for professional services and not those generally performed by a trustee without an attorney or accountant. See Section 328(b).
- c. If the Court determines that the professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to their employment, the Court may

deny allowance of compensation for services and reimbursement of expenses. See Section 328(c).

2. Allowable Compensation- The Court, after notice to parties in interest and a hearing, may award a professional person reasonable compensation for actual, necessary services and reimbursement for actual, necessary expenses. The Court can on its own motion, or that of any party in interest, award compensation that is less than that which is requested. See Bankruptcy Code Sections 330(a)(1) and (2).
  - a. Reasonable Compensation- The Court will consider the nature, the extent, and the value of the services, and take into account all relevant factors, including
    - i. the time spent on such services;
    - ii. the rates charges for such services;
    - iii. whether the services were necessary to the administration of or beneficial at the time rendered toward the completion of the case;
    - iv. whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and
    - v. whether the compensation is reasonable, based upon the customary compensation charged by comparably skilled practitioners in cases other than under Title 11. See Section 330(a)(3)(A).
  - b. Unreasonable Compensation- The Court shall not allow compensation for
    - i. unnecessary duplication of services; or
    - ii. services that were not
      - a. reasonably likely to benefit the debtor's estate; or
      - b. necessary to the administration of the case. See Section 330(a)(4)(A).
  - c. In re Big Rivers, 233 B.R. 768 (Bankr. W.D. Ky. 1999), rev'd and remanded, in part, Nos. 4:99CV-132-M and 4:99CV-115-M, Orders entered Oct. 29, 1999 (W.D. Ky. 1999). While this case has presently been reversed and remanded, in part, by the District Court for failure to hold a hearing and failure to apply the lodestar approach, Judge Roberts' opinion criticizing several law firms and other professionals

is worth noting. Some of the complaints the Judge noted include: failure to provide detailed descriptions of services rendered; excessively long phone conferences; excessive and unnecessary services (for example, billing two hours to draft a memo summarizing a one hour phone call); duplicative services (two or more attorneys from the same firm attending and billing for interoffice conferences, client meetings, hearing and other conferences); billing for secretarial tasks; and excessive time for preparing the bill. The court emphasized, "Attorneys must be disabused of the erroneous notion that they are entitled to compensation as long as the time recorded was actually expended. Simply put, billable hours do not necessarily translate into compensable hours."

- d. It is clear that the case of In re Boddy, 950 F.2d 334 (6<sup>th</sup> Cir. 1991), is controlling authority regarding the determination of the fee award for counsel for the debtor. Boddy holds that the court should apply the lodestar method, multiplying a reasonable hourly rate by the number of hours reasonably spend on the case, to calculate the appropriate fee award. Such award may thereafter be adjusted by the court on the basis of other factors.
- e. In his Order and Memorandum Opinion entered December 28, 1994 in In re East Kentucky Lumber Co., Inc., No. 93-60392 (Bankr. E.D. Ky), Judge Howard explained as follows:

The starting point for determining an award of attorney fees is the application of the "Lodestar" method, whereby "the attorney's reasonable hourly rate [is multiplied] by the number of hours reasonably expended." In re Boddy, 950 F.2d 334, at 337 (6<sup>th</sup> Cir. 1991). It is the Court's task to determine what is "reasonable".

Courts often apply a 12-factor formula set out in Johnson v. Georgia Highway Express, Inc., 488 F.2d 714 (5<sup>th</sup> Cir. 1974), in making determinations about "reasonableness".

- f. In In re Spendthrift Farms, Inc., No. 88-01719, Memorandum Opinion filed Oct. 24, 1990 (Bankr. E.D. Ky.), Judge Lee disallowed compensation for services performed prior to order authorizing retention; for services performed by persons identified only by initials and for daily totals rather than detailed hours. The importance of the



level of detail necessary in bills is clear. In the same opinion, Judge Lee also disallowed compensation for interoffice conferences and joint court appearances and disallowed or reduced reimbursement of expenses for first class travel, transportation costs for firm employees working in the evenings and overtime expenses for secretarial and other staff.

B. The Fee Application

1. Section 330 provides the court may award reasonable compensation to a trustee or other professional person after notice and an opportunity for hearing. Regardless of whether an objection is filed, because often parties in interest or the debtor have little incentive to object to compensation applications, the bankruptcy court has a duty to carefully scrutinize applications for fees and expenses. See In re: Big Rivers, 233 B.R. 768, 777 (Bankr. W.D. Ky. 1999) (“Even though no party-in-interest seriously objected to the fees of Big Rivers’ professionals, the Court has a duty to carefully scrutinize them.”).
2. The continually increasing involvement of the United States Trustee in the review of and objection to applications for compensation is making the award of compensation more uniform, but the application process more time consuming. Bankruptcy Code Sections 328, 329, 330 and 331, as well as Bankruptcy Rule 2016, govern the filing and content of compensation applications. However, on all cases commenced after October 22, 1994, practitioners must file fee applications in accordance with the United States Trustee’s Fee Guidelines.
3. Section 331 allows a trustee, examiner, debtor’s attorney or any other professional person employed under section 327 or 1103 to apply for compensation for services rendered and reimbursement of expenses “not more than once every 120 days after an order for relief in a case under this title, or more often if the court permits...”.

V. **CONCLUSION**

Many bankruptcy practitioners have felt like they are in a catch-22 situation for some time -- caught between a desire to counsel clients in an attempt to avoid bankruptcy and a desire to be assured payment if bankruptcy does occur. What these materials strive to make clear is that the increasingly hard line being taken by many courts opens attorneys up to graver dangers than the loss of a portion of fees. Indictments and disqualification with complete disgorgement of all fees are becoming more common. Complete candor with your clients and the court is the only way to conduct a bankruptcy practice. Anything less is a risk not worth taking.

**APPLICABLE UNITED STATES CODE SECTIONS**

**TITLE 18. CRIMES AND CRIMINAL PROCEDURE**

**PART 1. CRIMES, CHAPTER 9. BANKRUPTCY**

\* 18 USC, Section 152: Concealment of assets; False oaths and claims; Bribery

**TITLE 18. CRIMES AND CRIMINAL PROCEDURE**

**PART 1. CRIMES, CHAPTER 79. PERJURY**

\* 18 USC, Section 1623: False declarations before grand jury or court

**TITLE 11. BANKRUPTCY**

**CHAPTER 1. GENERAL PROVISIONS**

\* 11 USC, Section 101: Definitions

**CHAPTER 3. CASE ADMINISTRATION**

- \* 11 USC, Section 327: Employment of professional persons
- \* 11 USC, Section 328: Limitation on compensation of professional persons
- \* 11 USC, Section 329: Debtor's transactions with attorneys
- \* 11 USC, Section 330: Compensation of officers
- \* 11 USC, Section 331: Interim compensation
- \* 11 USC, Section 363: Use, sale or lease of property
- \* 11 USC, Section 364: Obtaining credit

**CHAPTER 11. REORGANIZATION**

- \* 11 USC, Section 1103: Powers and duties of committees
- \* 11 USC, Section 1107: Rights, powers and duties of debtor in possession



# UNITED STATES CODE

## TITLE 18. CRIMES AND CRIMINAL PROCEDURE

### PART I. CRIMES

#### CHAPTER 9. BANKRUPTCY

18 USCS § 152 (1999)

§ 152. Concealment of assets; false oaths and claims; bribery

A person who--

(1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;

(2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

(3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;

(4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;

(5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;

(6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

(8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

(9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor,

shall be fined under this title, imprisoned not more than 5 years, or both.

# UNITED STATES CODE

## TITLE 18. CRIMES AND CRIMINAL PROCEDURE PART I. CRIMES CHAPTER 79. PERJURY

18 USCS § 1623 (1999)

### § 1623. False declarations before grand jury or court

(a) Whoever under oath (or in any declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, United States Code) in any proceeding before or ancillary to any court or grand jury of the United States knowingly makes any false material declaration or makes or uses any other information, including any book, paper, document, record, recording, or other material, knowing the same to contain any false material declaration, shall be fined under this title or imprisoned not more than five years, or both.

(b) This section is applicable whether the conduct occurred within or without the United States.

(c) An indictment or information for violation of this section alleging that, in any proceedings before or ancillary to any court or grand jury of the United States, the defendant under oath has knowingly made two or more declarations, which are inconsistent to the degree that one of them is necessarily false, need not specify which declaration is false if--

(1) each declaration was material to the point in question, and

(2) each declaration was made within the period of the statute of limitations for the offense charged under this section.

In any prosecution under this section, the falsity of a declaration set forth in the indictment or information shall be established sufficient for conviction by proof that the defendant while under oath made irreconcilably contradictory declarations material to the point in question in any proceeding before or ancillary to any court or grand jury. It shall be a defense to an indictment or information made pursuant to the first sentence of this subsection that the defendant at the time he made each declaration believed the declaration was true.

(d) Where, in the same continuous court or grand jury proceeding in which a declaration is made, the person making the declaration admits such declaration to be false, such admission shall bar prosecution under this section if, at the time the admission is made, the declaration has not substantially affected the proceeding, or it has not become manifest that such falsity has been or will be exposed.

(e) Proof beyond a reasonable doubt under this section is sufficient for conviction. It shall not be necessary that such proof be made by any particular number of witnesses or by documentary or other type of evidence.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 1. GENERAL PROVISIONS

11 USCS § 101 (1999)

### § 101. Definitions

In this title--

(1) "accountant" means accountant authorized under applicable [applicable] law to practice public accounting, and includes professional accounting association, corporation, or partnership, if so authorized;

(2) "affiliate" means--

(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities--

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities--

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement;

(3) [Redesignated]

(4) "attorney" means attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law;

(5) "claim" 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, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

(6) "commodity broker" means futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer, as defined in section 761 of this title, with respect to which there is a customer, as defined in section 761 of this title;

(7) "community claim" means claim that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) of this title is liable, whether or not there is any such property at the time of the commencement of the case;

(8) "consumer debt" means debt incurred by an individual primarily for a personal, family, or household purpose;

(9) "corporation"--

(A) includes--

(i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;

(ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;

(iii) joint-stock company;

(iv) unincorporated company or association; or

(v) business trust; but

(B) does not include limited partnership;

(10) "creditor" means--

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or

(C) entity that has a community claim;

(11) "custodian" means--

(A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;

(B) assignee under a general assignment for the benefit of the debtor's creditors; or

(C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors;

(12) "debt" means liability on a claim;

(12A) "debt for child support" means a debt of a kind specified in section 523(a)(5) of this title for maintenance or support of a child of the debtor;

(13) "debtor" means person or municipality concerning which a case under this title has been commenced;

(14) "disinterested person" means person that--

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not an investment banker for any outstanding security of the debtor;

(C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;

(D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and

(E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason;

(15) "entity" includes person, estate, trust, governmental unit, and United States trustee;

(16) "equity security" means--

(A) share in a corporation, whether or not transferable or denominated "stock", or similar security;

(B) interest of a limited partner in a limited partnership; or

(C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph;

(17) "equity security holder" means holder of an equity security of the debtor;

(18) "family farmer" means--

(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$ 1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed; or

(B) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and

(i) more than 80 percent of the value of its assets consists of assets related to the farming operation;

(ii) its aggregate debts do not exceed \$ 1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and

(iii) if such corporation issues stock, such stock is not publicly traded;

(19) "family farmer with regular annual income" means family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under a plan under chapter 12 of this title;

(20) "farmer" means (except when such term appears in the term "family farmer") person that received more than 80 percent of such person's gross income during the taxable year of such person immediately preceding the taxable year of such person during which the case under this title concerning such person was commenced from a farming operation owned or operated by such person;

(21) "farming operation" includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state;

(21A) "farmout agreement" means a written agreement in which--

(A) the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and

(B) such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property;

(21B) "Federal depository institutions regulatory agency" means--

(A) with respect to an insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act [12 USCS § 1813(c)(2)]) for which no conservator or receiver has been appointed, the

appropriate Federal banking agency (as defined in section 3(q) of such Act [12 USCS § 1813(q)]);

(B) with respect to an insured credit union (including an insured credit union for which the National Credit Union Administration has been appointed conservator or liquidating agent), the National Credit Union Administration;

(C) with respect to any insured depository institution for which the Resolution Trust Corporation has been appointed conservator or receiver, the Resolution Trust Corporation; and

(D) with respect to any insured depository institution for which the Federal Deposit Insurance Corporation has been appointed conservator or receiver, the Federal Deposit Insurance Corporation;

(22) "financial institution" means a person that is a commercial or savings bank, industrial savings bank, savings and loan association, or trust company and, when any such person is acting as agent or custodian for a customer in connection with a securities contract, as defined in section 741 of this title, such customer;

(23) "foreign proceeding" means proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization;

(24) "foreign representative" means duly selected trustee, administrator, or other representative of an estate in a foreign proceeding;

(25) "forward contract" means a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon;

(26) "forward contract merchant" means a person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade;

(27) "governmental unit" means United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government;

(28) "indenture" means mortgage, deed of trust, or indenture, under which there is outstanding a security, other than a voting-trust certificate, constituting a claim against the debtor, a claim secured by a lien on any of the debtor's property, or an equity security of the debtor;

(29) "indenture trustee" means trustee under an indenture;

(30) "individual with regular income" means individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title [11 USCS §§ 1301 et seq.], other than a stockbroker or a commodity broker;

(31) "insider" includes--

(A) if the debtor is an individual--

- (i) relative of the debtor or of a general partner of the debtor;
- (ii) partnership in which the debtor is a general partner;
- (iii) general partner of the debtor; or
- (iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation--

- (i) director of the debtor;
- (ii) officer of the debtor;
- (iii) person in control of the debtor;
- (iv) partnership in which the debtor is a general partner;
- (v) general partner of the debtor; or
- (vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership--

- (i) general partner in the debtor;
- (ii) relative of a general partner in, general partner of, or person in control of the debtor;
- (iii) partnership in which the debtor is a general partner;
- (iv) general partner of the debtor; or
- (v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor;



# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER II. OFFICERS

11 USCS § 327 (1999)

### § 327. Employment of professional persons

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title [11 USCS §§ 101 et seq.].

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title [11 USCS §§ 701 et seq., 1201 et seq., or 1101 et seq.], a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

(f) The trustee may not employ a person that has served as an examiner in the case.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER II. OFFICERS

11 USCS § 328 (1999)

### § 328. Limitation on compensation of professional persons

(a) The trustee, or a committee appointed under section 1102 of this title [11 USCS § 1102], with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title [11 USCS § 327 or 1103], as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

(b) If the court has authorized a trustee to serve as an attorney or accountant for the estate under section 327(d) of this title [11 USCS § 327(d)], the court may allow compensation for the trustee's services as such attorney or accountant only to the extent that the trustee performed services as attorney or accountant for the estate and not for performance of any of the trustee's duties that are generally performed by a trustee without the assistance of an attorney or accountant for the estate.

(c) Except as provided in section 327(c), 327(e), or 1107(b) of this title [11 USCS § 327(c), 327(e), or 1107(b)], the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title [11 USCS § 327 or 1103] if, at any time during such professional person's employment under section 327 or 1103 of this title [11 USCS § 327 or 1103], such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER II. OFFICERS

11 USCS § 329 (1999)

### § 329. Debtor's transactions with attorneys

(a) Any attorney representing a debtor in a case under this title [11 USCS §§ 101 et seq.], or in connection with such a case, whether or not such attorney applies for compensation under this title [11 USCS §§ 101 et seq.], shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to--

(1) the estate, if the property transferred--

(A) would have been property of the estate; or

(B) was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or

(2) the entity that made such payment.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER II. OFFICERS

11 USCS § 330 (1999)

### § 330. Compensation of officers

(a) (1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, an examiner, a professional person employed under section 327 or 1103--

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney and by any paraprofessional person employed by any such person; and  
(B) reimbursement for actual, necessary expenses.

(2) The court may, on its own motion or on the motion of the United States Trustee, the United States Trustee for the District or Region, the trustee for the estate, or any other party in interest, award compensation that is less than the amount of compensation that is requested.

(3) (A) In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including--

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title [11 USCS §§ 101 et seq.];

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and

(E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title [11 USCS §§ 101 et seq.].

(4) (A) Except as provided in subparagraph (B), the court shall not allow compensation for--

(i) unnecessary duplication of services; or

(ii) services that were not--

(I) reasonably likely to benefit the debtor's estate; or

(II) necessary to the administration of the case.

(B) In a chapter 12 or chapter 13 case in which the debtor is an individual, the court may allow reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section.

(5) The court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate.

(6) Any compensation awarded for the preparation of a fee application shall be based on the level and skill reasonably required to prepare the application.

(b) (1) There shall be paid from the filing fee in a case under chapter 7 of this title [11 USCS §§ 701 et seq.] \$ 45 to the trustee serving in such case, after such trustee's services are rendered.

(2) The Judicial Conference of the United States--

(A) shall prescribe additional fees of the same kind as prescribed under section 1914(b) of title 28; and

(B) may prescribe notice of appearance fees and fees charged against distributions in cases under this title [11 USCS §§ 101 et seq.]; to pay \$ 15 to trustees serving in cases after such trustees' services are rendered. Beginning 1 year after the date of the enactment of the Bankruptcy Reform Act of 1994 [enacted Oct. 22, 1994], such \$ 15 shall be paid in addition to the amount paid under paragraph (1).

(c) Unless the court orders otherwise, in a case under chapter 12 or 13 of this title, the compensation paid to the trustee serving in the case shall not be less than \$ 5 per month from any distribution under the plan during the administration of the plan.

(d) In a case in which the United States trustee serves as trustee, the compensation of the trustee under this section shall be paid to the clerk of the bankruptcy court and deposited by the clerk into the United States Trustee System Fund established by section 589a of title 28.

**UNITED STATES CODE**

**TITLE 11. BANKRUPTCY**  
**CHAPTER 3. CASE ADMINISTRATION**  
**SUBCHAPTER II. OFFICERS**

11 USCS § 331 (1999)

§ 331. Interim compensation

A trustee, an examiner, a debtor's attorney, or any professional person employed under section 327 or 1103 of this title [11 USCS § 327 or 1103] may apply to the court not more than once every 120 days after an order for relief in a case under this title [11 USCS §§ 101 et seq.], or more often if the court permits, for such compensation for services rendered before the date of such an application or reimbursement for expenses incurred before such date as is provided under section 330 of this title [11 USCS § 330]. After notice and a hearing, the court may allow and disburse to such applicant such compensation or reimbursement.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER IV. ADMINISTRATIVE POWERS

11 USCS § 363 (1999)

### § 363. Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b) (1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

(2) If notification is required under subsection (a) of section 7A of the Clayton Act [15 USCS § 18a(a)] in the case of a transaction under this subsection, then--

(A) notwithstanding subsection (a) of such section [15 USCS § 18a(a)], the notification required by such subsection to be given by the debtor shall be given by the trustee; and

(B) notwithstanding subsection (b) of such section [15 USCS § 18a(b)], the required waiting period shall end on the 15th day after the date of the receipt, by the Federal Trade Commission and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, of the notification required under such subsection (a) [15 USCS § 18a(a)], unless such waiting period is extended--

(i) pursuant to subsection (e)(2) of such section [15 USCS § 18a(e)(2)], in the same manner as such subsection (e)(2) applies to a cash tender offer;

(ii) pursuant to subsection (g)(2) of such section [15 USCS § 18a(g)(2)]; or

(iii) by the court after notice and a hearing.

(c) (1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless--

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (e) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e), or 362(f) of this title.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if--

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

(g) Notwithstanding subsection (f) of this section, the trustee may sell property under subsection (b) or (c) of this section free and clear of any vested or contingent right in the nature of dower or curtesy.

(h) Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if--

- (1) partition in kind of such property among the estate and such co-owners is impracticable;
- (2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;
- (3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and
- (4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

(i) Before the consummation of a sale of property to which subsection (g) or (h) of this section applies, or of property of the estate that was community property of the debtor and the debtor's spouse immediately before the commencement of the case, the debtor's spouse, or a co-owner of such property, as the case may be, may purchase such property at the price at which such sale is to be consummated.

(j) After a sale of property to which subsection (g) or (h) of this section applies, the trustee shall distribute to the debtor's spouse or the co-owners of such property, as the case may be, and to the estate, the proceeds of such sale, less the costs and expenses, not including any compensation of the trustee, of such sale, according to the interests of such spouse or co-owners, and of the estate.

(k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

(l) Subject to the provisions of section 365, the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12, or 13 of this title [11 USCS §§ 1101 et seq., 1201 et seq., or 1301 et seq.] may provide for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interest in such property.

(m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

(n) The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.

(o) In any hearing under this section--

- (1) the trustee has the burden of proof on the issue of adequate protection; and
- (2) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 3. CASE ADMINISTRATION SUBCHAPTER IV. ADMINISTRATIVE POWERS

11 USCS § 364 (1999)

### § 364. Obtaining credit

(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt--

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if--

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

(f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933 [15 USCS § 77e], the Trust Indenture Act of 1939 [15 USCS §§ 77aaa et seq.], and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.



# UNITED STATES CODE

## TITLE 11. BANKRUPTCY CHAPTER 11. REORGANIZATION SUBCHAPTER I. OFFICERS AND ADMINISTRATION

11 USCS § 1103 (1999)

### § 1103. Powers and duties of committees

(a) At a scheduled meeting of a committee appointed under section 1102 of this title [11 USCS § 1102], at which a majority of the members of such committee are present, and with the court's approval, such committee may select and authorize the employment by such committee of one or more attorneys, accountants, or other agents, to represent or perform services for such committee.

(b) An attorney or accountant employed to represent a committee appointed under section 1102 of this title [11 USCS § 1102] may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest.

(c) A committee appointed under section 1102 of this title [11 USCS § 1102] may--

(1) consult with the trustee or debtor in possession concerning the administration of the case;  
(2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

(3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;

(4) request the appointment of a trustee or examiner under section 1104 of this title [11 USCS § 1104];  
and

(5) perform such other services as are in the interest of those represented.

(d) As soon as practicable after the appointment of a committee under section 1102 of this title [11 USCS § 1102], the trustee shall meet with such committee to transact such business as may be necessary and proper.

## TITLE 11. BANKRUPTCY CHAPTER 11. REORGANIZATION SUBCHAPTER I. OFFICERS AND ADMINISTRATION

11 USCS § 1107 (1999)

### § 1107. Rights, powers and duties of debtor in possession

(a) Subject to any limitations on a trustee serving in a case under this chapter [11 USCS §§ 1101 et seq.], 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 [11 USCS § 330], 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 [11 USCS § 1106(a)(2), (3), and (4)], of a trustee serving in a case under this chapter [11 USCS §§ 1101 et seq.].

(b) Notwithstanding section 327(a) of this title [11 USCS § 327(a)], a person is not disqualified for employment under section 327 of this title [11 USCS § 327] by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case.

**APPLICABLE RULES OF BANKRUPTCY PROCEDURE**

**FEDERAL RULES OF BANKRUPTCY PROCEDURE:**

**RULE 2014. EMPLOYMENT OF PROFESSIONAL PERSONS**

**RULE 2016. COMPENSATION FOR SERVICES RENDERED AND REIMBURSEMENT OF EXPENSES**

**RULE 2019. REPRESENTATION OF CREDITORS AND EQUITY SECURITY HOLDERS IN CHAPTER 9 MUNICIPALITY AND CHAPTER 11 REORGANIZATION CASES**

**RULE 4001. RELIEF FROM AUTOMATIC STAY; PROHIBITING OR CONDITIONING THE USE, SALE OR LEASE OF PROPERTY; USE OF CASH COLLATERAL; OBTAINING CREDIT; AGREEMENTS**



## FEDERAL RULES OF BANKRUPTCY PROCEDURE

### **Rule 2014. Employment of Professional Persons.**

**(a) Application for an Order of Employment.** An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

**(b) Services Rendered by Member or Associate of Firm of Attorneys or Accountants.** If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.

## FEDERAL RULES OF BANKRUPTCY PROCEDURE

### **Rule 2016. Compensation for Services Rendered and Reimbursement of Expenses.**

*(a) Application for Compensation or Reimbursement.* An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required. The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity. Unless the case is a chapter 9 municipality case, the applicant shall transmit to the United States trustee a copy of the application.

*(b) Disclosure of Compensation Paid or Promised to Attorney for Debtor.* Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 15 days after the order for relief, or at another time as the court may direct, the statement required by § 329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 15 days after any payment or agreement not previously disclosed.

## FEDERAL RULES OF BANKRUPTCY PROCEDURE

### **Rule 2019. Representation of Creditors and Equity Security Holders in Chapter 9 Municipality and Chapter 11 Reorganization Cases.**

*(a) Data Required.* In a chapter 9 municipality or chapter 11 reorganization case, except with respect to a committee appointed pursuant to § 1102 or 1114 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof. The statement shall include a copy of the instrument, if any, whereby the entity, committee, or indenture trustee is empowered to act on behalf of creditors or equity security holders. A supplemental statement shall be filed promptly, setting forth any material changes in the facts contained in the statement filed pursuant to this subdivision.

*(b) Failure to Comply; Effect.* On motion of any party in interest or on its own initiative, the court may (1) determine whether there has been a failure to comply with the provisions of subdivision (a) of this rule or with any other applicable law regulating the activities and personnel of any entity, committee, or indenture trustee or any other impropriety in connection with a solicitation and, if it so determines, the court may refuse to permit that entity, committee, or indenture trustee to be heard further or to intervene in the case; (2) examine any representation provision of a deposit agreement, proxy, trust mortgage, trust indenture, or deed of trust, or committee or other authorization, and any claim or interest acquired by any entity or committee in contemplation or in the course of a case under the Code and grant appropriate relief; and (3) hold invalid any authority, acceptance, rejection, or objection given, procured, or received by an entity or committee who has not complied with this rule or with § 1125(b) of the Code.

## FEDERAL RULES OF BANKRUPTCY PROCEDURE

### **Rule 4001. Relief from Automatic Stay; Prohibiting or Conditioning the Use, Sale, or Lease of Property; Use of Cash Collateral; Obtaining Credit; Agreements.**

#### **(a) Relief from Stay; Prohibiting or Conditioning the Use, Sale, or Lease of Property.**

(1) **Motion.** A motion for relief from an automatic stay provided by the Code or a motion to prohibit or condition the use, sale, or lease of property pursuant to § 363(e) shall be made in accordance with Rule 9014 and shall be served on any committee elected pursuant to § 705 or appointed pursuant to § 1102 of the Code or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed pursuant to § 1102, on the creditors included on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct.

(2) **Ex Parte Relief.** Relief from a stay under § 362(a) or a request to prohibit or condition the use, sale, or lease of property pursuant to § 363(e) may be granted without prior notice only if (A) it clearly appears from specific facts shown by affidavit or by a verified motion that immediate and irreparable injury, loss, or damage will result to the movant before the adverse party or the attorney for the adverse party can be heard in opposition, and (B) the movant's attorney certifies to the court in writing the efforts, if any, which have been made to give notice and the reasons why notice should not be required. The party obtaining relief under this subdivision and § 362(f) or § 363(e) shall immediately give oral notice thereof to the trustee or debtor in possession and to the debtor and

forthwith mail or otherwise transmit to such adverse party or parties a copy of the order granting relief. On two days notice to the party who obtained relief from the stay without notice or on shorter notice to that party as the court may prescribe, the adverse party may appear and move reinstatement of the stay or reconsideration of the order prohibiting or conditioning the use, sale, or lease of property. In that event, the court shall proceed expeditiously to hear and determine the motion.

(b) Use of Cash Collateral.

(1) Motion; Service. A motion for authorization to use cash collateral shall be made in accordance with Rule 9014 and shall be served on any entity which has an interest in the cash collateral, on any committee elected pursuant to § 705 or appointed pursuant to § 1102 of the Code or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed pursuant to § 1102, on the creditors included on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct.

(2) Hearing. The court may commence a final hearing on a motion for authorization to use cash collateral no earlier than 15 days after service of the motion. If the motion so requests, the court may conduct a preliminary hearing before such 15 day period expires, but the court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing.

(3) Notice. Notice of hearing pursuant to this subdivision shall be given to the parties on whom service of the motion is required by paragraph (1) of this subdivision and to such other entities as the court may direct.

(c) Obtaining Credit.

(1) Motion; Service. A motion for authority to obtain credit shall be made in accordance with Rule 9014 and shall be served on any committee elected pursuant to § 705 or appointed pursuant to § 1102 of the Code or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed pursuant to § 1102, on the creditors included on the list pursuant to Rule 1007(d), and on such other entities as the court may direct. The motion shall be accompanied by a copy of the agreement.

(2) Hearing. The court may commence a final hearing on a motion for authority to obtain credit no earlier than 15 days after service of the



motion. If the motion so requests, the court may conduct a hearing before such 15 day period expires, but the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.

(3) Notice. Notice of hearing pursuant to this subdivision shall be given to the parties on whom service of the motion is required by paragraph (1) of this subdivision and to such other entities as the court may direct.

(d) Agreement Relating to Relief From the Automatic Stay, Prohibiting or Conditioning the Use, Sale, or Lease of Property, Providing Adequate Protection, Use of Cash Collateral, and Obtaining Credit.

(1) Motion; Service. A motion for approval of an agreement (A) to provide adequate protection, (B) to prohibit or condition the use, sale, or lease of property, (C) to modify or terminate the stay provided for in § 362, (D) to use cash collateral, or (E) between the debtor and an entity that has a lien or interest in property of the estate pursuant to which the entity consents to the creation of a lien senior or equal to the entity's lien or interest in such property shall be served on any committee elected pursuant to § 705 or appointed pursuant to § 1102 of the Code or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed pursuant to § 1102, on the creditors included on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct. The motion shall be accompanied by a copy of the agreement.

(2) Objection. Notice of the motion and the time within which objections may be filed and served on the debtor in possession or trustee shall be mailed to the parties on whom service is required by paragraph (1) of this subdivision and to other such entities as the court may direct. Unless the court fixes a different time, objections may be filed within 15 days of the mailing of notice.

(3) Disposition; Hearing. If no objection is filed, the court may enter an order approving or disapproving the agreement without conducting a hearing. If an objection is filed or if the court determines a hearing is appropriate, the court shall hold a hearing on no less than five days' notice to the objector, the movant, the parties on whom service is required by paragraph (1) of this subdivision and such other entities as the court may direct.

(4) Agreement in Settlement of Motion. The court may direct that the procedures prescribed in paragraphs (1), (2), and (3) of this subdivision shall not apply and the agreement may be approved without further notice if the court determines that a motion made pursuant to subdivisions (a), (b), or (c) of this rule was sufficient to afford reasonable notice of the material provisions of the agreement and opportunity for a hearing.

**SAMPLE FORM: Rule 2019 Notice of Multiple Representation**

**(Three Creditors)**

**UNITED STATES BANKRUPTCY COURT  
EASTERN DISTRICT OF KENTUCKY  
LEXINGTON DIVISION**

**IN RE: CHAPTER 11**

**TECHNOLOGIES INTERNATIONAL  
HOLDINGS, INC.**

**CASE NO. 99-50867**

**DEBTOR**

**IN RE: CHAPTER 11**

**ADVANCED TECHNOLOGIES  
INTERNATIONAL, INC.**

**CASE NO. 99-50868**

**DEBTOR**

**IN RE: CHAPTER 11**

**MERIDIAN TRANSPORT COMPANY**

**CASE NO. 99-50869**

**DEBTOR**

**RULE 2019 NOTICE OF MULTIPLE REPRESENTATION**

---

Comes Fowler, Measle & Bell, LLP, and pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure, hereby gives notice that it has been engaged to represent three creditors in all matters related to the above referenced Chapter 11 proceedings, as follows:

1. Fowler, Measle & Bell, LLP, by and through Taft A. McKinstry, has been engaged herein to represent Commonwealth Technology, Inc., 2520 Regency Road, Lexington, Kentucky 40503. Commonwealth Technology, Inc. is an unsecured creditor herein asserting an unsecured claim (subject to reservation of rights as set forth in its Proof of Claim filed herein) in the amount of \$791,493.80. The claim was incurred for services rendered by Commonwealth Technology, Inc. from April, 1988 through February 18, 1999.

2. Fowler, Measle & Bell, LLP, by and through Taft A. McKinstry, has been engaged herein to represent Central Bank & Trust Company, 300 West Vine Street, Lexington, Kentucky 40507 ("Central Bank"). Central Bank is a secured creditor herein asserting a secured claim in the amount \$64,683.58, secured by motor vehicles. The claim was incurred between October, 1995 and February of 1997. Relief from stay was granted by Order entered herein on April 29, 1999.

3. Fowler, Measle & Bell, LLP, by and through Taft A. McKinstry, has been engaged herein to represent H & R Oil Company, Inc., 1144 Finney Drive, Lexington, Kentucky 40581. H & R Oil Company, Inc. is an unsecured creditor herein asserting an unsecured claim in the amount of approximately \$200,000.00 for breach by Associated Technologies, Inc. of remediation contract and cost incurred by H & R Oil Company, Inc. to perform said work. The claim was acquired on or about late 1998.

4. Each of the above-referenced creditors has retained Fowler, Measle & Bell, LLP and its attorneys and other professionals on an hourly basis. The attorney involved in this representation on behalf of each of the above-referenced creditors is Taft A. McKinstry.

5. The undersigned verifies that the foregoing is true and correct to the best of her knowledge and belief.

Respectfully submitted,

Fowler, Measle & Bell, LLP

By: \_\_\_\_\_

Taft A. McKinstry, Esq.

Kincaid Towers, Sixth Floor

300 West Vine Street

Lexington, Kentucky 40507-1660

Telephone: 606-252-6700

Attorneys for Commonwealth Technology, Inc.,  
Central Bank & Trust Company, and H & R Oil  
Company, Inc.

**CERTIFICATE OF SERVICE**



**SAMPLE FORM: Engagement Letter and Agreement****(Multiple Chapter 11 Debtors)**

February 23, 1999

Technologies International Holdings, Inc.  
 2365 Harrodsburg Road  
 Suite A-250  
 Lexington, KY 40504  
 Attention: P. Keith Nally, President

Meridian Transport Company  
 2365 Harrodsburg Road  
 Suite A-250  
 Lexington, KY 40504  
 Attention: Dwayne Justice, President

Advanced Technologies International, Inc.  
 2365 Harrodsburg Road  
 Suite A-290  
 Lexington, KY 40504  
 Attention: Brett C. Hensley, President

**Re: *Engagement of Pepper Hamilton LLP as Counsel for Technologies International Holdings, Inc., Advanced Technologies International, Inc. and Meridian Transport Company as Chapter 11 Debtors-in-Possession***

Dear Sirs:

This letter sets forth the agreement (the "Agreement") by and between Technologies International Holdings, Inc. ("TIH"), Advanced Technologies International, Inc. ("ATI") and Meridian Transport Company ("Meridian" and, together with TIH and ATI, hereinafter collectively, the "Companies") pursuant which the Companies have engaged this law firm (the "Pepper Firm") to commence voluntary cases under Chapter 11 of the Bankruptcy Code (the "Bankruptcy Code") for the Companies and, possibly, certain other affiliates of the Companies, in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") and to represent the Companies as debtors-in-possession therein.

The Companies and the Pepper Firm, intending to be legally bound, have agreed as follows:

P. Keith Nally, President  
Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

1. Engagement of the Pepper Firm

The Companies hereby engage the Pepper Firm to prepare and file voluntary cases (the "Bankruptcy Cases") under Chapter 11 of the Bankruptcy Code for the Companies and, possibly, certain other affiliates of the Companies, in the Bankruptcy Court and to act as general bankruptcy counsel for the Companies therein. The Pepper Firm hereby accepts such engagement on the terms and conditions set forth herein.

2. Scope of Engagement

(a) Subject to the approval of the Bankruptcy Court, the Pepper Firm shall appear for and represent the Companies as their general bankruptcy counsel in the Bankruptcy Cases.

(b) The services to be provided by the Pepper Firm shall include, without limitation, general advice and representation concerning the Companies' performance of their legal and fiduciary duties under the Bankruptcy Code as debtors-in-possession; commencing and representing the Companies in adversary proceedings and contested matters before the Bankruptcy Court as necessary and appropriate to protect and enforce the rights and the interests of the Companies and their estates; defending any adversary proceedings and contested matters initiated in the Bankruptcy Court against the Companies or their estates; other services necessary to enable the Companies, as debtors-in-possession, to comply with the legal requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").

(c) The Pepper Firm has not been engaged, and does not undertake, to appear for or represent the Companies in any pending or future action or proceeding in any state court, any federal court other than the United States District Court for the District of Delaware, the United States Bankruptcy Court for the District of Delaware and the United States Court of Appeals for the Third Circuit in connection with the Bankruptcy Case, or any state or federal administrative agency.

P. Keith Nally, President  
Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

3. Bankruptcy Court Approval of Engagement

(a) The parties recognize that the Companies must obtain the approval of the Bankruptcy Court, upon such notice as is required by the Bankruptcy Rules, to engage the Pepper Firm to represent the Companies as debtors-in-possession in the Bankruptcy Cases.

(b) The Pepper Firm shall prepare, the Companies shall execute and the Pepper Firm shall file an appropriate application (the "Retention Application") with the Bankruptcy Court for approval of the engagement of the Pepper Firm to serve as bankruptcy counsel for the Companies.

(c) If the Court fails to approve the Retention Application, then this Agreement shall become null and void and the Pepper Firm shall forthwith return the Retainer (defined below) to the Companies.

4. Fees and Expenses

(a) All work in this matter will be billed at our normal hourly rates which we traditionally adjust each January 1. The current hourly rates of those whom we presently expect to utilize in this matter are in these ranges: partners, \$210-340; associates, \$150-175 and legal assistants, \$100-105. I, as the partner in charge of the engagement, will review all bills before they are sent to assure that we are delivering our services as efficiently as we can. If so authorized by the Administrative Fee Order (defined below), our statements for professional fees and expenses ordinarily will be rendered to you monthly. Absent special instructions, statements will provide a summary of the services performed. We request payment of our statements within thirty (30) days of the statement date.

(b) In bankruptcy cases, the payment of compensation is subject to Bankruptcy Court approval. Periodically, we will be permitted and required to file applications with the Bankruptcy Court seeking allowance of interim compensation and reimbursement of expenses for services rendered for the Companies in the Bankruptcy Cases through a specified date. At the conclusion of the Bankruptcy Cases the Pepper Firm will file a final fee application.

(c) The Pepper Firm may also file an application with the Court seeking entry of an order (the "Administrative Fee Order") authorizing a special administrative procedure pursuant to which the Companies would be authorized to pay all or a designated percentage of the fees or expenses billed to the Companies by the Pepper Firm on a monthly



P. Keith Nally, President  
Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

basis. Any amounts so paid would be subject to review and approval by the Court when the interim and final fee applications referred to in paragraph (b) above are filed.

(d) If so authorized pursuant to the Administrative Fee Order, we will also bill the Companies monthly for any expenses incurred in our work and expect such bills to be paid within thirty (30) days. (Some disbursements are not always available on a current basis and may require supplemental statements.) In order to allocate these expenses fairly and keep our billing rates as low as possible, certain items are charged to the individual clients for whose benefit they are incurred. For services obtained on your behalf from suppliers outside the firm, unless you instruct us otherwise, we will ask outside vendors to send bills for their services to our attention so that we may review them for appropriateness before sending them on to you for payment. Unless previously agreed, vendors will be engaged only with your prior approval. If we are required to use air or rail transportation, our personnel will travel coach class.

(e) If (i) payment of any amount due to the Pepper Firm either pursuant to a monthly bill (if authorized pursuant to the Administrative Fee Order) or pursuant to an order of the Bankruptcy Court allowing interim compensation or reimbursement of expenses to the Pepper Firm, is not made within sixty (60) days after the due date or (ii) if the Pepper Firm has substantial grounds for believing that its future bills will not or cannot be paid because of the financial condition of the Companies' estates or their inability to acquire adequate working capital, the Pepper Firm reserves the right to seek to withdraw as counsel to the Companies; provided, however, no such withdrawal shall occur without the prior approval of the Bankruptcy Court.

##### 5. Retainer

(a) The Pepper Firm hereby acknowledges receipt of a cash payment in the amount of One Hundred Fifty Thousand Dollars (\$150,000), less any amount applied to our prepetition bills, as an "advanced fee retainer" for legal services to be rendered and expenses incurred by the Pepper Firm on behalf of the Companies during the Bankruptcy Cases (the "Retainer"). The Retainer shall be deemed earned upon receipt by the Pepper Firm subject only to the Pepper Firm's obligation to return such amount of the Retainer, if any, which exceeds the total amount allowed to the Pepper Firm for compensation and reimbursement of expenses less any additional amount paid to the Pepper Firm from the estate during the Bankruptcy Cases.

P Keith Nally, President  
Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

(b) The Pepper Firm may, in its discretion, either apply the Retainer against its monthly bills or retain the Retainer, or a portion thereof, until the allowance of final compensation to the Pepper Firm by the Bankruptcy Court.

(c) Should the Bankruptcy Court determine that the Retainer or any portion thereof is property of the Debtors' estates, then the Companies hereby grant to the Pepper Firm a lien on and a security interest in the Retainer and the proceeds thereof, which shall be perfected by the Pepper Firm's possession of the Retainer, as security for the claims of the Pepper Firm for compensation or reimbursement of expenses incurred in representing the Companies as debtors-in-possession in the Bankruptcy Cases.

(d) The Retention Application shall disclose all of the terms and conditions of the Retainer and request that the Bankruptcy Court approve the terms of the Retainer. If the Bankruptcy Court fails to approve the Retainer on the terms set forth herein, then the Pepper Firm, at its sole option, may withdraw from this engagement.

#### 6. Disclosure of Certain Matters

(a) The parties acknowledge that the Pepper Firm acted as special Delaware and New York counsel to ATI and Technologies SPE, L.L.C. ("TSPE"), a special purpose subsidiary of ATI, in connection with five (5) sales (collectively, the "Receivable Sales") in which Kentucky Leaking Underground Storage Tank Reimbursement Receivables (the "Reimbursement Receivables") in the total aggregate face amount of \$33,200,552.31, which had been contributed by ATI to TSPE, were sold by TSPE to Llama Capital Services, L.L.C. ("Llama") pursuant to Reimbursement Receivable Purchase and Sale Agreements by and among Llama, ATI and TSPE dated as of January 9, May 5, June 12, August 26 and November 25, 1998 (collectively, the "Purchase Agreements"). In connection with each Receivable Sale, the Pepper Firm provided to Llama and Fitch IBCA, Inc. a written "true sale" and "non-consolidation" legal opinion (collectively the "True Sale and Nonconsolidation Opinions") and to Llama and Gess, Mattingly & Atchison, P.S.C. a written legal opinion concerning certain corporate matters (together with the True Sale and Nonconsolidation Opinions, hereinafter collectively, the "Legal Opinions") In the True Sale and Nonconsolidation Opinions and subject to the terms, conditions, qualifications, assumptions and limitations set forth therein, the Pepper Firm advised the addressees therein that (i) in a bankruptcy case in which ATI or TSPE is a debtor, it would not be a proper exercise of the bankruptcy court's equitable discretion to disregard the separate existence of ATI or TSPE, and (ii) a bankruptcy court having jurisdiction over ATI or TSPE would not be entitled to treat any of the Reimbursement Receivables or the proceeds thereof

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Brett C. Hensley, President  
Dwayne Justice, President  
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contributed by ATI to TSPE and sold by TSPE to Llama as assets to be included in the estate ATI or TSPE pursuant to § 541 of the Bankruptcy Code or as subject to the automatic stay provisions of § 362(a) of the Code. The Companies acknowledge and agree that the Pepper Firm, in representing the Companies as debtors-in-possession, may not and shall not challenge, contradict or repudiate any of the opinions given by the Pepper Firm in the Legal Opinions. However, neither the Pepper Firm nor the Companies believe that the Pepper Firm's obligations under the Legal Opinions will conflict with or impair the Pepper Firm's performance of its duties as counsel to the Companies, as debtors-in-possession.

(b) The Companies' primary prepetition secured lender is Bank One Kentucky (the "Bank"), having made loans to the Companies in the total aggregate outstanding amount of approximately \$10,533,000. While the Pepper Firm has not represented and does not represent the Bank, from time to time the Pepper Firm has represented and it currently represents either the parent of the Bank or other affiliates of the Bank in various matters unrelated to the Companies or the Bankruptcy Cases. The Pepper Firm does not represent and will not represent the Bank, its parent or any other affiliate of the Bank in connection with the Bankruptcy Cases or any other matters which might conflict with the Pepper Firm's engagement hereunder. The fees earned and received by the Pepper Firm from the parent and other affiliates of the Bank during the last year comprised less than one percent (1%) of the gross revenues of the Pepper Firm during such time period.

7. Execution in Counterparts and by Facsimile Signatures

This Agreement may be executed in counterparts and by facsimile signatures.

If you have any questions or comments concerning any of the foregoing, please do not hesitate to call. Otherwise please confirm the Companies' agreement to the terms and conditions of this letter by signing the enclosed copy and returning it to the undersigned.

Sincerely yours,



Michael H. Reed

/mc  
Enclosure

P. Keith Nally, President  
Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

The undersigned acknowledge and agree to the foregoing terms of representation by Pepper  
Hamilton, LLP.

TECHNOLOGIES INTERNATIONAL HOLDINGS, INC.

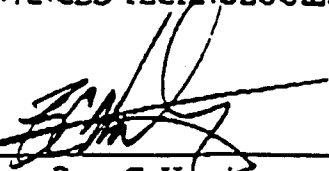


By: \_\_\_\_\_  
Name: ~~P. Keith Nally~~ **BRETT C. HENSLEY**  
Title: President

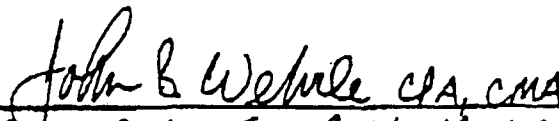
(EXECUTIONS CONTINUED)

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Brett C. Hensley, President  
Dwayne Justice, President  
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February 23, 1999

ADVANCED TECHNOLOGIES INTERNATIONAL, INC.

By:   
Name: Brett C. Hensley  
Title: President

MERIDIAN TRANSPORT COMPANY

By:   
Name: ~~Dwayne Justice~~ JOHN B. WEHALE, CPA, CMA  
Title: ~~President~~ TREASURER

**OFFICER, DIRECTOR AND ATTORNEY  
FIDUCIARY DUTIES  
TO CREDITORS UPON INSOLVENCY**

**Prof. G. Ray Warner  
University of Missouri - Kansas City School of Law  
Kansas City, Missouri  
- of counsel -  
Greenberg Traurig  
Chicago, Illinois**



**OFFICER, DIRECTOR AND ATTORNEY  
FIDUCIARY DUTIES TO CREDITORS  
UPON INSOLVENCY**

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**OFFICER, DIRECTOR AND ATTORNEY FIDUCIARY DUTIES  
TO CREDITORS UPON INSOLVENCY**

9<sup>th</sup> Annual Judge Joe Lee Bankruptcy Institute  
University of Kentucky College of Law

By: Prof. G. Ray Warner  
University of Missouri - Kansas City  
Of Counsel  
Greenberg Traurig, Chicago, Illinois

Introduction

Representation of financially troubled entities has always been a challenging area of legal practice. Several recent trends have begun to impose new duties on counsel for a troubled entity that are in conflict with the traditional attorney duties owed to the client. In addition to adding confusion to an already difficult area, these trends threaten to expose attorneys to personal liability to creditors for actions taken in connection with their representation of the debtor entity.

Corporate Duties to Creditors in the Vicinity of Insolvency<sup>1</sup>

One of the most significant, but least noticed, trends that threatens the traditional notion of attorney duties in the insolvency practice is the expansion of the trust fund and fiduciary duty theories to corporate governance issues.

Traditionally, courts have been extremely hostile to attempts to impose fiduciary duties in debtor-creditor relationships. Fiduciary duties generally are recognized and imposed only in the context of relationships that involve special trust or confidence. The lender-borrower relationship traditionally was viewed as the epitome of an arm's length transaction. The parties are clearly adverse and have diametrically opposed interests in the transaction. The borrower and lender bargain over their respective rights and duties, and the courts hesitate to impose additional rights. Thus, the concept of a fiduciary duty seems particularly inappropriate in the debtor-creditor context, especially where the debt arises from contract.

Traditional notions of corporate governance also rejected the concept of a fiduciary duty to creditors. Indeed, the most significant legal aspect of the corporate form is the concept of limited liability. The shareholders of the corporation were the beneficiaries of the corporate operations and the corporation's officers and directors owed fiduciary duties to those shareholders. The officers and directors did not owe a duty to manage the corporation for the benefit of its creditors.

The new trend of imposing fiduciary duties in cases of insolvency dates to Justice Story's opinion in *Wood v. Drummer*, 30 F. Cas. 435, #17,944 (1824). That case involved the

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<sup>1</sup>These points are explained in greater detail in the excellent article by Prof. Markell, The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors, 6 J. Bankr. L. & Prac. 403 (1997).

liquidation of a banking corporation. During the course of winding up the affairs of the company, substantial dividends were paid to the shareholders. When the remaining assets turned out to be insufficient to pay the debts in full, the unpaid creditors sued. Under the general rule, upon liquidation of a corporation creditors should be paid in full before shareholders receive a return on their investment. Justice Story reasoned that the capital of the corporation was a "trust fund" for the creditors and permitted them to use the trust doctrine of tracing to recover the dividends paid to the shareholders. The *Wood* theory subsequently fell into disuse because corporate statutes and fraudulent conveyance law provided a more direct theory for the recovery of improperly paid dividends.

However, in recent years, the *Wood* trust fund theory has been revived and used as the doctrinal basis for imposing on the directors and officers of insolvent corporations fiduciary duties that are owed to creditors. The influential courts of Delaware have been leaders in this trend. For example, in *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992), the Court began by reciting the general rule that "directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . ." The Court went on to note that one of those "special circumstances" was "insolvency." The remaining question for the Court was whether the "insolvency" exception was limited to situations involving an insolvency or dissolution proceeding, or whether it extended to situations where the corporation was merely insolvent in fact. Opting for the later interpretation, the Court stated, "I find that Delaware case law, primarily, and the ordinary meaning of the word insolvency, secondarily, require me to hold that fiduciary duties to creditors arise when one is able to establish the fact of insolvency."

This holding creates a difficult situation for officers and directors, and by extension, for attorneys representing insolvent entities. The first problem is that the courts have yet to spell out the precise nature of the fiduciary duties owed to creditors. Indeed some commentators take the view that this budding theory is not really a general rule imposing fiduciary duties; but rather that the fiduciary duty language is being used to establish specific duties that arise in particular circumstances. However, to the extent that fiduciary duties are imposed, the officers and directors are placed in a situation involving hopeless conflicts of interest. In a financially sound corporation the interests of the shareholders and creditors may be congruent. However, those interests are likely to be most diverse when the company is financially distressed.

One solution to this conflict would be to say that upon insolvency the fiduciary duties owed to shareholders are extinguished and replaced by the fiduciary duties owed to creditors. However, the problem here is in determining when that point is reached. The flipping point for the duties is easy to determine if the rule is limited to insolvency or dissolution proceedings. However, if the fact of insolvency is the critical event, then several problems emerge. First, as a practical matter, it may be very difficult to determine when a state of insolvency exists. Thus, officers and directors will not know to whom their fiduciary duties are owed until long after the fact. Even more troubling is the uncertainty as to the meaning of the term insolvency. Does it refer to equitable insolvency (inability to pay debts), or to legal insolvency (liabilities exceed assets), or to some combination? [A subsequent unreported Delaware case adopts the equitable insolvency test. See *Franco-Typ-Postalia AG & Co. v. On Target Technology, Inc.*, 1998 WL 928382 (Del. Ch. Dec. 24, 1999).] The interpretive and factual problems relating to the determination of insolvency have long troubled the courts in the fraudulent transfer area.

Perhaps in answer to the uncertainty problem, an unpublished, but widely cited, Delaware case took the theory to the next logical step. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe*

*Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), reprinted in 17 Del. J. Corp. L. 1099 (1991), the Court held that fiduciary duties arise when the company "is operating in the vicinity of insolvency." At that point, "a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." While this formulation does away with the difficulty of determining the precise point of insolvency by expanding the scope of the theory, it exacerbates the problem of conflicting duties because it necessarily creates a zone in which duties are owed both to shareholders and to creditors.

The contrary line of cases reads *Wood* more narrowly. *Wood* involved the dissolution of a corporation and, if restricted to its facts, stands for the proposition that directors owe duties to creditors upon the commencement of a dissolution or insolvency proceeding. See, e.g., *Henry I. Siegel Co. v. Holliday*, 663 S.W.2d 824 (Tex. 1984); Markell, *supra* at 408.

It is unclear whether Kentucky law recognizes the fiduciary duty theory. Older cases clearly adopt the trust fund view, that an insolvent corporation owes a fiduciary duty to its creditors, at least to the extent of prohibiting distributions to shareholders before all debts are paid. As the Court stated in *Louisville Banking Co. v. Etheridge Mfg. Co.*, 19 Ky. L. Rep 908, 43 S.W. 169, 171 (Ky. App. 1897):

Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, places the property in the condition of a trust, first for the creditors, and then for the stockholders. Whatever of trust there is arises from the peculiar and diverse equitable rights of the stockholders, as against the corporation, in its property, and their conditional liability to its creditors. It is rather a trust in the administration of the assets after possession by a court of equity, than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder.

Some of the older Kentucky cases even contain language asserting that the directors of an insolvent corporation owe fiduciary duties to creditors. For example, in *Marksberry v. First Nat'l Bank of Owensboro*, 194 Ky. 401, 239 S.W. 461, 465 (Ky. App. 1922), the Court quoted the following language from a Louisiana case, "The directors of a corporation are trustees, and its creditors, like the stockholders, are the cestui que trust. On account of that fiduciary relation of the directors to the corporation and to its creditors, the directors are under a certain moral obligation to see that its creditors are paid."

However, one of the clearest statements of this proposition, and one that relies upon Justice Story's analysis, comes from the dissenting opinion in *Blake v. Ray*, 110 Ky. 705, 23 Ky. L. Rep. 84, 62 S.W. 531, 535 (Ky. App. 1901) (O'Rear, dissenting):

But, it is argued, the director is only the trustee of the stockholders of the corporation, and unless they see proper to avoid his act no one else can complain. This was the original doctrine. To Mr. Justice Story, to whom the American people owe so much for the enrichment and enlargement of our equity jurisprudence, are we indebted for the extension of the principle of the trusteeship of the director to the interests of the creditor of the corporation as well as to its stockholders. *Thomp. Corp.* S 4150. In one sense of the word, the assets of a corporation, especially of an insolvent one, are a trust fund, set apart, first, for the payment of its debts, and then for distribution of the surplus among its stockholders. *Thomp. Corp. Id.* The director must, of necessity, exercise the conscience, as it were, of the debtor, and conserve its property to the end of the trust imposed upon it. *Bent v. Priest*, 86 Mo. 475. This doctrine that the director is a trustee for the creditors as

well as for the stockholders of the corporation has long been recognized and frequently applied in this state. *Gratz v. Redd*, 4 B. Mon. 178 (1843); *Widrig & Co. v. Newport St. Ry. Co.*, 82 Ky. 511 (1885); *Coal Co. v. Lotspeich (Ky.)* 20 S. W. 377; *Railroad Co. v. Bowler's Heirs*, 9 Bush. 468.

The more restrictive interpretation of the *Wood* theory – that it is limited to corporate dissolution – appears to have been adopted in an older Kentucky bankruptcy case. In *In re Federal Coal Co.*, 31 F.2d 375, 378 (E.D. Ky. 1927), the Court stated:

It is, we think, the result of the cases that when a private corporation is dissolved or becomes insolvent, and determines to discontinue the prosecution of business, its property is thereafter affected by an equitable lien or trust for the benefit of creditors. The duty in such cases of preserving it for creditors rests upon the directors or officers to whom has been committed the authority to control and manage its affairs. Although such directors and officers are not technical trustees, they hold, in respect of the property under their control, a fiduciary relation to creditors; and necessarily, in the disposition of the property of an insolvent corporation, all creditors are equal in right unless preference or priority has been legally given by statute or by the act of the corporation to particular creditors.

While the idea that an insolvent corporation owes fiduciary duties to its creditors continues to appear in more recent Kentucky cases, the principle that directors also owe fiduciary duties to creditors appears to have fallen into disuse

A recent unpublished Sixth Circuit Court of Appeals decision interpreting Kentucky law concluded that the Kentucky cases do not go so far as to impose on directors a fiduciary duty to creditors. Rejecting the argument that the director's obligation to creditors was a non-dischargeable debt under the section 523(a)(4) "defalcation in a fiduciary capacity" exception to discharge, the Court analyzed the scope of a director's duties under Kentucky law. The Court stated:

Peoples Bank's central argument, which the District Court adopted, was that Kentucky common law creates a trust whenever a corporation is insolvent, and that a director of the corporation then owes a fiduciary duty not to make payments to shareholders to the detriment of the insolvent corporation's creditors. We find that Peoples bank has failed to establish that, under Kentucky Law, the assets of an insolvent corporation form the res of a trust fund that the directors of the insolvent corporation hold in trust for their creditors. *The cases upon which Peoples Bank relies fail to establish more than the principle that an insolvent corporation owes fiduciary duties to its creditors.* In *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166, 168 (Ky.1974), Kentucky's highest court recognized that a fiduciary relationship exists between a corporation and one of its directors, based on "[t]he position of trust, the freedom of decision, and access to confidential corporate information" enjoyed by the director . . . These cases may recognize that a corporation has fiduciary duties to its creditors, but they fall far short of creating the type of clearly defined trusts that existed in *In re Johnson*, 691 F.2d at 252-53, and in *In re Interstate Agency, Inc.*, 760 F.2d at 124- 25. The mere recognition that an insolvent corporation or one of its directors owes a fiduciary obligation to the corporation's creditor's does not create an actual trust fund, as is required by § 523(a)(4). *Peoples Bank & Trust Co. v. Penick (In re Penick)*, 149 F.3d 1184 (table), 1998 WL 344039 (6<sup>th</sup> Cir. 1998) (emphasis added).

However, even if the current Kentucky authority does not yet recognize the Delaware-type fiduciary obligations, it appears that no recent Kentucky reported decision has yet addressed the precise issues raised in the recent Delaware cases. Neither the *Geyer* nor *Credit Lyonnais* opinions have been cited in any Kentucky or Sixth Circuit cases. Thus, it remains to be seen whether the current trend will be adopted in Kentucky.

Even if the Kentucky courts reject the fiduciary theory, the issue will still present problems for Kentucky attorneys representing financially troubled corporations. Many corporations are incorporated under the laws of Delaware. For these corporations, and for corporations incorporated in states following the Delaware trend, the directors will owe fiduciary duties to creditors.

Needless to say, the problems that fiduciary duty theory creates for officers and directors spills over to create problems for attorneys representing financially troubled entities. In addition to potential liability for conspiracy to breach fiduciary duties, the lawyer for a fiduciary may owe direct duties to the beneficiary of the fiduciary relationship.

#### DIP Counsel's Fiduciary Duties to Creditors in Bankruptcy

Of the many problems facing counsel for a Debtor-in-Possession [DIP], one of the thorniest theoretical problems is the conflict between the DIP's fiduciary obligation to the bankruptcy estate and the Debtor's interest in minimizing the plan's payout to unsecured creditors. This problem is compounded in the typical corporate Chapter 11 case by the fact that a corporate debtor can speak only through an authorized representative. Thus, while the client is the corporation that is the Debtor and DIP, the attorney must take his/her instructions from an individual who is merely a constituent of that organization. That individual's personal interest as a shareholder or manager of the debtor may well be at odds with the interests of the debtor entity, and almost certainly will be in conflict with the interests of other parties to the reorganization, such as the unsecured creditors.

Unfortunately, this already difficult conundrum was turned into an almost impossible dilemma by the 1988 decision of *In re Kendavis Industries International, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988). That decision looked through the form of the DIP's attorney's relationship and held that where the attorney's efforts were designed to advance the interests of the DIP's controlling shareholders/management, the attorney ceased to be "disinterested" and had a disqualifying conflict of interest.

Despite all of the sound and fury that followed the *Kendavis* decision, it appears to have more bark than bite. Although numerous cases cite *Kendavis*, and some actually apply it, the theory generally has been rejected in cases involving only a modest degree of shareholder/management self interest.

Judge Clark's opinion in the case of *In re Office Products of America, Inc.*, 136 B.R. 983 (Bankr. W.D. Tex. 1992), took much of the sting out of *Kendavis*. There the Court limited the *Kendavis* theory to extreme cases. The *Office Products* Court instead focused on the "benefit" provided to the estate by the legal services. *Office Products* is the classic example of more elegant solution provided by §330. In applying the "benefit" analysis, the Court also gave the DIP's attorney substantial leeway to zealously represent the entity client without putting the fee award at risk. Recognizing the reorganization policy of the Code, the Court focused on whether and when the attorney knew or should have known that the Debtor's plan could not satisfy the

Code's confirmation standards.

In addition, the case of *In re Spanjer Bros., Inc.*, 191 B.R. 738, 754-55 (Bankr. N.D. Ill. 1996), rejected a *Kendavis* argument that was based on the allegation that DIP's counsel had ignored the interests of the Debtors in favor of the interests of the shareholders. Neither the fact that the attorney took his instructions from management, nor the fact that management and equity interests were benefited by the attorney's opposition to the appointment of a Trustee, were sufficient.

Interestingly, most of the recent citations to *Kendavis* relate to other issues discussed in that opinion. The case is only rarely cited for the *de facto* conflict holding, and even then few cases adopt the absolutist tone of the opinion. Thus, it appears that the *Kendavis* holding is quietly fading into nothing more than an exceptional remedy that is available in a rare and exceptional case of overreaching by management/equity.

Unfortunately, as *Kendavis* fades away, *Rivers* and *CF Holding* raise a new challenge based on fiduciary theory, rather than "disinterestedness" and conflict of interest. As stated in *Rivers*:

The unique circumstances which surround insolvency and the filing of a Chapter 11 case place the attorney for the debtor in possession in the unusual position of *sometimes owing a higher duty to the estate and the bankruptcy court than to his client*. In fact, the status of the client and the attorney may often overlap in a Chapter 11 case, as the debtor's attorney must take conceptual control of the case and provide guidance for management of the debtor, not only to discern what measures are necessary to achieve a successful reorganization, but to assure that, in so doing, compliance with the Bankruptcy Code and Rules is sought rather than avoided. Debtor's attorney's duty as fiduciary of the estate requires an active concern for the interests of the estate and its beneficiaries.

*In re Rivers*, 167 B.R. 288, 300 (Bankr. N.D. Ga. 1994) (emphasis added), *citing*, *In re Consupak, Inc.*, 87 B.R. 529 (Bankr. N.D. Ill. 1988), and *In re Whitney Place Partners*, 147 B.R. 619, 620-21 (Bankr. N.D. Ga. 1992). This view has been restated in more recent cases. *See, In re Delta Petroleum (P.R.), Ltd.*, 193 B.R. 99, 110-111 (D. P.R. 1996); *In re Harp*, 166 B.R. 740, 746-748 (Bankr. N.D. Ala. 1993).

The fiduciary duty theory often arises from loose and ill-considered language in opinions. For example, in the Tenth Circuit, the theory began innocently enough in the case of *In re Interwest Business Equipment, Inc.*, 23 F.3d 311, 317 (10<sup>th</sup> Cir. 1994). There the Court stated that the debtor in possession and trustee owe fiduciary duties to the estate. Three years later, the Tenth Circuit Bankruptcy Appellate Panel picked up on that statement and distorted it into a fiduciary duty owed by the attorney for the debtor in possession. In *Smitty's Truck Stop, Inc.*, 210 B.R. 844, 850 (10<sup>th</sup> Cir. B.A.P. 1997), the Court cited *Interwest* for the proposition that, "Because of the unique nature of the bankruptcy estate, the debtor in possession is considered a fiduciary of that estate." The Court then went on to state, without any analysis, that, "For the same reason, courts have imposed a fiduciary duty upon counsel for the debtor in possession." The Panel then stated, "This duty requires the attorney to exercise independent professional judgment on behalf of the estate." Having stretched the law in order to find a fiduciary duty owed to the estate by the debtor in possession's attorney, the Panel used its new theory to accomplish a goal much more easily accomplished through proper use of existing provisions of the Bankruptcy Code and Rules. The upshot of the Panel's analysis was the unsurprising holding that the attorney has "the duty to disclose any actual or potential conflicts of interest with the

estate.” Unfortunately, the Panel’s use of a fiduciary duty theory to reach that result distorts the attorney-client relationship and creates much potential for mischief.

The fiduciary duty theory was also adopted by the Bankruptcy Appellate Panel for the Second Circuit in *Zeisler & Zeisler, P.C. v. Prudential Ins. Co. of Am. (In re JLM, Inc.)*, 210 B.R. 19, 26 (2d Cir. B.A.P. 1997). There the Court engaged in an analysis of the role of counsel and held that because of the debtor in possession’s duties to creditors, “counsel for the debtor in possession has fiduciary obligations not ordinarily foisted upon the attorney-client relationship.”

As a result, the attorney for a defalcating debtor “may not simply resign where the client refuses the attorney’s advice concerning the client’s fiduciary obligations to the estate and its creditors. Counsel must do more, informing the court in some manner of derogation by the debtor in possession.”

In *Rivers*, the Court recognized a duty for DIP’s counsel to advise the Court and the U.S. Trustee that an individual Chapter 11 Debtor was not capable of performing his obligations as DIP. In *CF Holding*, the Court imposed a duty on DIP’s counsel to disclose “to the creditor body and the Court” the potential conflicts of interest of another professional. *In re CF Holding Corp.*, 164 B.R. 799 (Bankr. D. Conn. 1994). While the *Rivers* case, and possibly the *CF Holding* case, could be viewed as exceptional cases, the more extreme application of the theory had already been expressed in the case of *In re James Contracting Group, Inc.*, 120 B.R. 868, 873-874 (Bankr. N.D. Ohio 1990). There, the Court held, “The [DIP’s] attorney, as an officer of the court, has a duty to notify both the U.S. Trustee and the court whenever it becomes evident that a reorganization is unlikely to succeed.” *See also, In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840, 848 (Bankr. S.D. Ill. 1993) (DIP’s counsel has a duty to bring the DIP’s breach of its fiduciary duties to the attention of the Court).

The *James Contracting* Court relied on *In re Blue Top Family Restaurant, Inc.*, 110 B.R. 777 (Bankr. W.D. Pa. 1990), which had recognized a fiduciary duty on the part of the DIP’s counsel to refrain from pursuing a hopeless reorganization. *Blue Top* did not impose a duty to disclose on the DIP’s counsel. However, the Court’s confusion about the DIP’s attorney’s ethical obligations, and a hint of the mischief that might lie ahead, is evident in the Court’s statement that:

Counsel filing cases in this court on behalf of debtors, in order to obtain the relief and protection accorded by the Bankruptcy Code, *stand in a fiduciary relation to their clients, the prepetition creditors and the postpetition creditors*; inflicting further damage on those parties is a violation of that fiduciary duty.

110 B.R. at 777-778 (emphasis added).

While other cases do not so blatantly confuse the issue of who is the client, numerous cases recognize a fiduciary duty owed by the DIP’s attorney to either the estate or its non-client beneficiaries. *See, e.g., In re El San Juan Hotel Corp.*, 149 B.R. 263, 272 (D. P.R. 1992), *aff’d*, 7 F.3d 218; *In re Chicago Art Glass, Inc.*, 155 B.R. 180, 185 (Bankr. N.D. Ill. 1993); *In re Black Hills Greyhound Racing Ass’n*, 154 B.R. 285, 295 (Bankr. D.S.D. 1993); *In re Prudent Holding Corp.*, 153 B.R. 629, 631 (Bankr. E.D.N.Y. 1993); *In re Doors and More Inc.*, 126 B.R. 43, 44 (Bankr. E.D.Mich. 1991); *In re Grabill Corp.*, 113 B.R. 966, 970 (Bankr. N.D. Ill.), *aff’d*, 135 B.R. 835 (N.D. Ill. 1991); *In re Coastal Equities, Inc.*, 39 B.R. 304, 309 (Bankr. S.D. Cal. 1984); *C.f. Everett v. Perez (In re Perez)*, 30 F.3d 1209, 1219 (9<sup>th</sup> Cir. 1994) (stating that client is the estate, not the debtor, and that counsel has responsibility to determine whether proposed actions are likely to benefit estate, rather than debtor).



Only the first hints of this theory have appeared in the opinions of the Kentucky Bankruptcy Courts and the Sixth Circuit Court of Appeals. Although the Courts have set the stage for this theory by using the term "fiduciary" loosely, they have not yet relied upon the fiduciary language to create new duties for attorneys. In *Mapother & Mapother, P.S.C. v. Cooper (In re Downs)*, 103 F.3d 472 (6<sup>th</sup> Cir. 1996), the Court was faced with a clear and intentional violation by an attorney of the duty to disclose his fee arrangement under section 329 and Bankruptcy Rule 2016. However, although the Court could deny compensation to the attorney without finding any fiduciary duties, the Court instead used loose fiduciary duty language to bolster its analysis. Thus, the Court began its analysis by stating that "[T]he bankruptcy court is vested with the inherent power to sanction attorneys for breaches of fiduciary obligations." *Id.* at 477. The Court then equated the attorney's statutory disclosure duties with a fiduciary obligation, stating, "[T]he bankruptcy court should deny all compensation to an attorney who exhibits a willful disregard of his fiduciary obligations to fully disclose the nature and circumstances of his fee arrangement under § 329 and Rule 2016." *Id.* at 479. Finally, the Court states, "Section 329 and Rule 2016 are fundamentally rooted in the fiduciary relationship between attorneys and the courts." *Id.* at 480. Thus, although *Downs* imposed no duties beyond those expressly stated in the Code and Rules, it appears to recognize a fiduciary relationship between the attorney and the Bankruptcy Court.

Similarly, the Kentucky Bankruptcy Court decision in *In re Allied Computer Repair, Inc.*, 202 B.R. 877 (Bankr. W.D. Ky. 1996), recognized a fiduciary duty owed to the estate by the attorney for the trustee. In deciding whether the attorney was entitled to compensation for pursuing litigation of questionable benefit to the estate, the Court used fiduciary duty language. The Court stated, "[C]ounsel for the estate does bear a fiduciary duty to the estate which requires counsel to exercise a certain degree of judgment in deciding what matters of litigation to pursue." *Id.* at 886. Amplifying the duty, the Court stated, "The attorney, in his or her fiduciary capacity, bears not only a duty to conserve the estate's net assets, but to 'maximize the value of the estate ...'" *Id.* at 887.

Is there an *Office Products* type of decision that can provide a path out of the fiduciary duty swamp? Although still lonely voices in the wilderness, two cases provide hope. The case of *In re Sidco, Inc.*, 173 B.R. 194 (E.D. Cal. 1994), rejected the fiduciary obligation theory and refocused the inquiry. The Court stated:

The authorities cited by appellant to create a fiduciary duty of counsel to the estate is [sic] very weak. These non-binding cases speak of the attorney's fiduciary duty to the estate in unusual contexts, and not as a general principle. [Citations omitted.] These cases do not overthrow Judge Dorian's basic tenet that attorneys for debtors-in-possession have a fiduciary duty to their client, the debtor-in-possession, not to the creditors and shareholders whose interests may be adverse to the debtor. In fact, 11 U.S.C. § 327 guards against concurrent representation of both the creditor and a debtor-in-possession.

Furthermore, it is the debtor-in-possession who ultimately manages the creditors' and shareholders' interests, while the attorney only advises the debtor. The debtor-in-possession, not the attorney, acts as the trustee to the estate.

173 B.R. 196-97.

Further support for the *Sidco* view comes from the ABA's 1994 formal ethics opinion #94-380. That opinion dealt with the question of whether the fact that the lawyer's client is a fiduciary alters the lawyer's basic ethical obligations. The opinion addresses the duties of a

lawyer who represents a fiduciary in a trust or estate matter. The opinion states, in part:

When the fiduciary is the lawyer's client, all of the Model Rules prescribing a lawyer's duties to a client apply. . . The fact that the fiduciary client has obligations toward the beneficiaries does not impose parallel obligations on the lawyer, or otherwise expand or supersede the lawyer's responsibilities under the Model Rules of Professional Conduct.

ABA Comm. on Ethics and Professional Responsibility, Formal Op. 94-380 (1994). With respect to the issue of disclosing the client's fiduciary breaches to the court, the opinion states:

A lawyer's duty of confidentiality to a client is not lessened by the fact that the client is a fiduciary. Although the Model Rules prohibit the lawyer from actively participating in criminal or fraudulent activity or active concealment of a client's wrongdoing, they do not authorize the lawyer to breach confidences to prevent such wrongdoing.

\* \* \*

. . . Clients may owe some duty to third parties, whether it be statute or common law-based. These clients do not, by virtue of retaining a lawyer, impliedly authorize the lawyer to breach confidences to protect third parties.

Perhaps the most promising authority is the recent case of *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434 (D. Utah. 1998). There the Court brought both the *Sidco* analysis and the ABA opinion together. The Court began by noting that the fiduciary duty theory "reflects a relatively recent development in bankruptcy law which is curiously undefined." *Id.* at 448. The Court proceeds to deconstruct the theory into two different theories. One is based on the view that the estate is the client, while the other is based on the view that the attorney's fiduciary duties are derivative of the client's fiduciary duties. Relying on *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S.Ct. 1188 (1984), the Court holds that the estate is not a legal person, but merely a collection of property interests. *Id.* at 451. Thus, the estate cannot be a client and the "estate as client" view cannot support the theory. Turning next to the derivative duty theory, the Court first examines the Bankruptcy Code to determine that it nowhere imposes bankruptcy-unique fiduciary duties on counsel for the debtor in possession. Those duties are imposed by the Code only on the debtor in possession. Thus, if the attorney has such duties they must be derivative of the client's duties. Completing the analysis, the Court turns to the ABA formal opinion to conclude that the fact that the client owes fiduciary obligations does not impose parallel obligations on the attorney. *Id.* at 461.

As noted in the ABA opinion, some state's ethics rules impose disclosure duties on attorneys that are different from the model rule. A review of the Kentucky version of Rule 1.6 shows that the Kentucky ethics rules do not permit or require disclosure of past defalcations by the debtor in possession.

The Kentucky Supreme Court Rule 3.130, Rules of Prof. Conduct, Rule 1.6 reads as follows:

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b).

(b) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

(1) To prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm; or

(2) To establish a claim or defense on behalf of the lawyer in a controversy

between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(3) To comply with other law or a court order.

Clearly, neither exceptions (b)(1) or (b)(2) apply to the likelihood that a reorganization will not succeed or to a mere breach of a fiduciary obligation, especially a past breach. Further, exception (b)(3) should not apply since there is no specific Bankruptcy Code provision mandating disclosure. The Kentucky comments make clear that while a provision of some non-ethics law may supersede Rule 1.6, "a presumption should exist against such a supersession." *See Kentucky Commentary, Para. 21.*

The Kansas comments confirm the distinction between past conduct and future action. While a lawyer may not assist the client in conduct that is criminal or fraudulent under Rule 1.2, that rule is not violated where the lawyer was innocently involved in past conduct by the client that was criminal or fraudulent. The Kentucky comment states, "If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1)." *Kentucky Commentary, Para. 15.* Even after withdrawal, "the lawyer is required to refrain from making disclosure of the client's confidences." However, the lawyer may give notice of the fact of withdrawal and may "withdraw or disaffirm any opinion, document, affirmation, or the like." *Kentucky Commentary, Para. 16.*

Thus, the proper course for the attorney in a case where the debtor in possession refuses to follow the attorney's advice regarding its fiduciary duties is to attempt to withdraw. The notice of withdrawal and the attorney's disaffirmance of prior actions, if appropriate, should be adequate to alert the Court, U.S. Trustee, and Creditor's Committee of the need for investigation. The Courts should require no more of bankruptcy attorneys.

**UPDATE ON PROFESSIONAL RESPONSIBILITY  
IN BANKRUPTCY**

**Gerald K. Smith  
Lewis and Roca LLP  
Phoenix, Arizona**



# UPDATE ON PROFESSIONAL RESPONSIBILITY

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## UPDATE ON PROFESSIONAL RESPONSIBILITY

By  
Gerald K. Smith, Esq.<sup>1</sup>

### I. Introduction.

#### A. Where We Are.

##### 1. Federal Standards.

The Bankruptcy Code provides inconsistent, incoherent, and incomplete guidance as to when professionals may be employed.<sup>2</sup> Even a cursory review of the statutory terrain makes this apparent. Perhaps most surprising, the standard for the employment of professionals by a disinterested trustee of professionals is stricter than the standard for the appointment of the disinterested trustee. Sections 701(a)(1) and 1104(d) of the Bankruptcy Code require that a trustee appointed by the U.S. Trustee in a liquidation or reorganization case be disinterested. In contrast, under § 327(a), a professional employed by the disinterested trustee must be disinterested and cannot hold or represent an adverse interest. The only exception is employment for a special purpose under § 327(c). Although the disinterestedness standard requires that the trustee not have interests materially adverse to the interests of the estate, any class of creditors, or any class of equity security holders, the adverse interest must be materially adverse, not simply adverse as required by § 327(a).

Section 327(a) provides that a trustee may employ professional persons "that do not hold or represent an interest adverse to the estate, and that are disinterested persons . . ." A disinterested person is defined in § 101(14) of the Bankruptcy Code. The definition consists of a

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<sup>1</sup> I am a Conferee of the National Bankruptcy Conference and Chair of its Ethics Committee. I was until September of 1999 a Member, Advisory Committee on Rules of Bankruptcy of the Judicial Conference of the United States and Chair of its Subcommittee on Rule 2014 Disclosure Requirements; Member, Ethics Working Group of the National Bankruptcy Review Commission; and Former Chair of the Ethics Subcommittee of the Business Bankruptcy Committee of the Business Section of the American Bar Association. In addition to the foregoing "connections," in keeping with the admonition of Justice William O. Douglas, I make the following disclosures. I am involved in a general practice, which includes commercial litigation and bankruptcy matters. From time to time, I represent trustees, debtors-in-possession, creditors' committees, secured creditors, unsecured creditors, and other parties-in-interest in bankruptcy cases. For more than ten years, I have been involved in efforts to improve employment standards, disclosure standards and employment procedures in bankruptcy cases. I have written and lectured on these matters and, as a result, I am undoubtedly biased in favor of the views I have come to hold over the years. I have also been involved in a few disqualification disputes, one of the more interesting of which is discussed in Gerald K. Smith, *Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases*, 48 S.C. L. Rev. 793, 863-65, 878-80 (1997). Although I have no client relationship in connection with this Article, I bring these matters which may have influenced my views to the attention of the reader. The views stated herein are not necessarily those of Lewis and Roca or any of the committees or organizations I am, or have been, associated with.

<sup>2</sup> The current Bankruptcy Rules provide no guidance other than that relating to employment of relatives of, and those having certain connections with, judges and the U.S. Trustees. Bankruptcy Rule 5002. For approximately eight years prior to 1983, the Rules did regulate employment in liquidation, reorganization and arrangement cases. See p. 13 *infra*.



series of provisions found in §§ 101(14)(A-D) specifying a number of relationships which existed at or before the filing date of the bankruptcy case. But § 101(14)(E) is general and disqualifies anyone with “an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker or for any other reason.”<sup>3</sup> Without furnishing any supporting authority, the Jones/Zywicki Memorandum and the article by Professor Zywicki assert that judges read materiality out of § 101(14)(E) by importing the “no adverse interest” requirement of § 327(a) into § 101(14)(e), and that “[a]s a result, the term ‘disinterested’ has come to be understood to refer to any *interest adverse to the estate, creditors, or the debtor, regardless of materiality.*”<sup>4</sup> It is puzzling why this “importation” argument is made since the “no adverse interest” standard of § 327(a), which is clearly applicable, applies to personal as well as representational interests and is not qualified by materiality,<sup>5</sup> although § 327(c) provides that under the Bankruptcy Code, representation of or employment by a creditor is not disqualifying,<sup>6</sup> absent an objection by a creditor and a finding by the court that the representation or employment creates an “actual conflict of interest.”

Under the definition in § 101(14), a person is not disinterested simply because of the representation of the debtor prior to the filing of the bankruptcy case. Nonetheless, § 327(e) continues to allow the trustee to employ, for a special purpose, an attorney who represented the debtor, if the attorney “does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.”<sup>7</sup> The draftsman altered the definition of disinterestedness in Chapter X of the Bankruptcy Act by deleting the *per se* prohibition of employment of prepetition debtor counsel by the trustee. Why this occurred is uncertain. The result is that prepetition counsel for the debtor is disqualified only if the court finds that this is an adverse interest under the particular facts. Section 1107(b) expressly so states as to the representation of the debtor-in-possession.

Extreme complexity and considerable duplication result from the addition of “insider” to the list of *per se* disqualifications resulting from the definition of disinterestedness.

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<sup>3</sup> For a general discussion of these provisions, see Gerald K. Smith, *supra* note 16, at 794-826.

<sup>4</sup> Zywicki, *supra* note 1, at 6; Jones/Zywicki Memorandum at 2-3.

<sup>5</sup> The “no adverse interest” standard includes both personal and representational interests, while § 101(14)(E) literally includes only personal interests or interests held.

<sup>6</sup> Section 327(e) allows the trustee to employ an attorney who has represented the debtor for a special purpose, “if such attorney does not represent or hold an interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.” This provision is meaningful only if § 327(a) precludes a trustee from employing prepetition counsel for the debtor. However, the draftsman deleted this prohibition against the employment of counsel for the debtor contained in the Bankruptcy Act and the pre-1983 Chapter X Bankruptcy Rules from the definition of disinterestedness in the 1978 Code. Perhaps the draftsman believed debtor’s prepetition counsel should be disqualified, if at all, only if counsel represented or had an adverse interest under § 327(a).

<sup>7</sup> Section 158 of the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, as amended by the Chandler Act of 1938, Act of July 22, 1938, ch. 575, 52 Stat. 840 (“Bankruptcy Act”).

Where several affiliated corporations have bankruptcy cases pending, Bankruptcy Rule 1015(b) provides for joint administration of affiliate cases. The court is directed to "give consideration to protecting creditors of different estates against potential conflicts of interest." If joint administration is ordered, Bankruptcy Rule 2009 contemplates the possibility of creditors electing a single trustee or, in the absence of an election, the appointment of a single trustee by the U.S. Trustee. Under Rule 2009(d), a creditor or equity security holder of one or more of the estates may seek the appointment of separate trustees if the requesting party-in-interest can establish that creditors or equity security holders of the different estates will be prejudiced by conflicts of interest of a common trustee. However, in a number of situations it will be impossible to use a single trustee. Even if a trustee of a parent is not considered an equity security holder of a subsidiary on the basis that the stock is owned in a fiduciary capacity, the trustee of the parent would be in control of the subsidiary and therefore, an insider under § 101(31)(B)(iii) and not disinterested under § 101(14)(A). Furthermore, upon appointment as trustee of the subsidiary, the trustee would no longer be disinterested as far as the parent's case is concerned since § 101(2)(B) provides that the subsidiary is an affiliate of the parent, and therefore, under § 101(31)(E), since the trustee would be in control of the affiliate, the trustee would be an insider under § 101(31)(E) and therefore not disinterested under § 101(14)(A).

In a major drafting gaff, the phrase "of the debtor" no longer qualifies creditor or equity security holder. The draftsman is to be forgiven, however, since the "appearance concept" was abandoned. This should lead courts to the conclusion that there has to be a materially adverse interest, rather than the appearance of one, but it has been overlooked in the cases as well as ignored by Professor Zywicki.<sup>8</sup> Finally, there was added to § 101(14)(E) the phrase "interests of the estate," which causes added confusion concerning the determination of a conflict or adverse interest and the duties of counsel.<sup>9</sup>

As far as professionals to be employed by the debtor-in-possession, the only mention of the subject is found in § 1107(b), which provides that a person is not disqualified for employment under § 327(a) by a debtor-in-possession solely because of employment by or representation of the debtor before the commencement of the case. As pointed out above, this provision of § 1107(b) was not necessary because of the deletion of attorney for the debtor from § 101(14)(D).<sup>10</sup> The leading treatise on bankruptcy concluded that § 1107(b) evidenced an intent that professionals employed by the debtor-in-possession need not be disinterested.<sup>11</sup>

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<sup>8</sup> E.g., *In re Roberts*, 46 B.R. 815 (Bankr. D. Utah 1985). *Contra In re Creative Restaurant Management, Inc.*, 139 B.R. 902 (Bankr. W.D. Mo. 1992). As pointed out in *In re Creative Restaurant Management, Inc.*, Canon 9 of the Code of Professional Responsibility was abandoned in the Model Rules of Professional Conduct. The Comment to Rule 1.10 of the Model Rules of Professional Conduct states that the reason for the abandonment was that the appearance of impropriety test was too subjective and it was question begging since impropriety itself was undefined. Undoubtedly the appearance of impropriety provision was dropped from the disinterestedness standard for similar reasons in the 1978 Reform Act.

<sup>9</sup> 11 U.S.C. § 101(14)(E) (1993 and Supp. 1997).

<sup>10</sup> Bankruptcy Code § 101(14)(D) provides:

(14) "disinterested person" means person that –

Loose drafting also characterizes the statutory provisions regulating the employment of an attorney or accountant by an "official" committee. Section 1103(b) of the Bankruptcy Code precludes representation in the same case of "conflicting interests," but adds that representation of a creditor of the class represented by the "official" committee is not necessarily an adverse interest:

an attorney or accountant employed to represent a committee appointed under § 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not *per se* constitute the representation of an adverse interest.<sup>12</sup>

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....

(D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph[.]

Bankruptcy Act § 158 provided:

A person shall not be deemed disinterested, for the purposes of section 156 and section 157 of this Act, if –

....

- (3) he is, or was within two years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter[.]  
*Compare Krovit, Gan & Weber v. Michel (In re Crivello)*, Bankr. Case No. 97-1646 (7<sup>th</sup> Cir. 1998) with *Michel v. Federated Department Stores, Inc. (In re Federated Department Stores, Inc.)*, 44 F.3d 1310 (6<sup>th</sup> Cir. 1995).

Chapter X Rule 10-202(c)(2)(C) of the 1979 Bankruptcy Rules provided:

- (2) A person shall not be deemed disinterested if ... (C) he is, or was within 2 years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter[.]

Part 2, 1979 *Collier Pamphlet Edition*, p. 509.

<sup>11</sup> 5 *Collier on Bankruptcy*, *supra* note 15.

<sup>12</sup> Section 1103(b).

There is no requirement that the counsel or accountant for the committee be disinterested or not hold or represent an adverse interest since § 327 does not apply. However, § 328 of the Bankruptcy Code states that

the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section . . . 1101 . . . if, at any time during such professional person's employment under section . . . 1103 . . . of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interests of the estate with respect to the matter on which such professional person is employed.<sup>13</sup>

The good news is that professionals, including lawyers and accountants, can be employed by the committee even though they are not disinterested or have an adverse interest, but the bad news is that they cannot be compensated or reimbursed for expenses if they are not disinterested or have an adverse interest. So much for the adequacy of the employment provisions of the Bankruptcy Code and the Jones/Zywicki position that all is well, given some modest tuning.

## 2. State Standards.

Nothing in the Bankruptcy Code nor in the Bankruptcy Rules overrides the otherwise applicable Rules of Professional Conduct regulating the conduct of professionals employed in bankruptcy cases. It is on occasion argued that the Bankruptcy Code standards preempt state standards so that if the bankruptcy judge approves the employment of a professional under the standards set forth in § 327(a) of the Bankruptcy Code, inconsistent standards are preempted. Although not precisely on point, the Arizona Supreme Court found no preemption in *In re Neville*.<sup>14</sup> Another instance where the attorney for a Chapter 11 debtor was disciplined under the state rules was *In re Breen*.<sup>15</sup>

The matter of the application of state rules of professional conduct in federal cases is generally handled under local rules. The current status of local rules in this regard is discussed hereafter in Paragraph IV(F), Proposed Federal Rules of Attorney Conduct. Although the possibility of federal rules which would preempt certain state rules is being considered, it seems fairly clear that neither the Bankruptcy Code nor the present Bankruptcy Rules do effect any preemption.

The focus of the state rules is a little different than that of the federal standards. The federal standards seek to insure independence and adequate representation, while the state

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<sup>13</sup> Section 327. A debate is taking place in the cases, spurred on by the U.S. Trustee, as to whether this seemingly clear discretionary power is inapplicable if it is later held that the person was not disinterested or held or represented an adverse interest. The theory is that there must be a valid appointment in the first instance.

<sup>14</sup> 708 P.2d 1297 (Ariz. 1985) (*en banc*).

<sup>15</sup> 830 P.2d 462 (Ariz. 1992).

rules not only seek to do this, but also seek to protect existing clients and former clients who are parties-in-interest in a bankruptcy case. The state standards seek to preserve confidences and avoid any breach of the duty of loyalty.

The National Bankruptcy Review Commission, which is discussed in more detail at Part IV(C) hereof, did address through its Working Group on Ethics a federal rule regulating admission to practice before the bankruptcy courts. It concluded that such a rule was advisable, but eviscerated its recommendation by allowing local rules to condition admission on the hiring of local counsel. This feather-bedding rule has little justification other than to increase fees and it thereby runs directly contrary to a century of efforts on the part of Congress and the members of the Rules Committee to reduce expenses in bankruptcy cases.<sup>16</sup>

More troublesome than the extraordinary diversity of rules regulating admission to practice before the federal courts, and particular the bankruptcy court, is the incredible diversity of rules regulating conduct of attorneys. These are essential federal district court local rules or bankruptcy court local rules, or in some cases, the absence thereof, which impose standards of conduct separate and apart from those imposed by the Bankruptcy Code. As pointed out earlier, these are discussed in more detail at Part IV(F), Proposed Federal Rules of Attorney Conduct.

B. Where We Are Going.

I am not confident there will be any real progress in either Congress or the Advisory Committee on Bankruptcy Rules as far as rules governing disclosures and attorney conduct. I used to optimistically talk about rules for the Twenty-First Century. Perhaps we should talk about rules for the second half of the Twenty-First Century. The pace of change is not slow, it is nonexistent.

Perhaps most discouraging is the lack of attention given collective proceedings and bankruptcy in particular by the American Law Institute and now by the Ethics 2000 Commission of the American Bar Association. Despite clear and convincing input from Dean Rapoport, it appears that nothing of significance will be proposed as far as bankruptcy cases.

This leaves it up to the courts and the U.S. Trustee. I am equally disappointed with the Executive Office of the U.S. Trustee. As I pointed out in my most recent law review article, the Executive Director supported the position of Judge Edith Jones that no significant change in the disinterestedness standard was required. Although the Office has been vigorous in its pursuit of standardized reporting for compensation purposes, it has not even updated its manual as far as employment and disclosure requirements, let alone formulate sensible guidelines.

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<sup>16</sup> 1 Report of the National Bankruptcy Review Commission, Chapter 3: Jurisdiction, Procedure and Administration, Recommendation 3.3.4, at pp. 883-888 (October 20, 1997). The portions of the Report dealing with a national admission to practice are attached as Appendix 1.

I am not too sure the courts are much better. From time to time we have thoughtful opinions, but by and large the judges seem to be in search of a standard not fully articulated other than perhaps by Chief Judge Carolyn King in her remarks concerning the conflict rules of the Restatement (Third) of the Law Governing Lawyers. If so, there will be a dramatic change in how reorganizations are staffed. Small, specialty firms will necessarily represent trustees, examiners and debtors-in-possession. In turn, they will employ as special counsel those who have the expertise or manpower to handle special problems. Law firms of any size and those not specializing in bankruptcy matters will, in almost every case, run afoul of a literal application of the federal and state standards.

## II. How We Got Here.

### A. Pre-Code.

Prior to the early 1930's, corporate reorganizations were accomplished through the use of the equity receivership. This technique was condemned by the Protective Committee Study since it

gave complete control of the reorganization with little or no judicial oversight, to those who had resort to it, managed its initiation, and guided its subsequent stages. The not infrequent, although not invariable, result, where these persons have conflictive motives and interests, was to make this procedure an instrument of personal benefit to them, and by that token an instrument of detriment to creditors and stockholders.<sup>17</sup>

To address these concerns, the Protective Committee Study recommended an independent trustee, one free of any "interest." Only through this independent person could there be an *impartial* investigation of claims, pursuit of claims, and formulation of a plan providing for those entitled to participate in the reorganized debtor. To ensure the independence of the trustee, a bright line test – the disinterestedness standard – was formulated; this standard precluded appointment of anyone with the specified interests or relationships the Protective Committee had found troublesome.

At about the time then Commissioner and Director Douglas and his staff were concluding their work, a group of lawyers, judges, and academics, who became known as the National Bankruptcy Conference, completed a sixth draft of legislation which was introduced in the House of Representatives by Congressman Chandler.<sup>18</sup> It recast the reorganization statutes

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<sup>17</sup> Securities and Exchange Commission Report on the Study and Investigation, Personnel and Functions of Protective and Reorganization Committees: Part I, Strategy and Techniques of Protective and Reorganization Committees 29 (May 10, 1937) ("Protective Committee Study").

<sup>18</sup> In addition to the Protective Committee Study, several Congressional investigations and the reports thereof, the Sabath, Thacher and McAdoo Reports, were influential to the legislative efforts of the 1930's.

enacted in the first half of the 1930's as Chapters X, XI and XII.<sup>19</sup> "Chapter X [was] a blend of the National Bankruptcy Conference's modest suggestions for revision of § 77B and the substantial changes recommended by the Securities and Exchange Commission. The key features, participation of the Securities and Exchange Commission and the independent trustee, were the result of Commissioner Douglas' efforts."<sup>20</sup>

Independence of the trustee was to be assured by the disinterestedness standard. Commissioner Douglas also persuaded Congress that a disinterested attorney should be a concomitant of the disinterested trustee.<sup>21</sup> The trustee was to conduct an investigation and pursue claims, operate the business and formulate a plan of reorganization. As a great bankruptcy lawyer, William R. Rochelle, was fond of saying, this was all fine in theory, but it was hard to find such supermen!<sup>22</sup> However, since a management-controlled arrangement under Chapter XI became the dominant reorganization vehicle, Commissioner Douglas' creation was not much utilized.<sup>23</sup>

Until 1938, General Order 44 regulated the employment of counsel. It provided that "no attorney for a receiver, trustee, or debtor-in-possession shall be appointed" unless the court is satisfied, after adequate disclosure of "all of the attorney's connections with the bankrupt or debtor, the creditors or any other party in interest, and their respective attorneys," that "the attorney represents no interest adverse to the receiver, the trustee, or the estate in the matters upon which he is to be engaged." General Order 44 continued to apply to the employment of counsel after the 1938 Chandler Act Amendments, but Chapter X added the requirement that counsel for the independent trustee must be disinterested. However, in Chapter X cases where the debtor continued in possession, the lawyer for the debtor-in-possession only had to satisfy the requirement of General Order 44.

The present rule-making process was initiated with the promulgation of the Federal Rules of Civil Procedure in 1938. Thereafter, the process evolved into its current form which is, pursuant to enabling legislation, for the Supreme Court to promulgate rules. The

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<sup>19</sup> Chapter X evolved into

a reorganization statute which furnished much needed protection and shifted control of the reorganization process away from management and the reorganizers. This was accomplished by requiring a disinterested trustee in most cases; generally allowing all interested parties to participate in the formulation of a plan, with the disinterested trustee as the focal point; providing a source of independent advice, the Securities and Exchange Commission; and the establishment of fiduciary concepts applicable to reorganizations."

Commission Report Part I, *supra* note 20, at 243-44.

<sup>20</sup> *Id.* at 243.

<sup>21</sup> In 1975, the Chapter X Rules, Rule 10-206(a), added accountants so that they, as well as attorneys, had to be disinterested to be employed by the trustee, except for a special purpose.

<sup>22</sup> Rochelle & Balzersen, Recommendation For Amendment To Chapter X, 46 Am. Bankr. L. J. 93 (1972).

<sup>23</sup> Commission Report Part I, *supra* note 20 at 244-45.

appropriate Advisory Committee and the Reporter for the Advisory Committee draft the rules. They are circulated to bench and bar and the comments are reviewed by the Advisory Committee. Revised rules are then submitted to the Standing Committee on Rules of Practice and Procedure which reports to the Judicial Conference. The Judicial Conference then reports to the Supreme Court with its comments and, after the rules are in final form, the Supreme Court transmits the rules to Congress. In 1964 the process was made applicable to bankruptcy. The first Reporter for the newly created Rules Committee was Professor Frank R. Kennedy.<sup>24</sup> In any event, the "straight" bankruptcy rules became effective October 1, 1973 and were applicable to Chapters I-VII of the 1898 Bankruptcy Act. As Professor Kennedy pointed out in his forward to *Bankruptcy Under The New Rules of Procedure*, "under the rule-making legislation enacted by Congress, all laws that are in conflict with such rules are superseded by them as soon as the rules become effective. That means that major portions of Chapters I-VII and of Chapter XIII of the Bankruptcy Act and all but five General Orders and ten of the old official forms were superseded as of October 1 of [1973]." The Chapter XI became effective July 1, 1974 and the Chapter X rules shortly thereafter on April 28, 1975. Chapter XI Rule 11-22 concerned employment of attorneys and accountants, but simply made Bankruptcy Rule 215 applicable in Chapter XI cases "to the employment of attorneys and accountants for a trustee, receiver, debtor-in-possession or creditors' committee. . . ." Chapter X Rule 10-206 also made Bankruptcy Rule 215 applicable "to the employment, in Chapter X cases, of attorneys and accountants by a trustee, receiver, or debtor-in-possession. But the rule also required that the attorney representing the trustee "shall be disinterested as specified in Rule 10-202(c)(2). That subdivision of Rule 10-202 simply tracked the statutory definition of disinterestedness. Bankruptcy Rule 10-206 did contain the special purpose exception. Bankruptcy Rule 10-206(b) contained a more humane provision as far as the employment of an attorney who was later determined to be not disinterested. It gave the bankruptcy judge discretion to deny the allowance of compensation or reimbursement of expenses, or both, but it required not only that the attorney was not disinterested, but also that the attorney failed to disclose a material fact on the question of disinterestedness. The Chapter XII Rules, Rule 12-21, simply made applicable Bankruptcy Rule 215 in Chapter XII cases.

B. Post-1978 Code.

When the Commission on the Bankruptcy Laws of the United States proposed a consolidation of Chapters X, XI and XII of the Bankruptcy Act of 1898, it recommended a continuation of the disinterestedness standard for an attorney or an accountant employed by the trustee.<sup>25</sup> The Commission also recommended the continuance of the special purpose exception

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<sup>24</sup> For an interesting discussion of the process and its first achievement, see *Bankruptcy Under the New Rules of Procedure* published by the Institute of Continuing Legal Education of Michigan in 1974, and in particular, Chapter I thereof, an overview by Professor Frank R. Kennedy.

<sup>25</sup> Proposed Bankruptcy Act of 1973, Report of the Commission on the Bankruptcy Laws of the United States (Part II), H.Doc. 93-137, 93<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 229 (1973) ("Commission Report Part II"). Proposed § 7-109 provided that: "An attorney or accountant employed by a trustee shall be disinterested unless the administrator, when it is in the best interest of the estate, authorizes the employment for a special purpose of an attorney or an accountant who has been employed by the debtor but who represents or holds no interest adverse to the debtor or the estate in the matters on which he is engaged." *Id.* at 229. The Commission's Note 1 gave the following explanation: "This section is derived from §157 of the present Act, but the requirement of disinterestedness is imposed on accountants



of Section 157 of Chapter X. The Commission's only modification of the disinterestedness standard was adding the exception that "representation of a creditor or equity security holder, other than in the [reorganization case], does not preclude an attorney . . . from representing a disinterested trustee."<sup>26</sup> This exception was based on what was then proposed Rule 10-206(a) of the Chapter X rules.<sup>27</sup> The Commission did not recommend that the Chapter X practice be changed for counsel for the debtor in a reorganization case when a trustee was not appointed. Although expressly stated in the Commission's Proposed Bankruptcy Act of 1973, the lawyer for the debtor-in-possession only had to meet the no adverse interest standard of General Order 44 which was replaced by Bankruptcy Rule 215(a), effective by October 1973.<sup>28</sup>

As drafted by the staff of the House Judiciary Committee, the 1976 draft of the 1978 Code provided that "the Trustee . . . may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons that do not hold or represent an interest adverse to the estate, and that are disinterested persons . . ."<sup>29</sup> The draft also provided that representation of or employment by a creditor was not in and of itself sufficient to disqualify and contained the special purpose exception.<sup>30</sup>

As the drafting of the 1978 Code evolved, two important events occurred which contributed to the application of the disinterestedness standard to the employment of professionals by the debtor-in-possession. First, Congress restricted the rule-making power of the Advisory Committee on Bankruptcy Rules and deleted the provision that "all laws in conflict with such rules shall be of no further force or effect after such rules have taken effect."<sup>31</sup> As a

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as well as attorneys. The elements of disinterestedness are found in §1-102(22). That definition is derived from §158 of the present Act, but qualified so that representation of a creditor or equity security holder, other than in the Chapter VII case, does not preclude an attorney or accountant from representing a disinterested trustee. See Proposed Rule 10-206(a)." *Id.*

<sup>26</sup> *Id.*, § 102(22), at 2-3..

<sup>27</sup> Rule 10-206(a) provided:

Bankruptcy Rule 215 applies to the employment, in Chapter X cases, of attorneys and accountants by a trustee, receiver, or debtor in possession. In addition, an attorney appointed to represent a trustee shall be disinterested as specified in Rule 10-202(c)(2). Notwithstanding the foregoing, the court may, when it is in the best interest of the estate, authorize the employment for special purposes to be set out in the order, other than to represent the trustee in conducting the case, of an attorney who is not disinterested provided that such attorney represents or holds no interest adverse to the estate in the matters upon which he is to be engaged.

<sup>28</sup> Order of the Supreme Court of the United States (April 24, 1973), Part 2, 1979 *Collier Pamphlet Edition*, p. 613.

<sup>29</sup> Section 327(a).

<sup>30</sup> Section 327(c).

<sup>31</sup> Section 405(d) of the Bankruptcy Reform Act of 1978 provided that

result of the 1983 revisions to the Bankruptcy Rules, the rules regulating the employment of lawyers, Bankruptcy Rule 215, Chapter X Rule 10-206, Chapter XI Rule 11-22 and Chapter XII Rule 12-21, were abrogated, and the revised Bankruptcy Rules did not address the employment of professionals except in Rules 2014, 2016 and 5002. Second, Congress added as § 1107(b) that “notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by debtor-in-possession solely because of such person’s employment by or representation of the debtor before the commencement of the case.” This provision implied that § 327 controlled the employment of counsel for the debtor-in-possession.

The Commission on the Bankruptcy Laws of the United States did not contemplate any change in regard to the employment of counsel for the debtor-in-possession in reorganization cases. Under the Bankruptcy Act, counsel for the debtor-in-possession did not have to be disinterested. At the time the respective Subcommittees of the House and Senate Judiciary Committees were rewriting the Commission’s Proposed Bankruptcy Act of 1973, the Bankruptcy Rules regulated the employment of attorneys and accountants by trustees and debtors-in-possession.

Shortly after the Code was effective, the district court in *In re Leisure Dynamics, Inc.*,<sup>32</sup> held that the draftsman of the Bankruptcy Reform Act of 1978 departed from the Rules by providing in Section 1107 of the Bankruptcy Code as follows:

(a) Subject to any limitations on a trustee serving in a case 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.

(b) Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person’s employment by or representation of the debtor before the commencement of the case.<sup>33</sup>

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The rules prescribed under section 2075 of title 28 of the United States Code and in effect on September 30, 1979, shall apply to cases under title 11, to the extent not inconsistent with the amendments made by this Act, or with this Act, until such rules are repealed or superseded by rules prescribed and effective under such section, as amended by section 248 of this Act.

See House Report No. 595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. 449 (1977); § 247 of Title II of the Bankruptcy Reform Act of 1978.

<sup>32</sup> 33 B.R. 121 (D. Minn. 1983).

<sup>33</sup> 11 U.S.C. § 1107.

The district court found the language of § 1107 clear, but nonetheless referred to the Senate Report.

This section places a debtor in possession in the shoes of a trustee in every way. The debtor is given the rights and powers of a Chapter 11 trustee. He is required to perform the functions and duties of a Chapter 11 trustee (except the investigative duties). He is also subject to any limitations on a Chapter 11 trustee, and to such other limitations and conditions as the court describes.<sup>34</sup>

The district court concluded that this restatement of § 1107(a) evidenced Congressional intent to have the disinterested standard apply. The court did not consider Chapter X § 188 which was the source of § 1107(a). Section 188 provided that the debtor-in-possession was “vested with all the rights, . . . subject to all the duties, and exercise[d] all the powers of a trustee . . . .”<sup>35</sup> This was nearly identical to § 1107(a). No case ever held that § 188 of Chapter X required disinterestedness on the part of counsel for the debtor-in-possession.<sup>36</sup>

The result of the case law interpreting § 1107 is incongruous at best. It imposes on professionals representing a debtor-in-possession a higher standard than that for the appointment of an independent trustee. This is so since a trustee need only be disinterested, while the professionals employed must be both disinterested and free of any adverse interest. However, it is not merely a matter of elegance. The *per se* disqualification of a professional who is a creditor, officer, director, employee, or insider has caused great difficulty, especially as far as the retention of prepetition counsel for the debtor as counsel for the debtor-in-possession is concerned. There is no justification for a *per se* disqualification of debtor’s prepetition counsel because of creditor status unless the claim is of a size or nature that would materially affect the representation. However, applied “rigidly” or literally, the disinterestedness standard disqualifies anyone who is unpaid for any work up to the filing of the petition, even though adequately secured by a cash retainer taken before the filing. The First Circuit struggled with this absurdity in *In re Martin*<sup>37</sup> and simply ignored the statute.

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<sup>34</sup> *In re Leisure Dynamics, Inc.* *supra* note 53 at 122-23, quoting from S. Rep. No. 95-989, 95<sup>th</sup> Cong. Second Sess. at 116 (1978).

<sup>35</sup> “A debtor continued in possession of its property shall have all the title, be vested with all the rights, be subject to all the duties, and exercise all the powers of a trustee appointed under this chapter, subject, however, at all times to the control of the judge and to such limitations, restrictions, terms and conditions as the judge may from time to time prescribe.” Bankruptcy Act § 188.

<sup>36</sup> “The draftsmen of the Chandler Act Amendments used a drafting convention in Chapters X and XI. Rather than providing separate rules for trustee and debtor in possession, Chapters X and XI provided that the debtor in possession was given the powers of a trustee. In Chapter X the debtor in possession was ‘vested with all the rights, . . . subject to all the duties, and exercise[d] all the powers of a trustee . . . .’ Chapter XI provided that the debtor in possession had the title and could ‘exercise all the powers of a trustee . . . .’” Gerald K. Smith, *Disinterestedness*, Annual Survey of Bankruptcy Law 641 (William L. Norton, Jr., ed., 1995-96) (footnotes omitted).

<sup>37</sup> *In re Martin*, 817 F.2d 175 (1<sup>st</sup> Cir. 1987).

The problem with the "creditor disqualification" rule is dramatically evidenced by *In re Sharon Steel Corp.*<sup>38</sup> In *Sharon Steel*, the district court upheld the bankruptcy court's authorization of the employment of Price Waterhouse as accountant and financial advisor to the debtor even though Price Waterhouse was a prepetition creditor of the debtor holding a claim approximating \$875,000. The Trustee objected to the application to employ Price Waterhouse and appealed to the district court and then to the circuit court. The bankruptcy and district courts characterized the situation as follows:

Price Waterhouse is most familiar with the debtors' accounting system and systems in operations. It assisted the debtor in preparation for the preliminary hearing on the use of cash collateral in early December. Following that hearing, the debtor's motion to use cash collateral was interimsly denied, but the debtor was given an opportunity to revise its business plan and to present further evidence of its ability to operate profitably at a final cash collateral hearing . . . The debtor requires the expertise of Price Waterhouse to develop and present its revised business plan.

Even if the debtor had the capability of engaging an accounting firm to replace Price Waterhouse, it would be extraordinarily expensive and take a substantial length of time to become familiar with the debtor's needs.

The debtor had no cash to pay a retainer to a new firm and it is unlikely that a new firm could be engaged without a retainer given the serious possibility that this estate will have no funds with which to pay administrative expenses. Further, the debtor is under time constraints to complete its work and present it to the court.

The economic realities of this case make Price Waterhouse's appointment imperative. No harm to any other party has been alleged or can be shown . . . Clearly, the failure to appoint Price Waterhouse would jeopardize any hope the debtor has of presenting a business plan demonstrating that the debtor has any chance at reorganization.<sup>39</sup>

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<sup>38</sup> 154 B.R. 53 (W.D. Penn. 1993).

<sup>39</sup> *Id.* at 55, citing 152 B.R. at 450 (footnotes omitted). Mr. Herb Minkel, counsel for the debtor, has informed the author that Mr. John Logan, then Executive Director of the Office of the U.S. Trustee, appealed to the Third Circuit in the anticipation that the Circuit would affirm, thus allowing the U.S. Trustee to be more flexible in its application of the disinterestedness standard.

The district court also observed that Price Waterhouse had stated in its affidavit that it would not participate as an unsecured creditor in the Chapter 11 case or vote its claim in connection with the confirmation of a plan. The official committee of unsecured creditors had voted unanimously to support the retention of Price Waterhouse and the secured lenders did not object, stating that “the cost to replace Price Waterhouse would probably be prohibitive.” The only objection was that of the United States Trustee. The Third Circuit reversed, holding that the Code’s disinterested standard clearly precluded employment of a creditor.<sup>40</sup>

### III. Major Problems – Missing Elements.

#### A. Meaning Of Adverse Interest Uncertain.

A major omission from the Code is the lack of guidance as to when an interest or representation is adverse to the estate. There is also a partial overlap of the § 327(a) adverse interest standard with the material adverse interest standard of § 101(14)(E). Which controls? Overlap occurs as to the phrase “interest materially adverse to the interests of the estate,” and it is a narrow overlap in that it only concerns those interests arising from “any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker,” although the catch-all, “for any other reason,” could be interpreted literally to make the overlap complete. If the no interest adverse to the estate standard of § 327(a) controls, the only effective role for § 101(14)(E) is as to “an interest materially adverse to . . . any class of creditors or equity security holders.” In those instances, the court should employ a materiality standard since § 327(a) does not reach those situations. Another difficulty is the use of the amorphous phrase “estate.” It is an undefined term and perhaps means no more than property and avoiding powers. If so, the adverse interest standard only relates to representational or personal interests in conflict with the assets and powers of the estate. Of course, that does include a lot of territory.

The term adverse interest was not used in the Bankruptcy Act of 1898<sup>41</sup> until introduced as part of the definition of disinterestedness by the Chandler Act Amendments of 1938.<sup>42</sup> Prior to that, the employment of counsel for a trustee was regulated by General Order 44 which precluded employment of an attorney representing an interest adverse to the trustee or the estate in the matters on which the attorney was to be engaged and which required that the attorney make appropriate disclosures.<sup>43</sup> However, General Order 44 did not define or elaborate upon what was an interest adverse to the trustee or the estate. Effective October 1, 1973, General Order 44 was abrogated and replaced in liquidation cases by Bankruptcy Rule 215(a) which closely tracked General Order 44 and conditioned employment of an attorney on the attorney

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<sup>40</sup> *United States Trustee v. Price Waterhouse*, 19 F.3d 138 (4th Cir. 1994).

<sup>41</sup> Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.

<sup>42</sup> Act of July 22, 1938, ch. 575, 52 Stat. 840.

<sup>43</sup> 4B Collier on Bankruptcy 1543 (James Wm. Moore & Lawrence P. King eds., 14<sup>th</sup> ed. 1978).

holding no interest adverse to the estate in the matters upon which he was to be engaged.<sup>44</sup> This was a significant change in the conflict standard for liquidation cases.

The word "estate" has been substituted in lieu of the reference in this sentence of the general order to "the receiver, trustee, creditors or stockholders." The interests of stockholders may not be identical to those of the receiver, trustee or creditors, but insofar as the interests of the estate may not embrace those of stockholders, the substitution of the less comprehensive term is not objectionable. The representation or holding of an undisclosed interest in no way adverse to the estate should afford the court no basis for denying compensation to an attorney . . . because the interest is adverse to the stockholders. Indeed, effective representation of a trustee or receiver by an attorney seems likely to run counter to the interests of the stockholders in a considerable number of cases, and such representation should not be discouraged by these rules.<sup>45</sup>

This animus toward stockholders in liquidation cases was not applicable to reorganization cases since the liquidation rule of Bankruptcy Rule 215 was overridden by the disinterestedness standard in Chapter X reorganizations. That standard was even handed and required that the person to be employed not have "an interest materially adverse to the interests of the estate or of any class of creditors or stockholders."<sup>46</sup>

Since there is no definition of adverse interest in the Bankruptcy Code, bankruptcy judges have struggled with its meaning and application. In *In re Roberts*,<sup>47</sup> Judge Glen Clark defined conflict of interest as "representation by a given attorney or law firm of two or more entities holding or claiming adverse interests or of an equity holding an interest adverse to that of its attorney, its attorney's firm or the firm's associates."<sup>48</sup> This approach is inadequate

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<sup>44</sup> Bankr. R. 215(a) (Law Co-op. 1974).

(a) *Conditions of Employment of Attorneys and Accountants.* No attorney or accountant for the trustee or receiver shall be employed except upon order of the court . . . . If the attorney or accountant represents or holds no interest adverse to the estate in the matters upon which he is to be engaged, and his employment is in the best interest of the estate, the court may authorize his employment. Notwithstanding the foregoing sentence, the court may authorize the employment of an attorney or accountant who has been employed by the bankrupt when such employment is in the best interest of the estate.

*Id.*

<sup>45</sup> Bankr. R. 215, Advisory Committee's Note (Law Co-op. 1974).

<sup>46</sup> Chapter X § 158, Collier Bankruptcy Act and Rules, Part I (1976), p. 307.

<sup>47</sup> 46 B.R. 815 (Bankr. D. Utah 1985), *aff'd in part*, 75 B.R. 402 (D. Utah 1987).

<sup>48</sup> *Id.* at 827. See 1 William J. Norton, Jr., Bankruptcy Law and Practice § 25:3.05 (2d ed. 1996), for additional cases defining the term.

since it does not focus on the real issue, the adequacy of the representation. The case foundered on actual versus potential conflicts and unnecessarily complicated matters by applying the Model Code's appearance of impropriety standard. In sharp contrast, in *In re Leslie Fay Companies, Inc.*,<sup>49</sup> Judge Tina Brozman squarely addressed the issue of adequacy of the representation by finding an adverse interest "if it is plausible that the representation of another interest may cause the debtor's attorney to act any differently than . . . without that other representation."<sup>50</sup>

In *In re Kendavis Industries International, Inc.*,<sup>51</sup> Judge Harold Abramson also focused on the adequacy of the representation:

This rule requires that an attorney not place him or herself in a position where he or she may be required to choose between conflicting loyalties. . . . Representation of a shareholder, officer or director of a debtor corporation led to a situation in this case where Locke Purnell's ability to exercise independent judgment on behalf of its client, the Debtors, was impaired.<sup>52</sup>

Judge Abramson disagreed with the concept of "potential conflict,"<sup>53</sup> but created a per se rule disqualifying a lawyer from representing a corporation as a debtor-in-possession in a bankruptcy case if the lawyer represents a person in control of a corporate debtor.<sup>54</sup>

Judge Jack Schmetterer in *In re American Printers & Lithographers, Inc.*,<sup>55</sup> recognized the logic of rejecting the distinction between potential and actual conflicts, but found

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<sup>49</sup> 175 B.R. 525 (Bankr. S.D.N.Y. 1994).

<sup>50</sup> *Id.* at 533.

<sup>51</sup> 91 B.R. 742 (Bankr. N.D. Tex. 1988).

<sup>52</sup> *Id.* at 752-53 (citation omitted).

<sup>53</sup> *Id.* at 754. "The concept of *potential* conflicts is a contradiction in terms. Once there is a conflict, it is *actual*—*not potential*." *Id.*

<sup>54</sup> *Id.*

To make the Court's holding more concrete, the Court holds that whenever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any control party, to protect the interest of that party, counsel holds a conflict. That conflict is not potential, it is actual, and it arises the date that representation commences. This holding would apply equally to partnerships. An attorney who claims to represent a partnership, but also has some agreement, whether express or implied, with the general or limited partners, or with any control person, to protect its interest, that attorney has an actual conflict of interest, and is subject to disqualification and a disallowance of fees.

*Id.*

<sup>55</sup> 148 B.R. 862 (Bankr. N.D. Ill. 1992).

Judge Abramson's approach "contrary to the well established rule against the formulation of bright-line *per se* rules of disqualification."<sup>56</sup> Nonetheless, Judge Schmetterer disqualified the law firm in *American Printers* since he found there was a high likelihood that the potential conflict would become an actual conflict and "no compelling reason which calls for this Court to set aside the general disfavor of authorities toward employment of professionals with potential conflicts,"<sup>57</sup> particularly when "it has not been shown that the pool of potential counsel available to debtor does not supply available skilled counsel."<sup>58</sup>

However, with an earlier nudge from the District Court, Judge Charles Matheson rejected the potential conflict concept in *In re Amdura Corp.*<sup>59</sup> In *Amdura*, Judge Matheson held the representation of a major creditor of Amdura in unrelated matters was an actual conflict since the relationship of the client to the lawyer adversely affected the ability of the lawyer to represent the interests of the debtor-in-possession.<sup>60</sup>

The Fifth Circuit adopted a *per se* rule in *In re W.F. Development Corp.*,<sup>61</sup> holding that one attorney could not represent both limited and general partners in a bankruptcy case.<sup>62</sup>

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<sup>56</sup> *Id.* at 866.

<sup>57</sup> *Id.* at 867.

<sup>58</sup> *Id.*

<sup>59</sup> 121 B.R. 862, 868 (Bankr. D. Colo. 1990). In *Amdura* Judge Matheson referred to the District Court's opinion in *Colorado National Bank v. Ginco, Inc. (In re Ginco, Inc.)*, 105 B.R. 620 (D. Colo. 1988), which reversed his holding in that case recognizing a distinction between actual and potential conflicts.

The District Court in *Ginco* set aside the order of appointment. Citing section 327 of the Code, the court noted the stringent adverse interest test imposed by the statute when it stated:

An attorney may not "hold or represent an adverse interest to the estate" in *any* matter. In the pending state litigation FMTG [the attorney] already represents Richard Ginder—the principal shareholder, officer and debt-guarantor of the corporation. Mr. Ginder may have an equity interest in Ginco and is a potential target for claims of corporate mismanagement. Under those circumstances, dual representation by FMTG of the estate and Mr. Ginder is a sufficient conflict to be an adverse interest under both subsection (a) and subsection (e). *Ibid.* at 621.

The court rejected the concept of distinguishing between an actual present conflict and a potential conflict. The court admonished that the liberal language of the Bankruptcy Code must be respected and followed.

The District Court's opinion in *Ginco* may have been softened somewhat by the opinion of Chief Judge Finesilver in the *Matter of W.V.S. Investment Joint Venture*, Civil Action No. 89-F-331 (D. Colo. January 4, 1990), but only to the extent of saying that an attorney can represent dual clients where their interests are common in the matter for which the attorney is retained.

*Amdura*, 121 B.R. at 866.

<sup>60</sup> *Amdura*, 121 B.R. at 869.

<sup>61</sup> *W.F. Dev. Corp. v. Office of the U.S. Trustee (In re W.F. Dev. Corp.)*, 905 F.2d 883 (5<sup>th</sup> Cir. 1990).



The court relied not on Judge Abramson's analysis in *Kendavis*, but on Judge Samuel Bufford's analysis in *In re McKinney Ranch Associates*.<sup>63</sup>

Because of his fiduciary duties, a general partner of a limited partnership will always be a potential target of claims by a limited partnership debtor. A general partner is responsible for the day to day affairs of a business, and makes the policy decisions that lead to the financial problems that result in bankruptcy. This may involve a breach of fiduciary duty or securities law violations. The general partners may have received preferential or fraudulent transfers, or have received property of the estate. In addition, a general partner may have given a guaranty of the partnership debts. Counsel for the debtor will likely be required to examine the relations between the partnership and its general partners for possible claims against them. Thus the potential conflict in the representation of a general partner of a limited partnership will always disqualify an attorney from simultaneously representing the limited partnership as a debtor in possession or from representing the trustee of a limited partnership.<sup>64</sup>

As is readily apparent, the courts have had difficulty applying the adverse interest standard. There are a number of definitions in the case law.<sup>65</sup> The result is a lack of uniformity and uncertainty. This has an impact beyond the litigated cases that come to the attention of the newspapers, academics, and judges. It affects what happens in the day-to-day practice; it has a significant impact on choice of counsel. It also substantially increases expenses since new counsel must represent the debtor. Another consequence of uncertainty and lack of uniformity is disqualification and the resulting economic loss and adverse publicity, not only to the professionals involved, but also to the bankruptcy system, including the judiciary.

#### B. Bilateral Litigation.

State Rules of Professional Responsibility preclude a lawyer from suing a client represented in an unrelated matter.<sup>66</sup> The application of this rule in federal bankruptcy cases raises two issues. The first is one of federal-state relations or preemption briefly discussed in an

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<sup>62</sup> *Id.* at 884.

<sup>63</sup> 62 B.R. 249 (Bankr. C.D. Cal. 1986), cited in *W.F. Dev. Corp.*, 905 F.2d at 884.

<sup>64</sup> *McKinney*, 62 B.R. at 255-256. Judge Bufford apparently was not troubled by the fact that the general partner managed the partnership and controlled the work performed by counsel.

<sup>65</sup> Gerald K. Smith, *Conflicts*, *supra* note 16, at 796-799.

<sup>66</sup> *Infra*, Parts II(C) and (D).

interesting Arizona case. In *In re Breen*,<sup>67</sup> Breen represented Hubbell and negotiated a loan from Hubbell to Macy secured by real property. Macy defaulted and Hubbell foreclosed. Breen no longer represented Hubbell and did not handle the foreclosure. Shortly before the foreclosure sale, Breen filed a Chapter 11 case for Macy without obtaining Hubbell's consent or informing Hubbell of the intended action. The Disciplinary Committee had given short shrift to the defense that § 327(c) of the Bankruptcy Code preempts the state rule.<sup>68</sup> Section 327(c) provides:

[I]n a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.<sup>69</sup>

The Committee stated that "the bankruptcy code does not release an attorney from his or her duties under the Arizona ethical regulations."<sup>70</sup> The Arizona Supreme Court affirmed the Disciplinary Committee's finding that the filing of the Chapter 11 was "an action directly adverse"<sup>71</sup> to Hubbell, and the finding that there were differing interests between Hubbell and Macy.<sup>72</sup> The Supreme Court finessed the preemption issue, stating that "the claim that the bankruptcy code insulated Respondent from his ethical duties is simply wrong."<sup>73</sup>

The second issue is more subtle. It is whether the bankruptcy case as a whole is civil litigation, thereby implicating the state rule precluding a lawyer from suing one client on behalf of another.<sup>74</sup>

As I have pointed out in my two law reviews on this subject, there is difficulty with what is sometimes referred to as the "bilateral litigation rule" which provides that an attorney cannot sue on behalf of a client another client the attorney represents in an unrelated matter. Difficult questions arose as to the application of this rule in bankruptcy cases. If the rule is applied without qualification, it may preclude an attorney from being involved in a bankruptcy

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<sup>67</sup> 830 P.2d 462 (Ariz. 1992).

<sup>68</sup> *Id.* at 464.

<sup>69</sup> 11 U.S.C. § 327(c) (1994).

<sup>70</sup> *Breen*, 830 P.2d at 464.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 465.

<sup>73</sup> *Id.* The court relied on *In re Greater Pottstown Community Church of the Evangelical Congregational Church*, 80 B.R. 706 (Bankr. E.D. Pa. 1987).

<sup>74</sup> *Infra*, Part II(D), Part III(D), and Part IV.

case on behalf of one client if another client in an unrelated matter is a party-in-interest, e.g. a creditor, in the bankruptcy case.

It is clear that a reorganization case is different than "bilateral" civil litigation. This was pointed out in the Protective Committee Study nearly sixty years ago. The Report observed that "[t]he reorganization of corporations is primarily an exercise in corporate finance and management. Only incidentally are reorganization proceedings law suits; and they are never law suits in the ordinary sense of procedures designed to settle simple issues between individual litigants."<sup>75</sup>

The Protective Committee Study also observed that "[i]t is only after these broader economic business issues are decided that attention should properly be given to questions concerning the extent of the participations to be allocated among former security holders, the problem of the 'fair plan' as traditionally understood."<sup>76</sup>

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<sup>75</sup> Securities & Exch. Comm'n, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees Part VIII 1 (1940).

The *Protective Committee Study* observed that "[t]his is equally true of proceedings under Sections 77 and 77B, and Chapter X, of the Bankruptcy Act, and of proceedings in equity receiverships." *Id.* at 1 n.1. The Report quoted from a 1934 district court opinion, *Lincoln Printing Co. v. Middle West Utilities Co.*, 6 F. Supp. 663, 682-83 (N.D. Ill. 1934), as follows:

The conduct of any equity receivership is of necessity largely administrative; it involves more than a decision of "yes" or "no" upon a single issue or a multiple of single issues presented by appropriate pleadings. It involves decisions on matters of policy with nice gradations of refined reasoning and conservative judgment . . . often . . . questions of policies or courses of conduct concerning which two apparently equally consistent views may be taken. Such questions and situations constantly recur in the conduct of an equity receivership, giving to it a character requiring the exercise of administrative jurisdiction, as distinguished from decision of controverted or litigated issues.

Securities & Exch. Comm'n, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees Part VIII 1 n.1 (1940).

The *Protective Committee Study* delineated "the most important aspects of reorganization." *Id.* at 2.

Reorganization involves all the problems of corporate finance and management: it requires an inquiry into the causes of the financial collapse of the corporation; and into its worth if salvaged as a going concern; and, if reorganization instead of liquidation is determined upon, how this can best be accomplished upon a basis not only fair but economically sound. The answers to these questions will necessitate inquiry among other things into general economic factors, competitive conditions in the industry, its trend of demand, and its price policies, as well as inquiry into more immediate questions such as the quality of the debtor's management. More narrowly, there will have to be inquiry into earnings in the past and the prediction of future earnings, and chiefly on the latter basis, a determination of what would constitute a sound capitalization and financial structure.

*Id.* at 1-2.

<sup>76</sup> *Id.* at 2.

It is also true that a reorganization is largely consensual. Equity and debt securities are often altered in both form and substance. The reorganized debtor is often different than the original debtor. However, although the mechanism exists to “cramdown” a reorganization, generally speaking affected classes will consent by the requisite majority. Indeed, one of the functions of committees is to assist in obtaining the requisite consents to the plan.

But even though a reorganization case differs in important respects from bilateral, civil litigation, this is not dispositive. The question remains whether the rule precluding a lawyer from suing a client in an unrelated matter precludes a lawyer from filing a reorganization case if a party-in-interest is a client in an unrelated matter.

The Bankruptcy Code’s adverse interest rule and state disqualification rules as to simultaneous representation are related but different – like the opposite sides of a coin. An example may make this clear. Take the common situation of counsel for a bank in matters not involving a particular debtor. Bank counsel may be asked by the debtor to file a Chapter 11 case and represent the debtor-in-possession after the case has been filed. Depending on counsel’s relationship with the bank, the representation of the bank in unrelated matters may constitute an adverse interest under the Bankruptcy Code which will prevent counsel from representing the debtor-in-possession.<sup>77</sup> And even if counsel clears this hurdle, the other side of the coin must be considered and absent appropriate consent state rules disqualify counsel from representing the debtor-in-possession on the basis that this would result in a conflict of interest.<sup>78</sup>

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<sup>77</sup> *In re Amdura Corp.*, 121 B.R. 862 (Bankr. D. Colo. 1990). “The Court questions whether counsel can be said to be disinterested when they acknowledge their inability to take a position contrary to Continental because, at least as to W & S, it is unwilling to offend the ‘hand that feeds.’” *Id.* at 867.

The question of whether F & W is “disinterested” within the meaning of section 327 of the Code is really one that only F & W can answer. In the Court’s view, the firm’s past representation of that bank does not create a conflict within the meaning of 327, or otherwise make F & W not disinterested, unless that law firm, for whatever reason, believes that it would not be able to diligently and zealously represent the debtors on issues concerning the Continental loan. If the Continental is not the “hand that feeds” F & W, and if the firm is not otherwise inhibited, then past representation of the Continental on matters not relating to these debtors would not serve to disqualify F & W from acting as counsel for the fiduciary in these cases.

As to W & S, the same analysis must apply. That firm, however, has openly declared its inability or, at least, unwillingness to joust with the bank. It appears to the Court, as concluded in the Order, that issues surrounding the Continental Bank are so pervasive, and the Bank’s status as a multimillion-dollar-a-year client of W & S is so significant, that it is difficult, if not impossible, for this Court to reach the conclusion that W & S is “disinterested.”

*Id.* at 871.

<sup>78</sup> *Infra*, Part III(D) and Part IV.

C. Disclosure Requirements Uncertain.

The only disclosures required by the Bankruptcy Code are in connection with compensation “paid or agreed to be paid within one year of the filing of a bankruptcy case” for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.” Although not expressed in the Bankruptcy Code, obviously additional disclosures were contemplated. This is so since employment often requires that the person be disinterested and not hold or represent an interest adverse to the estate.

Disclosures are dealt with under the Bankruptcy Rules. Bankruptcy Rule 2016(b) basically restates the requirements of Bankruptcy Code § 329. Both Rule and Code Section are somewhat uncertain as to who must comply. The Rule refers to “every attorney for a debtor.” A debtor is a person “concerning which a case under [title 11] has been commenced.”<sup>79</sup> Nonetheless, both the Rule and Section 329 clearly reach back to the prepetition period; they do not concern disclosures solely by those representing the debtor postpetition.

Bankruptcy Rule 2016(b) also requires that any agreements to share compensation, other than with a member or regular associate of an attorney’s law firm, must be disclosed. This is, of course, intended to allow the bankruptcy judge and other parties-in-interest to make sure there is no violation of the Bankruptcy Code’s proscription against sharing of compensation under Bankruptcy Code § 504(a). These statutory and rule provisions are designed to allow the court to police and avoid to the extent appropriate contractual provisions which may unnecessarily increase the cost of bankruptcy proceedings.

The disclosures required under Bankruptcy Rule 2014 are of a different nature. They are designed to assure independent and fair representation. They are essentially designed to require disclosure of information relevant to whether the person to be employed is not disinterested and holds or represents an adverse interest. Bankruptcy Rule 2014, however, contrary to the required disclosure of Bankruptcy Code § 329 as to fee agreements, does not have any supporting Code provision. Instead, it takes on the task of defining the required disclosure all alone and with a one-sentence provision which requires disclosure of “the person’s connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.” Although omitted from Bankruptcy Rule 2014, one would assume that professionals should nonetheless disclose relationships with the bankruptcy judge since Bankruptcy Rule 5004 disqualifies bankruptcy judges from allowing compensation to a person who is a relative or so connected with the bankruptcy judge as to render it improper for the judge to authorize compensation. Bankruptcy Rule 5004(b).

Under Rule 2014(a), a professional seeking employment must disclose any connection the professional has with a creditor or any party-in-interest. In addition, the professional must disclose any connection the professional has with any lawyer or any

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<sup>79</sup> Bankruptcy Code § 101(13).

accountant for a creditor or party-in-interest in the case. Under § 1109(b), party-in-interest includes an equity security holder. Apparently the drafters of Rule 2014(a) assumed that the person to be employed could determine connections with accountants or attorneys for a creditor, equity security holder or other party-in-interest. How is this possible? Perhaps the Rules need to be amended to require that the debtor (or in appropriate cases the trustee) identify the accountants and lawyers of creditors and other parties-in-interest in the schedules.

Bankruptcy Rule 2014(a) requires a disclosure of connections with the debtor, creditors and any other party-in-interest and their respective attorneys and accountants. The trustee had a connection with Deloitte, but the trustee could not determine whether Deloitte was an accountant for a debtor, creditor or other party-in-interest. Without such knowledge, how could the relationship of Deloitte to a creditor or equity security holder or other party-in-interest create a problem?

The rule as written is unsound and its application by the U.S. Trustee and the courts is causing unnecessary misery to the courts as well as professionals ensnared in its beguilingly simple language. This reflects badly on courts, lawyers and the bankruptcy system. At the very least, the rule should eliminate the requirement of disclosure of connections with attorneys and accountants, replacing this with the requirement that there be disclosure of any adverse interest. I would also recommend that we define connections. The dictionary definition is too broad. It is as follows:

**1** : the act of connecting : the state of being connected: as **a** : causal or logical relation or sequence <the *connection* between two ideas> **b** : (1) : contextual relation or association <in this *connection* the word has a different meaning> (2) : relationship in fact <wanted in *connection* with a robbery> **c** : a relation of personal intimacy (as of family ties) **d** : COHERENCE, CONTINUITY **2 a** : something that connects : LINK <a loose *connection* in the writing> **b** : a means of communication or transport **3** : a person connected with another especially by marriage, kinship, or common interest <has powerful *connections*> **4** : a political, social, professional, or commercial relationship: as **a** : POSITION, JOB **b** : an arrangement to execute orders or advance interests of another <a firm's foreign *connections*> **c** : a source of contraband (as illegal drugs) **5** : a set of persons associated together : as **a** : DENOMINATION **b** : CLAN<sup>80</sup>

More than a decade ago, the Business Bankruptcy Committee and its Ethics Committee in particular recommended changes in the disclosure requirements. The proposals of the Ethics Committee which became the proposals of the Section of Business Law were detailed. They are attached as Appendix 2. Despite the Resolution of the House of Delegates of the

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<sup>80</sup> Merriam-Webster, Incorporated (1999).

American Bar Association, Report No. 119A (1991), the Advisory Committee on Bankruptcy Rules gave little attention to the proposals.

D. Lack Of Uniformity.

Of considerable importance to lawyers involved in bankruptcy cases in districts other than those in the state in which they are admitted to practice are rules governing admission and professional conduct. No national rules governing admission and professional conduct have been promulgated under the Rules Enabling Act.<sup>81</sup> Rules of conduct are governed by local rules of the bankruptcy courts, to the extent they are governed. The resulting lack of uniformity is a serious problem.

Patricia Channon of the Administrative Office of the United States Courts reviewed the local rules of the bankruptcy courts and found that most bankruptcy courts do not have a local rule concerning professional responsibility.<sup>82</sup> Bankruptcy courts in thirty-five districts have no rule at all.<sup>83</sup> Bankruptcy courts for twenty-seven districts have adopted the district court rule, but provide no text of the adopted rule.<sup>84</sup> Bankruptcy courts for six districts specify the rules adopted by the highest court of the state in which the district is located.<sup>85</sup> Two courts impose standards which vary from those of the states in which the districts are located, although one of these districts has also adopted the state standard.<sup>86</sup> Of the districts that have a rule, one district requires that attorneys read and become familiar with the state bar's Rules of Professional Conduct, while another district encourages counsel to be familiar with the discovery guidelines of the state bar.<sup>87</sup>

The recent study by the Federal Judicial Center for the Standing Committee canvassed the rules governing admission to practice and professional conduct of lawyers in the federal district courts.<sup>88</sup> The study established that rules as to bar membership in the district

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<sup>81</sup> Rules Enabling Act of 1988, Pub. L. 100-702, 102 Stat. 4648.

<sup>82</sup> Letter from Patricia S. Channon, Administrative Office of the United States Courts, to Gerald K. Smith, Advisory Committee on Bankruptcy Rules (April 4, 1997) (on file with author). However, nearly every bankruptcy court has a local rule as to who may practice before the court. Most of the latter rules required that the individual be admitted to the district court for the particular district in which the bankruptcy court was located.

<sup>83</sup> *Id.* at 1.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 2.

<sup>87</sup> *Id.* at Attachment 5.

<sup>88</sup> Marie Cordisco, Eligibility Requirement For, and Restrictions On, Practice Before the Federal District Courts (1995) (unpublished table, on file with the author).

courts vary significantly among districts.<sup>89</sup> All but four districts allow lawyers admitted to practice in another federal district court or before a state court to seek permission to appear *pro hac vice*. The four districts which do not allow such appearances have liberal bar membership rules.<sup>90</sup> The majority of districts allowing *pro hac vice* appearances require the association of "local counsel."<sup>91</sup>

Another recent report by Daniel Coquillette<sup>92</sup> reviewed the local rules governing conduct for the ninety-four district courts. Slightly more than half or forty-eight of these districts "have adopted local rules and incorporate state standards in states that, in turn, have adopted some version of the *ABA Model Rules of Professional Conduct* (1983)."<sup>93</sup> Twelve districts or approximately thirteen percent had rules incorporating state standards from states which had some version of the 1969 ABA Code of Professional Responsibility.<sup>94</sup> The Eastern and Southern Districts of California adopted the California Rules of Professional Conduct.<sup>95</sup> Ten districts adopted rules referring to an ABA Model, four of which referred to the ABA Code, three to the Model Rules and one to both.<sup>96</sup> The Districts of Montana and the Southern District of Georgia even referred to the 1908 ABA Canons of Professional Ethics.<sup>97</sup> Ten districts referred to both an ABA Model and to state standards.<sup>98</sup> Eleven districts have no local rules governing attorney conduct, but a number of these districts have standing orders. One district followed neither state standards nor an ABA Model, but incorporated its own substantially modified version of the ABA Model Rules.<sup>99</sup>

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<sup>89</sup> Every federal district court has a provision in its local rules listing criteria that an attorney must possess to be eligible to apply for admission to that court's Bar. Fifty-five (55%) federal district courts limit membership in its Bar to attorneys who are members of the bar of the state or territorial possession in which the district court is located

.....  
Eligibility requirements in the remaining thirty-nine districts vary considerably, but some of them do fall into a number of patterns, all of which qualify a broader pool of applications for admission.  
*Id.* at 2-3 (footnotes omitted).

<sup>90</sup> *Id.* at 4.

<sup>91</sup> *Id.* at 5.

<sup>92</sup> Daniel R. Coquillette, Report on Local Rules Regulating Attorney Conduct 1-2 (July 5, 1995).

<sup>93</sup> *Id.* at 4.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* at 4-5.

<sup>97</sup> *Id.* at 5.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* at 5.



In a follow-up Study Coquillette discussed the considerable number of variances in the local rules. Coquillette concluded that a possible approach to more uniformity among local rules would be to adopt uniform federal rules for attorney conduct in several key areas, with other areas to be governed by state standards, was a possible approach to more uniformity.<sup>100</sup> “Obvious candidates for ‘national’ treatment would be . . . : (1) ‘Conflict of Interest,’ (2) ‘Represented Parties,’ (3) ‘Lawyer as a Witness,’ and (4) ‘Fees.’”<sup>101</sup> If a choice of law category were added, the Study noted that the proposed uniform federal rules would then cover the issues in almost ninety percent of all reported federal cases since 1990.<sup>102</sup>

#### IV. Recent Developments.

##### A. Restatement Of The Law (Third) Governing Lawyers.

The American Law Institute labored for a decade to “express clearly and completely the legal rules and doctrines that courts apply [to lawyers] . . . and to explain the basis for those rules and doctrines”<sup>103</sup> in its *Restatement*. Chapter 8 of the *Restatement* restates the law of conflicts. The basic rule is that “a lawyer may not represent a client if the representation would involve a conflict of interest.”<sup>104</sup> A conflict exists “if there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to another current client, a former client, or a third person.”<sup>105</sup> More specific conflict rules are applications of this basic rule,<sup>106</sup> with the exception of the rule precluding suit against an existing client.<sup>107</sup>

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<sup>100</sup> Daniel R. Coquillette, Study of Recent Federal Cases (1990-1995) Involving Rules of Attorney Conduct (December 1, 1995). As summarized in its methodology and finding sections, the initial phase of the Study was the design of a computer search of cases from January 1, 1990 forward. Even that limited period led to a large number of cases, some 851. These cases were analyzed and sorted into 443 cases involving rules governing attorneys and 408 involving issues of attorney conduct in federal courts governed by Rule 11 and other standards. The largest category of rules involved were conflict of interest rules. “Rules Analogous to ABA Model Rules 1.7, 1.8, 1.9, 1.10 and 1.11 accounted for forty-six percent of reported federal disputes, or 204 cases of 443.” Of these conflicting cases, nearly eighty percent were civil in nature. *Id.* at 3-4.

<sup>101</sup> *Id.* at 6.

<sup>102</sup> *Id.*

<sup>103</sup> Charles W. Wolfram, The Concept of a Restatement of the Law Governing Lawyers, 1 *Geo. J. Legal Ethics* 195, 196 (1987).

<sup>104</sup> Restatement (Third) of the Law Governing Lawyers § 201 (Proposed Final Draft No. 1, 1996).

<sup>105</sup> *Id.*

<sup>106</sup> Those of particular relevance to bankruptcy cases are section 206, Lawyer’s Personal Interest Affecting Representation of Client, section 209, Representing Parties With Conflicting Interests in Civil Litigation, section 211, Multiple Representation in Non-Litigated Matter, § 212, Conflicts of Interest in Representing Organization, section 213, Representation Adverse to Interest of Former Client, and section 216, Lawyer With Fiduciary or Other Legal Obligation to Third Person.

<sup>107</sup> Restatement (Third) of the Law Governing Lawyers § 209(2) (Proposed Final Draft No. 1, 1996).

As will become evident in the discussion of conflict issues in workouts and reorganizations, the conflicts sections of the *Restatement* are instructive. However, there is an important, unresolved issue. All agree that a lawyer may not assert a claim against or defend against a claim of a client in an unrelated matter. This is precluded by section 209(2). However, there is sharp disagreement as to whether section 209(2) or section 201 should apply to the bankruptcy case as a whole.

This sharp disagreement may seem odd to some considering that all agree that a lawyer has a duty of loyalty to a client. However, it is doubtful that it was ever an absolute duty, and its less than absolute nature is recognized by the current drafts of the *Restatement*. The American Law Institute in its Second *Restatement of the Law on Agency* concluded that the duty of loyalty is limited by the scope of the agency.<sup>108</sup> Under this approach a lawyer could be adverse to the client as to a matter outside the scope of the representation. But this common law rule has been altered as a result of the widespread adoption of the American Bar Association's Model Code and Model Rules. The Model Code provides that "[a] lawyer shall decline proffered employment . . . if it would be likely to involve him in representing differing interests."<sup>109</sup> The Model Rules preclude representation of a client "if the representation of that client will be directly adverse to another client."<sup>110</sup> Comment 1 to Rule 1.7 implies that the rule is grounded in the duty of loyalty.<sup>111</sup>

In the *Restatement*, the duty of loyalty is reaffirmed but subtly changed. Comment b to section 201 of the *Restatement* makes it clear that underlying the basic conflict rule of the *Restatement* is the lawyer's duty of loyalty to the client.

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<sup>108</sup> Restatement (Second) of Agency § 394 (1958). "Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed." *Id.*

<sup>109</sup> Annotated Code of Professional Responsibility DR 5-105(A) (1979). A differing interest is defined in the Model Code as an "interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other interest." *Id.* at 454, Definition 1. While Disciplinary Rule 5-105(A) precludes new employment, Disciplinary Rule 5-105(B) provides the same protection against continued multiple employment. In both situations the problem can be solved by informed consent.

<sup>110</sup> Model Rules of Professional Conduct Rule 1.7(a) (1995). Model Rule 1.7(a) precludes representation of a client directly adverse to another client. Rule 1.7(a) is not limited to conflicts in litigation.

<sup>111</sup> *Id.* at Rule 1.7 cmt. 1.

Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined. The lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the parties and issues involved and to determine whether there are actual or potential conflicts of interest.

*Id.*

A client is entitled to be represented by a lawyer whom the client can trust. Instilling such confidence is an objective important in itself. For example, the principle underlying the prohibition against a lawyer's filing suit against a present client in an unrelated matter (see § 109 Comment e) may also extend to situations, not involving litigation, in which significant impairment of a client's expectation of the lawyer's loyalty would be similarly likely. Contentious dealings, for example involving charges of bad faith against the client whom the lawyer represents in another matter would raise such a concern. So also would negotiating on behalf of one client when a large proportion of the lawyer's other client's net worth is at risk.<sup>112</sup>

Section 209 sets forth conflict rules for civil litigation. Section 209 covers (1) representation of two or more clients as co-clients involved in the same litigation and (2) representation of a client in asserting or defending a claim against another client. Again, the comments make it clear that a basis for Section 209 is the duty of loyalty.

Fundamental conflicts of loyalty and threats to client confidentiality would be inevitable if a lawyer were to represent clients opposing each other in the same litigation. Many actions that the lawyer took on behalf of one client would have the potential for being at the expense of the other. Furthermore, the public interest in the orderly management of litigation could be seriously compromised. Thus, the same lawyer may not represent both plaintiff and defendant in a breach of contract lawsuit, for example.<sup>113</sup>

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[T]he lawyer has a duty of loyalty to the client being sued. Moreover, the client on whose behalf suit is filed might fear that the lawyer would pursue that client's case less effectively out of deference to the other client. Thus, a lawyer may not sue a current client on behalf of another client, even in an unrelated matter, unless consent is obtained under the conditions and limitations of § 202.<sup>114</sup>

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<sup>112</sup> Restatement (Third) of the Law Governing Lawyers § 201 cmt. b (Proposed Final Draft No. 1, 1996).

<sup>113</sup> *Id.* § 209 cmt. c.

<sup>114</sup> *Id.* § 209 cmt. e.

Section 209(2) of the *Restatement* provides that “a lawyer in civil litigation may not . . . represent one client in asserting or defending a claim against another client currently represented by the lawyer, even if the matters are not related.”<sup>115</sup> Although the duty of loyalty is absolute as to civil suits involving clients asserting claims against each other, the duty is not absolute as to clients adverse to each other in a context other than that of civil litigation. Section 201 allows a lawyer to represent one client in a transaction with another client represented in unrelated matters unless there is a substantial risk that the client represented would not be adequately represented in some material way.<sup>116</sup>

The treatment of the duty of loyalty in section 201 is in sharp contrast to how the duty is treated in section 209. Section 209 focuses on the duty of loyalty to the client represented in unrelated matters, while section 201 focuses on the adequacy of the representation of the client represented. Section 201’s only expression of concern for the client in unrelated matters is the statement in comment b that some situations may result in a “significant impairment of a client’s expectation of the lawyer’s loyalty.”<sup>117</sup> If so, counsel is disqualified from representing the client, not because of the injured feelings or impairment of the expectation of the lawyer’s loyalty to the client in the unrelated matter, but because the duties to the client in the unrelated matter may materially and adversely affect the representation of the client. The focus of the basic conflict rule of section 201 is whether the personal interest of the lawyer or the lawyer’s duties to others will inhibit the representation of the client. See, for example, comment d, entitled “Representation of Client.”

In yet other situations, the conflict of interest arises because the circumstances indicate that the confidence that a client reasonably reposes in the loyalty of a lawyer would be compromised due to the lawyer’s relationship with another client or person whose interests would be adversely affected by the representation.<sup>118</sup>

Somewhat opaquely comment d refers to the impact on the expectation of loyalty of the client in the unrelated matter. “The prohibition of conflicts of interest ordinarily restricts a lawyer’s activities only where those activities materially and adversely affect the lawyer’s ability to represent a client including such an effect on a client’s reasonable expectation of the lawyer’s loyalty.”<sup>119</sup>

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<sup>115</sup> *Id.* § 209.

<sup>116</sup> *Id.* § 201.

<sup>117</sup> *Id.* § 201 cmt. b.

<sup>118</sup> *Id.* § 201 cmt. d.

<sup>119</sup> *Id.*

Section 28 of the *Restatement* lists the duties of a lawyer to a client, but the black letter rule does not mention the duty of loyalty:

To the extent consistent with the lawyer's other legal duties and subject to the other provisions of this Restatement, a lawyer must, in matters within the scope of the representation:

- (1) proceed in a manner reasonably calculated to advance a client's lawful objectives, as defined by the client after consultation;
- (2) act with reasonable competence and diligence;
- (3) comply with obligations concerning the client's confidences and property, avoid impermissible conflicting interests, deal honestly with the client, and not employ advantages arising from the client-lawyer relationship in a manner adverse to the client; and
- (4) fulfill valid contractual obligations to the client.<sup>120</sup>

Comment e to section 28 states that "[t]he responsibilities entailed in promoting the objectives of the client may be broadly classified as duties of loyalty."<sup>121</sup> The concluding paragraph of comment e states that "[t]he duties of loyalty are subject to exceptions described elsewhere in this *Restatement*. Those exceptions typically protect the concerns of third persons and the public or satisfy the practical necessities of the legal system."<sup>122</sup> The Reporter's Note to comment e refers to other Reporters' Notes on the duties of loyalty; however, a review of the references does not reveal any discussion of the duty of loyalty except for that found in section 111 on confidential information and in the conflicts chapter.<sup>123</sup>

In a communication on behalf of the NBC to Professor Wolfram in October of 1995, concern was expressed as to "whether a lawyer representing creditors, stockholders or owners of a debtor in unrelated matters can represent the debtor or other creditors, stockholders or partners in connection with a bankruptcy case"<sup>124</sup> under the conflict provisions of the

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<sup>120</sup> *Id.* § 28.

<sup>121</sup> *Id.* § 28.

<sup>122</sup> *Id.* § 28 cmt. e.

<sup>123</sup> The Reporter's Note cross-references sections 44, 53, 56-58, 72, 111, 112 and 201-214. Section 111 defines confidential client information. Comment b thereto states that "[a] client's approach to a lawyer for legal assistance implies that the client trusts the lawyer to advance and protect the interests of the client (see § 28(1)). The resulting duty of loyalty is the predicate of the duty of confidentiality." *Id.* § 111 cmt. b.

<sup>124</sup> Letter from Gerald K. Smith to Professor Charles W. Wolfram 1 (Oct. 18, 1995) (on file with author).

*Restatement*. It was pointed out that the limited discussion of bankruptcy matters in Chapter 8 of the *Restatement* suggested that a bankruptcy case is a variety of civil litigation. If that is so, did the Reporters intend to preclude a lawyer "from filing a bankruptcy case, assuming no consent, if a creditor, partner or stockholder of the debtor is a client of the lawyer as to unrelated matters?"<sup>125</sup> Professor Wolfram's response of November 21 and his subsequent letters of November 27 and December 6, 1995 made it clear that Professor Wolfram viewed the filing of a bankruptcy case as the commencement of civil litigation.

The NBC held its spring meeting in March of 1996. At that meeting, the Conference directed its Committee on Professional Responsibility to continue discussions with the Reporters and Director Hazard and to urge

that Chapter 8 of the *Restatement* be clarified to make clear that conflict of interest principles designed to address non-bankruptcy "civil litigation", such as those contained in Section 209, should not automatically be applied to the entirety of a bankruptcy case. While the conflict of interest principles applicable to civil litigation may properly be applied to an adversary proceeding or contested matter where the debtor, trustee or creditors' committee is asserting or defending against a claim, it should not be presumed that bankruptcy counsel is materially adverse to individual stakeholders with regard to other matters in the case. The appropriate section of the *Restatement* under which such other matters should be tested is Section 201, which requires a determination of the actual risk of material adversity.<sup>126</sup>

Professor Wolfram responded that:

We addressed the bankruptcy issues under § 209 in its *Comment d(iii)* on pages 662-63 of Proposed Final Draft No. 1. We there specifically refer to the fact that the context of multi-party litigation such as bankruptcy must be examined before assessing whether a conflict exists. That seems to be the same point made in the position paper. I'm curious to know in what way the two positions don't agree. The position paper is, of course, far more elaborate (although it remains at a very high level of generality), but our effort in the Proposed Final Draft has been to avoid getting into great detail on any practice area.<sup>127</sup>

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<sup>125</sup> *Id.*

<sup>126</sup> Memorandum from the Committee on Professional Responsibility of the National Bankruptcy Conference to Professor Charles W. Wolfram 4 (Apr. 18, 1996) (on file with author).

<sup>127</sup> Letter from Professor Charles W. Wolfram to Gerald K. Smith (Apr. 24, 1996) (on file with author).

In a Memorandum of May 2, 1996 NBC Conferee Donald S. Bernstein suggested additional commentary.

I have looked at *comment d*(iii) to Section 209 of the *Restatement* (referred to by Wolfram in his letter to you). If I understand the *comment d* correctly, the whole comment relates only to determining whether there is a conflict when simultaneously representing in a single litigation multiple clients “nominally on the same side.” It appears to me that the issues we have raised are really more like the issues raised in *comment e* (“Suing present client in unrelated matter.”)

Because of the oversimplified “plaintiff vs. defendant” model of “civil litigation”, this comment does not address civil cases which, like bankruptcy, where parties who are adverse as to some issues are not materially adverse with respect to numerous others.

Perhaps we should suggest a new *comment e*(i):

*e*(i). *Proceedings Involving Multiple Parties in Disparate Controversies.* Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and multiple disputes. While Section 209 (2) addresses the lawyer’s role in asserting or defending against a claim made by one client against another in the context of such a proceeding, a lawyer is not disqualified from representation of a client in such a proceeding with respect to other matters where material adversity does not exist.<sup>128</sup>

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<sup>128</sup> Memorandum from Mr. Bernstein to Gerald K. Smith (May 2, 1996) (on file with author). Subsequently, Mr. Bernstein articulated additional reasons why he believed the bankruptcy case as a whole should not be subject to the bilateral litigation rule:

I do not see the bright line distinction between the pre and post-filing period . . . . In business reorganization (chapter 11) cases, most of the disputes between clients will be the same ones that existed prior to bankruptcy in the context of efforts to restructure out of court: are the claims valid, are the liens good, how should the company’s debt be scaled back, how much equity should the old equity holders retain. Although after the filing the court will be involved in determining whether these disputes give rise to a conflict (because the court must approve retention of counsel by the DIP), from the lawyer’s perspective, the potential disputes have not, in the main, changed.

This leads me to ask why, if the treatment of creditors is still the subject of negotiation rather than litigation, the ground rules should change by virtue of the fact that the debtor comes under court supervision by filing a petition. One might take the view, instead, that if the per se civil litigation rule did not apply to pre-bankruptcy situation, the fact of the filing should not change this unless and until the issues between the parties degenerate into litigated disputes in the case. Prior to that time—and in the pre-filing

At the same time, Susan M. Freeman suggested to Professor Wolfram a specific amendment to comment d(iii) to section 209 of the *Restatement* and the Reporter's Note to Professor Wolfram:

*d(iii). Complex and multi-party litigation.* Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients' interests predominate, (2) circumstances such as the size of each client's interest make separate representation impracticable, and (3) the extent of active judicial supervision of the representation. *Further, the fact that one client merely holds a claim against the other client in a judicial proceeding is not "assertion" of a claim for conflict purposes. A claim is "asserted" or "defended" when a dispute concerning the claim is resolved.* For example, a lawyer might represent several unsecured creditors in a bankruptcy proceedings. In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.

... [comment continues with discussion of class actions]

Reporter's Note *Comment d(iii).* Add a citation to *In re Amdura*, 121 B.R. 862 (Bankr. D. Colo. 1990) and 139 B.R. 963 (Bankr. D. Colo. 1992) after *In re Aircraft Instrument & Dev., Inc.*, 151 B.R. 939, 943-44 (Bankr. D. Kan. 1993).<sup>129</sup>

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context as well—the general rules stated in Sections 201 and 209(1) should apply. There may well be a conflict, but it is *not* generated by the pendency of the bankruptcy case. It is generated, if at all, because the parties are on opposite sides of the table trying to resolve disputes in a negotiated restructuring.

Maybe we haven't been clear on this point because it is so intuitive to those of us in bankruptcy practice: *most chapter 11 cases are in the eyes of bankruptcy practitioners continuation of an out of court restructuring transaction.* The fact that a bankruptcy proceeding has been commenced does not mean, at least to the bankruptcy lawyer, that all aspects of the relations between the parties have become the subject of litigation.

Memorandum from Donald S. Bernstein to Professor Charles Wolfram 1-2 (Oct. 3, 1996) (on file with author).

<sup>129</sup> Draft Accompanying Letter from Susan M. Freeman to Professor Charles W. Wolfram 1 (May 3, 1996) (on file with author).



Ms. Freeman's explanation for the proposed changes focused on what she believed was the Reporter's position:

"[A]sserting" and "defending" a claim for conflict purposes means litigating over the claim. Merely holding or filing a claim is not deemed "asserting" it. This matters.

As the Restatement comment properly notes, resolution of conflicts in bankruptcy depends on the interpretation of bankruptcy statutes and rules in addition to lawyer code provisions and judicial decisions. The Bankruptcy Code does not prevent all representation of debtors in possession and trustees when the lawyer's firm represents a creditor. 11 U.S.C. § 327(c). In some circumstances, the creditor may hold such a minimal interest that representation of the debtor or trustee would not "be materially and adversely affected by the lawyer's duties to [the creditor] client in the matter," in the words of Restatement § 209. However, if the mere holding or filing of a claim or interest is considered "asserting" it, under the Restatement prospective counsel for a debtor or trustee still must obtain the informed consent of each creditor client before he can take on the debtor or trustee representation. The same would be true for representing a defendant in a class action context, where firm clients are likely class members. This may be extremely impractical in a large case, especially since Restatement § 202 comment c states that the requirement of consent generally requires an affirmative response by each client, and that counsel cannot just assume consent from client acquiescence.

The size of the claim by the creditor client is a factor in determining whether there is a substantial risk of material adversity in a bankruptcy case, wholly apart from whether separate representation is impracticable. Thus, the phrase in the comment about the size "mak[ing] separate representation impracticable" should be deleted. Second, a citation to the *Amdura* case would be useful, since it discusses at length the application of Restatement criteria to a single law firm's representation of a debtor in possession and a creditor, while the *Aircraft Instrument & Development* case cited for that issue concerns an accounting firm instead of a law firm, and includes a discussion of lawyer restrictions on conflicts being inapplicable to accountants.

Finally, the reporters' understanding about the meaning of "asserting" a claim should be expressly set forth, since courts and attorneys could reasonably understand that a creditor client's invoices or letters demanding payment or filing of a proof of claim

would be “asserting” a claim. If “assertion” and “defense” of a claim instead means litigation of the claim, the intent of the Restatement provision would be met in the bankruptcy context. A law firm could not litigate against a present client in a courtroom dispute without its informed consent, no matter how small the claim. Absent claim litigation, however, whether counsel could represent a debtor in possession or trustee and, on unrelated matters, creditors or other parties in interest, would depend on whether there was a substantial risk that representation of one would be materially and adversely affected by the lawyer’s duties to the other in the case.<sup>130</sup>

Professor Wolfram immediately responded with a proposed text for the first paragraph of Section 209, comment d(iii), based on Ms. Freeman’s draft and earlier suggestions of Professor Wolfram.

*d(iii). Complex and multi-party litigation.* Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients’ interests predominate, (2) circumstances such as the size of each client’s interest, and (3) the extent of active judicial supervision of the representation. *For example, in a bankruptcy proceeding, the fact that one client holds a claim against another client is not necessarily “assertion” of a claim for conflict purposes. A claim is “asserted” or “defended” when a dispute concerning the claim is involved. On the other hand, when there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no adversity is ordinarily involved as between the clients and hence no conflict of interest is present.* In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.<sup>131</sup>

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<sup>130</sup> *Id.* at 1-2.

<sup>131</sup> Letter from Professor Charles W. Wolfram to Susan M. Freeman (May 3, 1996) (on file with author). The suggested language “when there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no adversity is ordinarily involved as between the clients and hence no conflict of interest is present,” came from Director Hazard. See Letter from Professor Charles W. Wolfram to Gerald K. Smith (May 3, 1996) (on file with author).

Several drafting matters were then considered, along with a substantive point raised by Mr. Bernstein.<sup>132</sup> A final draft of agreed amendments to the Commentary to section 209 was achieved on May 9, 1996:

*Amendment No. 1 - § 209, Comment c*

- (1) Change the heading of present Comment c (Proposed Final Draft, page 659) to read as follows: *c(i) Clients aligned in opposition to each other—in general.*
- (2) Add a new Comment *c(ii)* at the end of the present Comment c (Proposed Final Draft, page 660), to read as follows:

*c(ii). Opposing client in multi-party litigation.*  
Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and multiple disputes. The fact that one client holds a monetary claim against another client in a bankruptcy proceeding is not necessarily “assertion” of a claim for purposes of this Section. A claim is “asserted” or “defended” when a dispute concerning the claim is involved. When there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no conflict of interest under this Section is ordinarily present as between the clients. Further, a discrete conflict between two clients, such as a dispute over the validity of a claim in a bankruptcy proceeding, may not disqualify a lawyer from representing one client with respect to aspects of the case not involving the dispute between the clients. In addition to general conflict rules that may apply, a lawyer must also comply with statutory

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<sup>132</sup> See Memorandum from Susan M. Freeman to Professor Charles W. Wolfram (May 6, 1996) (on file with author).

I sent Don Bernstein your Friday letter to me for his review. He appropriately points out that in bankruptcy cases, courts may allow counsel to represent a debtor in possession even when there is a known conflict of interest with an existing creditor client. The court may simply have other special counsel (authorized under § 327(e)) or committee counsel handle that portion of the case. The *Amdura* case I referred you to addresses a proposal to do precisely that. The court held in that case that the creditor client’s role in the case was so pervasive and critical that special counsel wouldn’t work. In other cases, it will work. *E.g. In re Blinder, Robinson & Co.*, 131 B.R. 872, 880 (D. Colo. 1991); *In re Lee Way Holding Co.*, 102 B.R. 616 (S.D. Ohio 1988). The court will look to the materiality of the conflict from the perspective of the case as a whole.

*Id.*

regulations if more stringent, such as provisions of the bankruptcy code.

*Amendment No. 2--§ 209, Comment d(iii)*

Amend the first paragraph of § 209, Comment *d(iii)* (Proposed Final Draft, page 662) to read as follows:

*d(iii). Complex and multi-party litigation.* Not all possibly differing interests of co-client in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients' interests predominate, (2) circumstances such as the size of each client's interest, and (3) the extent of active judicial supervision of the representation. Among other considerations, assessment of the existence of a conflict should take into account the requirements of materiality (see § 201 & Comment *c(ii)* thereof) and substantial risk (see *id.* & Comment *c(iii)* thereto) of conflict. In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.<sup>133</sup>

Unanticipated opposition to the proposed amendments was voiced by Judge Caroline D. King at the annual meeting of The American Law Institute.<sup>134</sup>

**Judge Carolyn Dineen King (Tex.):** Yes. I think, if I understand this correctly, that I do object. You will note that § 209 is broken down into Subsection (1) and Subsection (2), Subsection (1) precluding the representation where you "represent two or more clients . . . if there is a substantial risk that the lawyer's representation of one of the clients would be materially and adversely affected by the lawyer's duties to another client" and Subsection (2) dealing with representing "one client in asserting or defending a claim against another client . . . represented by the lawyer."

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<sup>133</sup> Proposed Text of Amendments Accompanying Memorandum from Professor Charles Wolfram to Gerald K. Smith, Susan M. Freeman, and Donald S. Bernstein (May 9, 1996) (on file with author).

<sup>134</sup> A member of the American Law Institute's Council and Judge on the Fifth Circuit Court of Appeals, and next in line to be the Chief Judge of the Fifth Circuit.

Now, if you take a look at the language that is proposed in this amendment, it starts out as if it were addressing Subsection (2). It says "The fact that one client holds a monetary claim against another client in a bankruptcy proceeding is not necessarily 'assertion' of a claim . . . ." And then it says, "A claim is 'asserted' or 'defended' when a dispute concerning the claim is involved," and that looks as if it is addressing the second part of this § 209. But then it goes on to say where "there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no conflict of interest under this Section is ordinarily presented," which of course takes Subsection (1) out of play also. So I am not altogether sure that was intended, but that is the effect of it. I know that the bankruptcy lawyers have assiduously pursued the proposition that they would like to be carved out of this Restatement, and we have, I think quite properly, resisted that, and I hope we will to our dying day. But I believe that, with the way this has been drafted, they have been carved out.

And the next sentence doesn't give me any more comfort because it says, "a discrete conflict between two clients, such as a dispute over the validity of a claim . . . , may not disqualify a lawyer from representing one client with respect to aspects of the case not involving the dispute between the clients."

I would like to make the point here that there is a fundamental problem with what we are doing here, and that is there are two ways in which a claim can be adversely affected in a bankruptcy proceeding. One is at the end of the day, so to speak, when we will adjudicate, most often at the end of the day, whether it is valid, whether it is secured, whether it will be subordinated, and so on, all right, and you can be killed if you are a claimant at the end of the day. But you can be equally as dead by virtue of the way that claim is treated under the plan. And you draw a distinction in your language here between the administration of the case, which sounds like sort of bookkeeping but is in fact where the heavy hitting is done in a bankruptcy case. So my suggestion is that it is naive, I think it looks naive, to buy into this distinction.<sup>135</sup>

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<sup>135</sup> Transcript of Debate over Amendments to Section 209 of the Restatement of the Law Governing Lawyers at the 1996 Annual Meeting of the American Law Institute, in 73 A.L.I. Proc. 389 (1996).

King: The following colloquy then took place between Professor Hazard and Judge

**Director Hazard:** Well, I mean if you say once bankruptcy is filed, then you have to treat it as though all claimant positions are hostile in a disqualifying sense to the debtor.

**Judge King:** Right.

**Director Hazard:** Is that the position you would take? So that, if you represent anybody who is a claimant, you cannot represent the debtor?

**Judge King:** I think that there is –

**Director Hazard:** That is the crunch that they are worried about.

**Judge King:** I know. I know that is the crunch. Let me say that is the crunch they are in today, all right.

**Director Hazard:** I understand.

**Judge King:** So we have now what I think the bankruptcy lawyers view as an opportunity to get out of the crunch that they are currently in, and I would say let's be very careful about that.

**Director Hazard:** Well, I agree with that, but I have to say the word "administration" was my word, and I take responsibility for it. I had in mind that there are lots of bankruptcies where it is to a large extent a bookkeeping matter, . . . but the question is, is there a way you can describe a stage prior to, how shall we say, a prelitigation or a precrunched stage where you would feel more comfortable saying, "Well, you can go that far but you've got to stop." I am questioning do we have any words that can describe the boundary?

**Judge King:** I don't at this point. I think the thing needs to be rethought. I mean, I really think it needs to be recommitted. The problem is that in many prepacks all of this stuff gets worked out ahead of time, but those present their own problems, too. I think that may be what you are talking about.<sup>136</sup>

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<sup>136</sup> *Id.* at 391.

Professor Wolfram joined in.

**Professor Wolfram:** Judge, at least as I understand it – but I will let the bankruptcy people, if there are any here, speak for themselves, – it was a sub (2) problem, their problem. They simply didn't want to be in the position of being tagged with the sub (2) disqualification, even though they were clean under sub (1), just because bankruptcy is thought to be an adjudication, and that was the point of treating it as administration devolving into dispute.

....

**Professor Wolfram:** But as I understand it, your problem is that when you prepackage things, for example, the negotiation that goes into that is where the hostility is.

**Judge King:** That's right.

**Professor Wolfram:** The fact that it is all sweetness and light by the time it comes to court doesn't mean there was never a conflict.

**Judge King:** That's right.

**Professor Wolfram:** I quite agree with that, but I wonder whether that isn't a sub (1) problem and adequately covered by sub (1).

**Judge King:** I am really not sure, because when you have a claim in one of these proceedings, the question that you have is it plays out in such ways that you can't see vis-a-vis the way in which the debtor is administered, the way in which the plan is confected . . . .

**Professor Wolfram:** Well, I see the problem, and I think I take your point, that it might be well if we went back to possibly a larger group in which you would be included – if I may suggest that – to negotiate this further. But I think that, under sub (1), the kind of problem that you are worrying about could be dealt with. Possibly it can't be dealt with in a rule disqualifying. It is really a rule that permits the unwinding of the representation later with inspection into whether it in fact has been appropriate in terms of adverse impact on the lawyer's representation, and it could be that simply referring, for example, as the Comment does in the last sentence here, to superadded requirements under the bankruptcy

statute that might require a heightened duty, also has to be observed as insufficient.

**Judge King:** May I respond to that? I mean in my court, if someone asks you a question from up there, you get to respond; I don't know if that is how it works here. *(Laughter)* Even when the red light is on, you get to answer the question, and they generally say, "But only one sentence."

You have in here this reference to complying with more stringent statutory requirements, but you understand, of course, that the statute operates in significant part, not exclusively but in significant part, by incorporating the state conflict-of-interest rules. So when you do this, when you do whatever you do here, you need to understand that it will de facto amend the bankruptcy law. Okay?

**Ms. Susan M. Freeman (Ariz.):**

....

The Bankruptcy Code in § 327(c) says that you are not disqualified from representing the debtor because your firm represents a creditor. That is not per se a disqualification, and the Bankruptcy Code specifically authorizes special counsel to come in and handle matters in a case that the attorney for the trustee or the attorney for the debtor cannot handle. This provision is intended to deal, you are correct, Professor Wolfram, with Subsection (2), in saying that the mere fact that a client in your office has a claim is not enough to disqualify you from representing the debtor or the trustee. The question is, is there going to be a dispute involving that claim, whether it is a dispute over the validity of the claim or a dispute over treatment of the claim under the plan, but those kinds of disputes you could not handle on behalf of the debtor.

And then you get to the question of, well, can you still represent the debtor if there are other claimants out there, if there is a possibility of a dispute with an existing client of your office? And then it comes down to the fact that you are depending on other rules, the Subsection (1) rules, § 201, where there is not a likelihood that there is going to be a significant contest, then –

**Mr. Sheldon H. Elsen (N.Y.):** I think the Director has put his finger on it. This ought to go back for more work. I speak as a nonbankruptcy lawyer who has been involved in these situations,



and I think that Geoff alluded to the fact that there are institutional problems that this is intended to solve. In a large city like New York, with giant bankruptcies involving big-board companies, a situation where law firms represent creditors, such as the major banks, would be barred from representing debtors-in-possession would be bad public policy, because these firms accumulate a high degree of expertise and skill in dealing with the problems of public companies and complex accounting and other financial problems and society, would simply be harmed if their skills could not be made available to debtors because they represent the banks.

On the other hand, these firms have, in the better situations, when the actual litigation has arisen, referred the case to special counsel. I think what Judge King is pointing to in the *Leslie Fay* case is a situation where that firm would have probably done better to have done some referrals earlier in the game, but I know the firm in question has solved that in other situations. It is immensely complex, and I do think the Director is right. It ought to go back for some further working, but I don't think you ought to throw the baby out with the bath water. The institutional situation here is socially desirable.

**Mr. Brian Redding (Ill.):** I have great sympathy with the practical problems that Ms. Freeman articulated and also with Judge King's comments. Having wrestled with this a bit, one of the things I might suggest that the Reporters might think about if, as seems likely, they are going to do more work on it, is the consent problem. When I talk to bankruptcy lawyers one of the enormous problems here is the practical problem of getting consent from a huge number of clients of your law firm who are representing creditors, and, in the short run, sometimes in some courts the bankruptcy judge can be of assistance on that. I think maybe, as you discourse with the bankruptcy folks, maybe you ought to think about whether there isn't a way to help solve the problem by relaxing consent in terms of doing consent through the court rather than the kind of consent that we are all used to, individualized consent with individualized contact back and forth through a client list that may include 75 or 100 or 200 creditors in a given bankruptcy.

**Vice President Traynor:** Do the Reports wish to respond briefly?

**Professor Wolfram:** I think I am sympathetic to the motion, which I understand to be a motion to recommit for further consideration, but I don't wish to withdraw the matter from the

floor. We are on the tipping point of a vote which I think is inevitable in any event.

**Vice President Traynor:** Judge King, do you wish to take a minute to respond?

**Judge Carolyn Dineen King (Tex.):** I think recommitting this is the thing to do. I am very sympathetic to the problem, and I want very badly to see this problem taken hold of by the horns and fixed. I think Mr. Redding's comments go right to it, but I don't want to see something like this. I would rather see us tackle the whole thing head on instead of trying to do something like this, so I think recommitting it is what I would espouse.<sup>137</sup>

Judge King's opposition doomed the proposed amendments and resulted in the recommittal of section 209.

As a result of discussions and correspondence among those concerned, including Judge King, Council Draft No. 13 reflects changes to the commentary to section 209.

*c(ii). Opposing clients in multi-party litigation.* Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and disputes. There is substantial disagreement whether various bankruptcy proceedings should be considered under Subsection (2). Tribunals must resolve such questions in light of a body of decisions developed in the specific context of bankruptcy, and often the issues are controlled by statute. The context involves transformation of a business relationship into one that is at least in part controlled by different principles and rules, some of them of a fiduciary nature. The Restatement takes no position on the applicability of Subsection (2) in the many situations that may arise in bankruptcy. However, "asserting or defending a claim" within the meaning of the Subsection refers to a dispute about the claim and not merely holding or filing a claim as to which there is no reasonable likelihood of dispute.

In all such situations the lawyer must comply with Subsection (1) and Section 201 generally, both before and after the filing of a formal proceedings. For example, two or more present clients of a lawyer or law firm may be involved in contentious negotiations about such issues as the validity, amount, or priority of claims, the voidability of a pre-bankruptcy transfer, or the nature of a claim as secured or unsecured. Whether a conflict exists in

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<sup>137</sup> *Id.* at 391-95.

such multiple representations must be analyzed under Subsection (1) (see also § 211). In addition to general conflict rules that may apply, a lawyer must also comply with statutory and regulatory requirements if more stringent, such as applicable provisions of the bankruptcy code.

A dispute between two clients—either before or after filing of a bankruptcy proceedings—may not disqualify a lawyer from representing one client with respect to aspects of the matter not involving that dispute. For example, as may be true in other contexts as well, a separable disputed matter may be handled by one or more special counsel not affiliated with the lawyer or law firm in question (see § 203).<sup>138</sup>

Thus, Judge King believes that the entire bankruptcy case should be treated as a civil lawsuit, thus precluding representation of a trustee, debtor-in-possession, or creditors' committee, absent consent of a party-in-interest represented by the attorney in an unrelated matter. Judge Jones concurs, but is also of the view that this is so under the Bankruptcy Code and cannot be cured by consent. Others have suggested that until there is a "face-to-face dispute," there should be no disqualification.

Mr. William Zewadski of the Florida Bar requested that the ALI address conflicts in The Restatement of the Law Governing Lawyers. Professor Geoffrey C. Hazard, Jr., the Director of the ALI, responded to Mr. Zewadski as follows:

If the Restatement addressed the conflict problem in bankruptcy in terms of the rules governing conflicts as set forth in the Restatement – rules universally accepted in this country – the statement would, in my opinion, provide that a firm handling a bankruptcy for a debtor, whether Chapter 7 or Chapter 11, would require consent of any concurrent client represented by the same firm who was a creditor whose claim stood in any substantial degree of risk of being compromised in the course of the proceeding, and of any former client having a claim subject to that risk which had arisen from a transaction in which the client has been represented by the firm. In my opinion, this rule may well be too onerous, and bankruptcy law should recognize the efficacy of an "insulation wall" within a firm between lawyers for the debtor and lawyers for creditors not likely to suffer substantial financial harm if their claims are compromised. However, such a rule cannot be fashioned out of the generalized recognized rules on conflict of interest. We thought it prudent, and certainly to the interest of the bankruptcy bar, not to prejudice or foreclose a

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<sup>138</sup> *Restatement (Third) of the Law Governing Lawyers* (Council Draft No. 13, 1996), pp. 36-38.

development in "bankruptcy conflicts" by speaking specifically to the issue in the Restatement. If strongly pressed, however, the Reporters could reconsider and tender a formulation like that stated above.<sup>139</sup>

B. Ethics 2000.

The American Bar Association's Commission on Evaluation of the Rules of Professional Conduct has been renamed the Ethics 2000 Commission. Its membership includes Professor Geoffrey C. Hazard, Jr. and others who are expert in the rules of professional conduct. Its Chief Reporter is Professor Nancy J. Moore and an additional Reporter is Professor Thomas D. Morgan, the Assistant Reporter in charge of Chapter 8 of the American Law Institute's Restatement (Third) of the Law Governing Lawyers. Chapter 8 concerned conflicts of interest.

The Ethics 2000 Commission has a three-year-plus mission to review the ABA's Model Rules of Professional Conduct. Additional public hearings are scheduled in Dallas February 10, 2000 and in New Orleans, June 2, 2000. Its goal is to have a preliminary report available for the ABA House of Delegate in October 2000.

The Commission released a draft set of rules in March of 1999 for a six-month comment period that ended in mid-September. Included among those rules were amended rules concerning confidentiality and conflicts of interest. The proposed amended rules are attached as Appendix 3.

Additional rules have now been released for comment. These were posted on the Commission's website in November. These include a new disciplinary rule for prospective clients, an amended rule on fees and an amended rule on the respect for rights of third parties. A copy of this release is attached as Appendix 4.

Considerable input was made to the Commission by Dean Nancy B. Rapoport. Her recent article is instructive and concerns bankruptcy cases.<sup>140</sup>

As Chairman of the National Bankruptcy Conference's Ethics Committee and as a member of the Board of Directors of the American College of Bankruptcy Professionals, I wrote the Commission in January 1999 and brought to its attention the two articles I had written which concern conflicts in bankruptcy cases.

It is once again my impression that the Ethics 2000 Commission does not care to concern itself with bankruptcy matters. Although I received a polite response from Professor Moore, it merely invited specific recommendations or suggestions from me, the National

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<sup>139</sup> Letter from Geoffrey C. Hazard, Jr. to William Knight Zewadski, Esq. (Nov. 25, 1997) (on file with author).

<sup>140</sup> Nancy B. Rapoport, Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics, 6 Am. Bankr. Inst. L. Rev. 45 (1998).

Bankruptcy Conference or the American College of Bankruptcy Professionals along with a description of the problems that exist under the present Model Rules. Since Dean Rapoport had adequately presented these issues to the Commission, I did not submit any additional concrete proposals. My suggestions as well as those of The National Bankruptcy Conference were adequately covered in my two law review articles.

Because of the structure of the Model Rules, it is doubtful that the Commission will recommend specific bankruptcy rules. However, it may be willing to introduce some commentary which would be useful. Unfortunately, the present drafts do not do so.

C. National Bankruptcy Review Commission.

The National Bankruptcy Review Commission had a capable Working Group. It consisted of Commissioners Ginsberg and Butler, Senior Adviser Professor Lawrence P. King, and Staff Attorney Elizabeth Holland. Participants invited to discuss relevant issues included Professor Charles W. Wolfram, the Reporter for the *Restatement*, practicing lawyers Don Bernstein, Michael Bloom, Susan Freeman, Barney Shapiro, and the author. Mr. John R. Byrnes sat in as the representative of the Executive Office of the U.S. Trustee. The Working Group and participants had working sessions July 18-19, 1996, in Washington, D.C., September 18, 1996, in Santa Fe, New Mexico; December 17, 1996, in Washington, D.C.; and January 22-23, 1997, in Washington, D.C. The Working Group explored a number of issues,<sup>141</sup> but the Working

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<sup>141</sup> The Service to the Estate & Ethics Issues List consisted of the following:

Should the existence of a material adverse impact be the only grounds for disqualification to represent, or receive compensation from, the estate? Should a definition of material adverse interest be included in the Bankruptcy Code?

Should the "disinterestedness" standard be relaxed? Should professionals with existing relationships with their clients be able to serve as counsel to the debtor in possession?

Who are the "professionals" who should be supervised by the court?  
Management consultants? Media relations advisors? Lobbyists? Surveyors?  
Appraisers? Real Estate Brokers?

Should parties be able to waive disinterestedness requirements?

Are potential, rather than actual, conflicts sufficient to disqualify counsel?  
Should the standard be different for section 327(a) counsel versus section 327(e) counsel?

Should rules enacted in the Bankruptcy Code supersede local regulation under canons of ethics and disciplinary rules?

How should conflicts of interest be defined for application to the engagement and compensation of professionals?

Group's work was cut short at admission to practice, the disinterestedness standard, and a definition of adverse interest.<sup>142</sup> The Working Group recommended to the Commission that the disinterestedness standard be abandoned as to those employed by the debtor-in-possession, but

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When should multiple professionals be required to represent multiple, related parties and when can such parties be represented by one professional? Should certain inter-company relationships affect this result?

Does the disqualification of an individual in a law firm disqualify the entire firm? Do "Chinese walls" work in bankruptcy?

What criteria should judges use to approve applications for professional compensation? Should fees be judged by local or national standards? Should routine hold-backs be approved? Are lodestars appropriate? Are other compensation schemes more likely to produce an efficient system? Does the appointment of a fee examiner help the process or does an examiner usurp the judge's role and drive up the cost to the professional?

Do requirements for local counsel drive up costs? Should they be abolished? Or do they reduce costs by demanding representation by counsel familiar with local court practices?

<sup>142</sup> The proposal as to the national admissions rule was that

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another bankruptcy court, to appear in the other bankruptcy court in the United States without the need for any other admission procedure.

Service to the Estate and Ethics Proposal #3: Nationwide Admission to Practice (revised for 1/22/97 Meeting). Even this recommendation was watered down in the form approved by the Commission so as to leave intact local rules requiring local counsel:

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure. The proposal will not affect requirements (if any) to associate with local counsel. Similarly, the proposal will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The proposal will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located.

National Bankruptcy Review Commission – Proposals Initially Adopted by the National Bankruptcy Review Commission p. 4 (revised April 29, 1997). The Admission Rule drafted by Professor Coquillette for the Circuit Courts of Appeals does not require local counsel. Daniel Coquillette, Study of Federal Cases Involving Federal Rules of Appellate Procedure 46, Standing Committee Report July 19-20, 1997, published in Working Papers of the Committee on Rules of Practice and Procedure – Special Studies of Federal Rules Governing Attorney Conduct, Appendix III, p. 259 (A.O. Sept. 1997) ("Working Papers").

be retained as to those employed by the trustee.<sup>143</sup> Concerning the definition of adverse interest, the Working Group recommended that the Commission give serious consideration to the adoption of the language worked out by the reporters and participants in the process of creating the *Restatement*, which basically identified a conflict of interest or an adverse interest in the Code terminology as a representational or personal interest which resulted in a substantial risk of a material and adverse effect on the representation. It was believed that this would give the courts guidance. Under this approach, a lawyer who is a prepetition creditor of the debtor might very well be disqualified, not under a *per se* rule, but because of a significant interest, whether as a result of the amount or the nature of the claim. On October 19, 1996, the Commission adopted the first proposal of the Working Group that:

Professionals retained by a debtor in possession in a chapter 11 case should not have to meet the disinterestedness requirement of 11 U.S.C. § 327(a). The deletion does not change the requirement that such professionals (i) not have any interest materially adverse to the estate or (ii) disclose all potential conflicts to the court.<sup>144</sup>

However, the proposal was revoked at a Commission Meeting in June, 1997, and by a mail ballot August 5, 1997, by a vote of six to two. The following alternative language for Proposal No. 1 was adopted:

Section 1107(b), which authorizes an exception to the disinterestedness/conflict of interest standards for professionals in Chapter 11 cases, should be modified as follows:

(b) Notwithstanding § 327(a) of this title, a person is not disqualified for employment under § 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case, or solely because of such person's being the holder of an insubstantial unsecured claim against or equity interest in the debtor.<sup>145</sup>

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<sup>143</sup> The Jones/Zywicki memorandum makes much of the fact that the Commission's initial recommendation, and the proposal of the Working Group, eliminated the disinterestedness standard as to professionals employed by the debtor-in-possession. Somehow it was concluded that the failure to extend the recommendation to the trustee indicated a flaw in the approach. That is really grasping at straws. Problems had not been encountered in practice with the disinterestedness standard of counsel for the trustee. It is rare that the trustee seeks to employ anyone having any relationship to the debtor, except in a special role. Nonetheless, it would make sense to eliminate the disinterestedness standard as to the trustee in all likelihood; it no longer serves a useful purpose and the independence of counsel would be adequately assured by the no material adverse interest standard which would apply across the board.

<sup>144</sup> National Bankruptcy Review Commission – Proposals Initially Adopted by the National Bankruptcy Review Commission, at 4 (revised April 29, 1997).

<sup>145</sup> Service to the Estate & Ethics Ballot.

As a result, the Commission and its staff did not pursue other issues or the adverse interest definition proposal of the Working Group:

The Bankruptcy Code should define conflict of interest for purposes of retention of professionals under section 327. A professional has a conflict of interest if there is a substantial risk that such professional's representation will be materially and adversely affected by the professional's own interests or by the professional's duties to another person that currently employs or formerly employed such professional, or a third person. The proposal does not affect a professional's duty under Fed. R. Bankr. P. 2014 to disclose "all connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee."<sup>146</sup>

D. Proposed Amendments To 28 U.S.C. § 1334.

The number of claims being asserted against professionals involved in bankruptcy cases is increasing. The most dramatic example is the most recent lawsuit against Ernst & Young arising out of alleged fraud and negligence in the *Merry-Go-Round* case. The *Wall Street Journal* devoted considerable space to the fact that Ernst & Young paid \$185 million to settle the case.<sup>147</sup> Needless to say, with the notoriety given the settlement, we can expect that the incidents of lawsuits of that nature will dramatically increase in the years to come.

The Ernst & Young lawsuit was not the only lawsuit of its nature resolved in 1999. Milbank, Tweed, Hadley & McCloy was reported to have paid \$1,860,000 to settle a claim against it arising out of nondisclosures and conflicts in the *Bucyrus International, Inc.* Chapter 11 case.<sup>148</sup> One of the interesting issues that arises in cases of this nature is the appropriate forum to resolve the claims. Intuitively, one would assume that it is the bankruptcy court. If there has been a nondisclosure, the court where it occurred should deal with the matter. Furthermore, the bankruptcy court must pass on requests for compensation in any event and one would normally assume any claims for improper services should be raised in that context. The cases are legion where not only compensation has been reduced or denied, but where additional sanctions were imposed. The bankruptcy court deals with these issues all the time. On the other hand, it is an entirely different situation in state court. There the claimant generally asks for a

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<sup>146</sup> Memorandum from Prof. Lawrence King to National Bankruptcy Review Commission, Prof. Elizabeth Warren and Stephen H. Case, dated April 28, 1997 at 4.

<sup>147</sup> Elizabeth McDonald and Scott J. Paltro, *Merry-Go-Round: Ernst & Young Advice to Client, But Not About Everything: It Didn't Reveal Business Ties Alleged Posed Conflict With Its Consulting Job: Settlement For 185 Million Dollars*, *The Wall Street Journal*, Tuesday, August 10, 1999.

<sup>148</sup> 31 B.C.D. 21 at A1, A9-A11.



jury trial and it is an extraordinarily difficult process to recreate the events that transpired in a complicated Chapter 11 case before a jury.

In the *Merry-Go-Round* case, the plaintiff did just that. The plaintiff was the trustee in bankruptcy and the liquidation case following the unsuccessful Chapter 11 reorganization attempt of *Merry-Go-Round*. Ernst & Young removed the case to the bankruptcy court, but the plaintiff requested that it be remanded to the state court and it was. The decision of the bankruptcy judge was affirmed by the district court.<sup>149</sup> In a very similar situation Coopers & Lybrand was sued in connection with an inadequate disclosure in a Texas state court. After learning of the inadequate disclosure, the debtor asked the bankruptcy judge to require Coopers & Lybrand to disgorge all of its fees. The bankruptcy judge did require that Coopers & Lybrand return nearly 15% of the fees. Thereafter, the state court lawsuit was filed and removed to the bankruptcy court which had presided over the *Southmark* bankruptcy case. The bankruptcy judge then considered the claim and concluded that it was barred under principles of collateral estoppel and *res judicata*. The Fifth Circuit affirmed on appeal. On the issue of which court should hear the matter, the Fifth Circuit concluded that the claim was a core proceeding and that the bankruptcy court had exercised its discretion appropriately in refusing to abstain.<sup>150</sup> The Ninth Circuit has also recently considered whether the jurisdiction of the bankruptcy court is exclusive as to a misconduct of a professional employed in a bankruptcy case. In *Elias v. Lisowski Law Firm, Chtd. (In re Elias)*,<sup>151</sup> the Bankruptcy Appellate Panel for the Ninth Circuit in a case initiated in a state court where the state court judge in essence referred the matter to the bankruptcy court, in a dissenting opinion dissenting from a determination that there was no jurisdiction because the case was closed, Judge Russell, a highly respected bankruptcy judge from the Central District of California, concluded that the bankruptcy court not only had jurisdiction, it had exclusive jurisdiction:

Indeed, the bankruptcy court has exclusive jurisdiction over the determination of debtor's attorney's fees: "The determination of fees of an agent of the estate is a core proceeding within the exclusive jurisdiction of the Bankruptcy Court." *In re Edgewater sun spot, Inc.*, 183 B.R. 938, 943 (N.D. Fla. 1995), aff'd sub. nom *Edgewater Sun v. Pennington & Haben*, 84 F.3d 438 (11<sup>th</sup> Cir. 1996), cert denied sub. nom *Edgewater Sun Spot, Inc. v. Pennington & Haben, P.A.*, 136 L.Ed 2d 220, 117 S. Ct. 303 (1996). Moreover, the Ninth Circuit has ruled that the bankruptcy court has exclusive jurisdiction over claims of misconduct on the part of debtors' attorneys. In *In re Balboa Improvements, Ltd.*, 99 B.R. 966 (9<sup>th</sup> Cir. BAP 1989), the BAP held that:

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<sup>149</sup> *Ernst & Young, LLP v. Devan (In re Merry-Go-Round Enterprises, Inc.)*, 222 B.R. 254 (D. Md. 1998).

<sup>150</sup> *Southmark Corp. v. Coopers & Lybrand (In re Southmark Corp.)*, 163 F.3d 925 (5<sup>th</sup> Cir. 1999).

<sup>151</sup> 215 B.R. 600 (9<sup>th</sup> Cir. BAP 1997).

Jurisdiction over a claim of misconduct by the debtor's attorney in the administration of an estate may be analogized to the exclusive jurisdiction over similar claims against a court-appointed trustee or debtor-in-possession. It is well settled that such fiduciary cannot be sued in state court without leave of the bankruptcy court for acts done in his official capacity and within his authority as an officer of the court.<sup>152</sup>

dissented: On appeal to the Ninth Circuit, the Ninth Circuit affirmed, but Judge Fernandez

Bankruptcy courts surely have the most expertise and interest in controlling their own proceedings and in regulating the behavior of professionals who seek to appear before them or work on cases under their tutelage. It is those courts that help prevent distressed debtors, and their creditors, from becoming cheerless carrion for voracious vultures, who would pick the estate clean. In my opinion, there is a need for exclusivity and I would require it, but I need not even consider the farthest reaches of bankruptcy court jurisdiction over fees at this time.<sup>153</sup>

One of the amendments to S. 625 is a provision which seeks to assure that the bankruptcy court will at least exercise exclusive jurisdiction over nondisclosures by bankruptcy professionals.

Amendment No. 2478 as modified

(Purpose: To provide for exclusive jurisdiction in federal court for matters involving bankruptcy professional persons)

On page 124, insert between lines 14 and 15 the following:

Sec. 322. Exclusive Jurisdiction in Matters Involving Bankruptcy Professionals.

Section 1334 of title 28, United States Code, is amended—

(1) in subsection (b) by striking “Notwithstanding” and inserting “Except as provided in subsection (e)(2), and notwithstanding”; and

(2) amending subsection (e) to read as follows:

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<sup>152</sup> *Id.* at 49-50.

<sup>153</sup> *Elias v. Lisowski Law Firm, Ltd. (In re Elias)*, 188 F.3d 1160, 1165 (9<sup>th</sup> Cir. 1999).

“(e) The district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction—

“(1) of all the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate;

and

“(2) over all claims or causes of action that involve construction of section 327 of title 11, United States Code, or rules relating to disclosure requirements under section 327.”<sup>154</sup>

E. Proposed Amendments To Bankruptcy Rule 2014.

As Chair of the Ethics Committee of the Advisory Committee on Bankruptcy Rules, I drafted a proposed amendment to Rule 2014 which would eliminate the term “connections.” With the help of the members of that committee, including useful suggestions from Len Rosen and Alan Resnick, I came up with a second draft which will be considered by the Advisory Committee and its Ethics Committee. Ken Klee has taken over as chair of the Ethics Committee and Jeff Morris is the new Reporter replacing Alan Resnick.

The proposed amendment is as follows:

**Rule 2014. Employment of Professional Person**

(a) MOTION FOR AN ORDER APPROVING EMPLOYMENT. A request for an order approving employment under § 327, § 1103, or § 1114 of the Code may be made only by written motion of the trustee or committee. The motion shall:

- (1) state specific facts showing why the employment is necessary;
- (2) state the name of the person to be employed and the reasons for the selection;
- (3) state the professional services to be rendered;
- (4) disclose any proposed arrangements for compensation; and

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<sup>154</sup> Senator Strom Thurmond Amendment No. 2478 (Senate – November 16, 1999)

(5) state that, to the best of the movant's knowledge, the person to be employed is eligible under the Bankruptcy Code for employment for the purposes set forth in the motion.

(b) **STATEMENT OF PROFESSIONAL.** The motion shall be accompanied by a verified statement of the person to be employed. The statement shall:

(1) state that the person is eligible under the Bankruptcy Code for employment for the purposes set forth in the motion;

(2) disclose any interest that the person holds or represents that is adverse to the estate;

(3) disclose any interest or relationship relevant to a determination that the person is disinterested;

(4) disclose the person's relationship to the United States Trustee, or any person employed in the office of the United States Trustee;

(5) if the professional is an attorney, state the information required to be disclosed under § 329(a); and

(6) state whether the person shared or has agreed to share any compensation with any person and, if so, the particulars of any sharing or agreement to share other than the details of any agreement for the sharing of compensation with a partner, employee, or regular associate of the partnership, corporation, or person to be employed.

(c) **SERVICES RENDERED BY MEMBER OR ASSOCIATE OF FIRM OF EMPLOYED PROFESSIONAL.** If, under the Code and this rule, a court authorizes the employment of an individual, partnership, or corporation, any partner, member, or regular associate of the individual, partnership or corporation may act as the person so employed, without further order of the court. If a partnership is employed, a further order authorizing employment is not required solely because the partnership has dissolved due to the addition or withdrawal of a partner.

(d) **SUPPLEMENTAL STATEMENT OF PROFESSIONAL.** Within 30 days after becoming aware of any matter that is required to be disclosed under Rule 2014(b), but that has not yet been disclosed, a person employed under this rule shall file a supplemental verified statement concerning the additional matter or matters to be disclosed, serve copies on the entities listed in

Rule 9014( ), and, unless the case is a chapter 9 municipality case, transmit a copy to the United States Trustee.

This will eliminate the requirement of identifying and disclosing "connections" while retaining the requirement to disclose necessary information. I have long been concerned with the uninformative nature of Bankruptcy Rule 2014. The absurd result in *In re The Bennett Funding Group, Inc.*, 226 B.R. 331 (B. Ct. N.D.N.Y. 1998) makes it clear to me that the term "connections" should be abandoned. Connections is too general a term. The problem is compounded since the rule requires disclosure of connections with accountants and attorneys for various parties-in-interest. The one required to disclose such information does not know who the various parties-in-interest are let alone their accountants and attorneys.

I do not intend to belabor the point, but the rule as written is unsound and its application by the U.S. Trustee and the courts is causing unnecessary misery to the courts as well as professionals ensnared in its beguilingly simple language. This reflects badly on courts, lawyers and the bankruptcy system. My recent law review article concerning disinterestedness has some of the background of the drafting of the rule and how it evolved.<sup>155</sup> At the very least, we should eliminate the requirement of disclosure of connections with attorneys and accountants, replacing this with the requirement that there be disclosure of any adverse interest. This is the proper focus and relevant inquiry. We can understand adverse interest (even better if defined), but we cannot understand connection. We can conflict check adverse interests, but we cannot conflict check connection.

F. Proposed Federal Rules of Attorney Conduct.

For several years, the Standing Committee has been exploring rules regulating attorney conduct. The Standing Committee directed its Reporter, Professor Daniel R. Coquillette, of Boston College Law School, to review local rules governing attorney conduct. Professor Coquillette's Report to the Standing Committee describes the sensitive nature of the project and the magnitude of the problem:

No area of local rulemaking has been more fragmented than local rules governing attorney conduct. This difficult subject was first raised at the outset of the Local Rules Project in 1988, and was then discussed extensively by the Standing Committee at a Special Conference on Local Rules, convened by the Committee at Boston College on November 14, 1988. Many of the goals of the Local Rules Project, including uniform numbering, were relatively uncontroversial, but review of local rules governing attorney conduct proved to be highly contentious. Rather than jeopardize

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<sup>155</sup> Gerald K. Smith, Standards for the Employment of Professionals in Bankruptcy Cases: A Response to Professor Zywicki's "Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals," 18 Miss. C. L. Rev. 327 (1998).

the early progress of the Local Rules Project, it was decided to defer this divisive issue to a later date.

Since that time, the “balkanization” of local rules governing attorney conduct appears to have grown worse . . . . [T]here are now seven fundamentally different approaches, and even within these “groups” there are great variations. The most common approach, local rules that incorporate the relevant standards of the state in which the district is located, actually divides federal districts because of the many differing state rules . . . . The Department of Justice, other major federal agencies, and many national legal organizations, including civil rights groups, national corporations, financial networks, large law firms, and groups facing multi-district litigation have been severely inconvenienced. . . . Further, the rise of legal malpractice actions has led to subsidiary dispute about choice of law—often of mind numbing complexity. This situation has led some major governmental agencies, including the Department of Justice, to consider adopting their own professional standards. The Department of Justice has now actually done so with regard to communications with represented parties, promulgating new Department regulations that differ significantly from most state standards and the standards adopted by local rule in most Districts and Circuits . . . . This adds further to the number and variation of the rules.<sup>156</sup>

After considering the Report, the Standing Committee voted to hold a special study conference and the Chair of the Standing Committee, Honorable Alice-Marie Stotler, directed Professor Coquillette to determine the frequency with which ethical issues arise in reported federal cases. This led to an additional report to the Standing Committee.<sup>157</sup>

The Special Study Group considered the two Reports at two sessions – one in January, 1996 in California and one in June, 1996 in Washington, D.C. At the conclusion of the second session, a substantial majority of the Study Group favored the drafting of a model local rule, but did not favor a uniform rule promulgated under the Rules Enabling Act. A majority concluded that additional empirical data should be gathered as to (1) the experience in districts that had adopted the earlier model rule, (2) the experience in districts that handle attorney discipline matters, (3) the experience with attorney discipline in the courts of appeal, and (4) the federal decisional law involving discipline of attorneys.<sup>158</sup>

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<sup>156</sup> Daniel R. Coquillette, Report on Local Rules Regulating Attorney Conduct 1-2 (July 5, 1995).

<sup>157</sup> Daniel R. Coquillette, Study of Recent Federal Cases (1990-1995) Involving Rules of Attorney Conduct (December 1, 1995).

<sup>158</sup> Judicial Conference of the United States, Standing Committee, June 1996 Minutes.

Thereafter, the Standing Committee appointed an Attorney Conduct Rules Subcommittee which included representatives of each of the Advisory Committees.

The Attorney Conduct Subcommittee recommended a rule of dynamic conformity to the law governing professional conduct of the state within which the district is located. Each Advisory Committee has been requested to consider the recommendation and report and respond to the Standing Committee in March 2000.

The following are comments by Professor Coquillette concerning the conclusions of the Subcommittee:

The Standing Committee Subcommittee on Federal Rules of Attorney Conduct met on September 29, 1999. The draft Minutes of the meeting are attached. This brief summary addresses the request of the Subcommittee that each advisory committee consider the attached draft of a possible FRAC 1 and offer advice to the Standing Committee at its January 2000 meeting. The draft is not submitted as a model that might be published for comment. Instead it is used only to illustrate one possible approach to the role of federal courts with respect to questions of attorney conduct in connection with federal court proceedings.

The basic approach illustrated by the draft Rule 1 distinguishes between matters of "professional responsibility" and matters of "procedure." All questions of professional responsibility are reserved to state authorities, whether or not the conduct involved is connected to federal proceedings. Federal courts retain control of federal "procedure" and control of the right to practice in a federal court. The federal court of federal procedure is protected against state encroachment by immunizing against state sanctions attorney conduct that is authorized by federal court order or by federal procedure. The question before the advisory committees is whether it might be useful to attempt to develop this approach through another round of work by the subcommittee, advisory committees, and Standing Committees, with the hope of developing a draft that could be published for comment in August 2000. The most probable alternative is to defer indefinitely any further national-level work on federal regulation of attorney conduct. Federal regulation then would continue to be imposed through the welter of local district rules now in place, as they may be revised by each district.<sup>159</sup>

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<sup>159</sup> Introduction to the Summary for Fall 1999 Advisory Committee Meeting (Sept. 1999).

The draft rule prepared by Professor Cooper, the Reporter for the Committee on Federal Rules of Civil Procedure, is as follows:<sup>160</sup>

Rule 1. Applicable Rules.

(a) Rules of Professional Responsibility

(1) District court. Except as provided in these rules, the professional responsibility of an attorney for conduct in connection with any action or proceeding in a United States District Court is governed by the rules that apply to an attorney admitted to practice in the state where the district court sits.

(2) Court of Appeals. Except as provided in these rules, the professional responsibility of an attorney for conduct in connection with any appeal or proceeding in a United States Court of Appeals is governed:

(A) With respect to any appeal from a district court, and any other proceeding directed to a district court, by the rules that apply to an attorney admitted to practice in the state where the district court sits.

(B) With respect to any other action or proceeding:

(i) if the attorney is admitted to practice only in one state, by the rules of that state, or

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<sup>160</sup> Professor Cooper's preface identified the reason for the phrase "except as provided in these rules" as follows:

My charge was to draft a model Civil Rule 83(c) establishing dynamic conformity with state rules of professional responsibility. I have chosen to frame this draft as a revised Rule 1, FRAC. It will be easy to revise it as a Civil Rule provision if that is the course to be taken in the end. On the other hand, if a decision is made to go forward with additional national rules addressing the concerns of bankruptcy practice or the concerns of the Department of Justice, for example, there could be "FRAC 2" and "FRAC 3" and so forth.

It may make sense to have a single Federal Rule of Attorney conduct even if it is decided not to have any additional rules; the "except as provided in these rules" preface in Rule 1(a)(1) and (2) is easily deleted. One reason not to have any additional rules may be that only clear procedural policies justify adoption of specific federal rules. These procedural policies might better be reflected in specific procedural rules – grand-jury problems, for example, could be addressed in the Criminal Rules. Bankruptcy problems provide a general example. On the other hand, there may be specific topics that cut across the various bodies of procedural rules and that should become FRAC 2 et seq.



- (ii) if the attorney is admitted to practice in more than one state, by the rules of the state in which the attorney principally practices, but the rules of another state in which the attorney is licensed to practice govern conduct that has its predominant effect in that state.
  
- (b) **Enforcing Professional Responsibility.** The rules of professional responsibility that govern under subdivision (a) are enforced by the property state authority. A United States District Court or Court of Appeals may initiate an investigation of an alleged infraction of a rule of professional responsibility, and – with or without an investigation – may refer any question of professional responsibility to the proper state authority.
  
- (c) **Procedure.** Federal law governs all matters of procedure in the United States District Courts and Courts of Appeals[, whether addressed by the Federal Rules of Attorney Conduct, Appellate Procedure, Bankruptcy Procedure, Civil Procedure, Criminal Procedure, or Evidence; by judicially developed rules; or by the court in its inherent power]. The court may, after notice and opportunity to be heard, enforce the procedural rules and its orders by all appropriate sanctions, including forfeiture of fees, reprimand, censure, or suspension or revocation of the privilege to appear before the court.
  
- (d) **Practice in United States Court.** A court of the United States may establish and enforce rules governing the right to appear as counsel in that court.
  
- (e) **State Sanctions Preempted.** No state authority may impose any sanction, civil liability, or other consequence on an attorney for conduct in connection with an action or proceeding in a United States District Court of Appeals if the conduct is authorized by order of the United States court or by the federal rules of procedure that apply under subdivision (c).

Earlier, I had drafted specific rules for bankruptcy cases using the Restatement of the Law (Third) Governing Lawyers as a model. I did this in the hopes of stimulating discussion. These are contained at pages 378 and 379 of my Mississippi Law Review article. “Standards for the Employment of Professionals in Bankruptcy Cases: A Response to Professor Zywicki’s ‘Case for Retaining the Disinterestedness Requirement for Debtor in Possession’s Professionals,’” 18 Miss. C. L. Rev. 327 (1998). The first rule defined adverse interest.

Rule [1]. Adverse Interest

For purposes of §§ 101(14)(E), 327, 328 and 1103, a person holds or represents an adverse interest if there is a substantial risk that the representation or performance of duties would be materially and adversely affected by the person's own interests or by the person's duties to another.

Another rule modified the "bilateral litigation" rule as to bankruptcy cases.

Rule [5]. Representing Person with Adverse Interest

Unless all affected clients consent to the representation under the limitations and conditions provided in Rule [ ], a person may not:

- (1) represent a person if the representation would significantly impair another client's expectation of the person's loyalty;
- (2) represent two or more clients in a matter not involving litigation if there is a substantial risk that the persons' representation of one or more of the clients would be materially and adversely affected by the person's duties to one or more of the other clients;
- (3) represent two or more clients in a disputed matter in a bankruptcy case if there is a substantial risk that the person's representation of one of the clients would be materially and adversely affected by the person's duties to another client in the matter; or
- (4) represent one client in a dispute in a bankruptcy case against another client currently represented by the person, even if the matters are not related.

The Advisory Committees on Appellate, Civil, Criminal and Evidence Rules have been asked to report to the Standing Committee this fall. Since the Advisory Committee on Bankruptcy Rules does not meet until March 2000, it has been asked to report after that meeting. The input of interested persons to the Advisory Committee and Professor Coquillette, the Reporter primarily in charge of the Federal Rules of Attorney Conduct, will be helpful.

Marie Leary of the Federal Judicial Center conducted a survey of bankruptcy judges concerning the standards governing attorney conduct. Standards Governing Attorney Conduct in the Bankruptcy Courts - Report to the Judicial Conference Advisory Committee on Bankruptcy Rules, Federal Judicial Center March 1999 (unpublished report, available upon request to author or the Federal Judicial Center's Information Services Office).

The Federal Judicial Center had conducted an earlier survey concerning local rules of attorney conduct in the federal district courts. However, as Marie Leary pointed out in her introduction to the bankruptcy survey,

Bankruptcy courts are different from the district courts in the attorney conduct area in that attorneys who practice in bankruptcy courts are subject to a complex statutory system, which includes bankruptcy-specific conflict of interest criteria and other standards directly governing attorney conduct. The Standing Committee has already given attorney conduct in the bankruptcy context some attention through a study report issued in June 1997. That study [hereinafter Study of Bankruptcy Cases], which examined reported bankruptcy opinions involving rules of attorney conduct, demonstrated that the proposals being considered by the Standing Committee for the federal district courts raise many additional issues for bankruptcy courts.<sup>161</sup>

Marie Leary developed a questionnaire with the assistance of the Advisory Committee on Bankruptcy Rules. Two versions were circulated, one was sent to all chief bankruptcy judges and all bankruptcy judges in districts with only bankruptcy judge. There were 90 judges in that category. The other questionnaire was sent to all other bankruptcy judges. It varied from the first questionnaire only in that it did not inquire as to the formal and informal sources of attorney conduct standards in the district.

There was a high rate of response. Out of the 90 chief judge questionnaires, 86 responded, and out of the 227 questionnaires to other judges, 174 or 77% responded.

Marie Leary discusses the survey results in-depth in her Report. In addition, she attached as appendices summaries of comments she received. Attached as Appendices 5, 6, 7, 8 and 9 are these appendices.

G. Cases.

In *In re Merry-Go-Round Enterprises, Inc.*, 222 B.R. 254 (D. Md. 1998) the district court affirmed the remand of a lawsuit filed by the Chapter 7 trustee of Merry-Go-Round Enterprises, Inc. in the Maryland state court. The case had been removed to the bankruptcy court under the provisions of 28 U.S.C. § 1452. The bankruptcy judge, however, remanded the case to state court and an appeal followed to the district court. The district court affirmed even though the district judge acknowledged that the case involved a core bankruptcy proceeding. *Id.* at 259. Since a decision to remand is not reviewable by the Court of Appeals under 28 U.S.C. § 1452(b),

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<sup>161</sup> Report to the Judicial Conference Advisory Committee on Bankruptcy Rules, p. 4 (footnote omitted), referencing Daniel R. Coquillette, Study of Recent Bankruptcy Cases (1990-1996) Involving Rules of Attorney Conduct 293 (1997), reprinted in Working Papers of the Committee on Rules of Practice and Procedure: Special Studies of Federal Rules Governing Attorney Conduct (Administrative Office of the United States Courts 1997).

that was the end of the line. As reported by the *Wall Street Journal*, Ernst & Young paid \$185 million to settle the case.

Allowing the state court to resolve claims of the nature asserted in the *Merry-Go-Round* litigation raises a number of issues. First, there is a considerable duplication of judicial effort. The bankruptcy judge has lived through the case and it need not be recreated before the state court trier of fact. Second, the bankruptcy judge generally supervises the employment and services of professionals. Any nondisclosure goes to the integrity of the bankruptcy system and should be resolved by the bankruptcy court. Third, the bankruptcy court should interpret the provisions of the Bankruptcy Code and Bankruptcy Rules so that there will be uniformity in their interpretation. Allowing state courts to do so will result in many different interpretations. Fourth, there are issues of *res judicata* and collateral estoppel inherent in those cases where interim and final awards of compensation or sanctions have been made. These matters are best resolved by the court that considered requests for compensation or sanctions.

In *In re The Bennett Funding Group, Inc.*, 226 B.R. 331 (B. Ct. N.D.N.Y. 1998), the trustee had a consulting agreement with Deloitte & Touche (USA) LLP ("Deloitte"). According to the opinion it provided that the trustee would "provide consulting services to Deloitte concerning regulatory and other matters affecting domestic and international capital markets and the financial services industry generally . . . . [I]t included consulting services [for] legislative, regulatory, administrative or business issues as to which Deloitte may seek . . . advice and counsel and that are reasonably acceptable to . . . the trustee." *Id.* at 332.

*Bennett Funding* and related cases have been pending for several years. The trustee filed a third supplemental affidavit on April 16, 1998 stating that he had entered into an agreement with Deloitte in February of 1998 to provide consulting services. At the time of the initial hearing on the trustee's sixth application for compensation, the U.S. Trustee expressed concern as to the adequacy of the disclosure as to the contractual agreement.

According to the Court's opinion, the trustee's search of public records (Deloitte would not disclose its clients) established that Deloitte was the independent auditor of A.G. Edwards, Inc. and American Gaming & Entertainment, Ltd. The opinion only focused on the latter relationship since the trustee was only suing Edwards "for an individual investor." *Id.* at 333, n.3. I do not quite understand this, but it is not important as far as the concerns expressed in this memorandum.

The trustee's disclosure stated that American Gaming is a publicly owned holding company of Shamrock Holdings Group, Inc., a subsidiary of one of the debtors included in the Consolidated Estate. *Id.* at 333. Shamrock owned 40% of the common stock and all of the preferred stock of American Gaming. American Gaming was also indebted to Shamrock in the approximate amount of \$65 million.

The U.S. Trustee insisted on disclosure by Deloitte of its private clients since "it is not possible to determine whether there is a potential for conflict for Breeden in representing the Consolidated Estate and in acting as a consultant to Deloitte." *Id.* at 334. The court stated that Rule 2014(a) "requires the Trustee to disclose any connections Deloitte might have with the

Debtors, creditors and any other party in interest.” *Id.* at 334. The court went on to observe that it was “left without answers to whether, in addition to A.G. Edwards and . . . [American Gaming], any of Deloitte’s private clients have ties to the case and to what extent.” *Id.* at 335.

The trustee argued that the services he was rendering under the consulting arrangement with Deloitte were services on behalf of Deloitte, not its clients. Deloitte was neither a creditor nor a party-in-interest in the consolidated cases. Nonetheless, the court observed that

[t]he question of “whether a professional [in this case, the trustee] has ‘either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors -- an incentive sufficient to place those parties at more than acceptable risk -- or the reasonable perception of one,’” . . . cannot be addressed in a vacuum without the benefit of knowing whether Deloitte numbers among its private clients any of the creditors of the estate or defendants in any of the thousands of adversary proceedings commenced by the Trustee in this case.

*Id.* at 335.

The court concluded that Breeden must either resign as trustee or terminate his consulting arrangement with Deloitte effective as of the date of his consulting agreement.

Under Rule 2014(a), a professional seeking employment must disclose any connection the professional has with a creditor or any party-in-interest. In addition, the professional must disclose any connection the professional has with any lawyer or any accountant for a creditor or party-in-interest in the case. Under section 1109(b), party-in-interest includes an equity security holder. Apparently the drafters of Rule 2014(a) assumed that the person to be employed could determine connections with accountants or attorneys for a creditor, equity security holder or other party-in-interest. How is this possible? Perhaps the Rules need to be amended to require that the debtor (or in appropriate cases the trustee) identify the accountants and lawyers of creditors and other parties-in-interest in the schedules.

Bankruptcy Rule 2014(a) requires a disclosure of connections with the debtor, creditors and any other party-in-interest and their respective attorneys and accountants. The trustee had a connection with Deloitte, but the trustee could not determine whether Deloitte was an accountant for a debtor, creditor or other party-in-interest. Without such knowledge, how could the relationship of Deloitte to a creditor or equity security holder or other party-in-interest create a problem?

In *Southmark Corp. v. Coopers & Lybrand (In re Southmark Corp.)*, a very similar situation to that in *Merry-Go-Round*, Coopers & Lybrand was sued in connection with an inadequate disclosure in a Texas state court. After learning of the inadequate disclosure, the debtor asked the bankruptcy judge to require Coopers & Lybrand to disgorge all of its fees. The bankruptcy judge did require that Coopers & Lybrand return nearly 15% of the fees. Thereafter, the state court lawsuit was filed and removed to the bankruptcy court which had presided over

the *Southmark* bankruptcy case. The bankruptcy judge then considered the claim and concluded that it was barred under principles of collateral estoppel and *res judicata*. The Fifth Circuit affirmed on appeal. On the issue of which court should hear the matter, the Fifth Circuit concluded that the claim was a core proceeding and that the bankruptcy court had exercised its discretion appropriately in refusing to abstain.<sup>162</sup>

In *Elias v. U.S. Trustee (In re Elias)*, 188 F.3d 1160 (9<sup>th</sup> Cir. 1999), the Ninth Circuit upheld the bankruptcy court's refusal to rule on the propriety and amount of fees incurred by the debtor in a Chapter 11 bankruptcy case after the case had been dismissed. The bankruptcy judge's ruling was affirmed by the Bankruptcy Appellate Panel for the Ninth Circuit in *Elias v. Lisowski (In re Elias)*, 215 B.R. 600 (9<sup>th</sup> Cir. BAP 1997). There was, however, a vigorous dissent by Judge Barry Russell. The Ninth Circuit *per curiam* decision pointed out that the bankruptcy court generally has discretion as to whether to reopen proceedings to reconsider its prior orders and the bankruptcy court also had discretion as to whether to consider the matter of fees since it was ancillary to its core function of adjudicating the estate. "Because we agree with the bankruptcy court that the state court is fully capable of resolving the fee dispute in this case, we hold that the bankruptcy court did not abuse its discretion in declining to decide the fee issue." *Id.* at 1162.

There was an interesting dissent by Judge Fernandez. Judge Fernandez pointed out that this was a matter of nondisclosure. The attorney for the debtor has failed to disclose "all . . . connections with the debtor, creditors, [or] any other party in interest. Fed. R. Bankr. P. 2014(a). . . . Moreover, a statement of consideration paid or agreed to be paid for attorney services was required. See 11 U.S.C. § 329. The bankruptcy court and the BAP agreed that a failure to make the required disclosures is sanctionable." *Id.* Judge Fernandez concluded that the questions were whether the bankruptcy court abused its discretion when it declined to reopen and whether there was jurisdiction to decide the attorneys' fees issue, whether or not the case was reopened. Judge Fernandez could find no abuse of discretion. Nonetheless, Judge Fernandez found that there was jurisdiction. In support of that ruling, Judge Fernandez cited numerous decisions. He also pointed out that one court even found that it had *exclusive jurisdiction* to decide attorneys' fees issues as core issues.

At least one court has gone even further and asserted that bankruptcy courts have exclusive jurisdiction to decide attorney's fee issues because they constitute core proceedings. See *Edgewater Sun Spot, Inc., v. Pennington & Haben, P.A. (In re Edgewater Sun Spot, Inc.)*, 183 B.R. 938, 943 (N.D. Fla. 1995), *aff'd*, 84 F.3d 438 (11<sup>th</sup> Cir. 1996). In reaching that conclusion, the court relied in part on a BAP opinion that affirmed the bankruptcy court's jurisdiction to sanction parties, even after a case had been dismissed. See *Mangun v. Bartlett (In re Balboa Improvements, Ltd.)*, 99 B.R. 966, 970 (B.A.P. 9<sup>th</sup> Cir. 1989); see

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<sup>162</sup> 169 F.3d 925 (5<sup>th</sup> Cir. 1999).

also *In re French Bourekas, Inc.*, 183 B.R. 695, 696 (Bankr. S.D.N.Y. 1995), *aff'd*, 195 B.R. 19 (S.D.N.Y. 1996).

*Id.* at 1165.

Judge Fernandez pointed out that the Ninth Circuit itself had previously concluded that “regulation of the activities of parties before the bankruptcy court should be in the hands of that court alone. See *MSR Exploration, Ltd. v. Meridian Oil, Inc.*, 74 F.3d 910, 915 (9<sup>th</sup> Cir. 1996).” *Id.* And Judge Fernandez finally observed that:

Bankruptcy courts surely have the most expertise and interest in controlling their own proceedings and in regulating the behavior of professionals who seek to appear before them or work on cases under their tutelage. It is those courts that help prevent distressed debtors, and their creditors, from becoming cheerless carrion for voracious vultures, who would pick the estate clean. In my opinion, there is a need for exclusivity and I would require it, but I need not even consider the farthest reaches of bankruptcy court jurisdiction over fees at this time.

*Id.*

The difficult issues that arise when matters involving performance of professionals are left to another forum are obvious in *Pipkin v. Henry & Peters, P.C. (In re R & C Petroleum, Inc.)*, E.D. Tex., Tyler Div. 1999. In *Pipkin*, the trustee of an unsecured creditors’ trust filed an adversary complaint against an accountant and the accounting firm employed by the Chapter 11 debtor-in-possession alleging breach of fiduciary duty, professional negligence, gross negligence and violation of the Texas Deceptive Trade Practices Act. The accountant’s motion for summary judgment was not entirely successful. The bankruptcy court left for resolution at the trial on the merits such matters as the doctrine of *res judicata* based on matters determined at the confirmation hearing, the preclusive effect of an earlier ruling on the accountant’s fee application and when the alleged malpractice was discoverable. These are issues best left to the bankruptcy court.

As in the *Pipkin* case, the bankruptcy judge handled the disputes concerning the performance by an accounting professional in *In re Southmark*.

In *In re MPM Enterprises, Inc.*, 231 B.R. 500 (E.D.N.Y. 1999), the bankruptcy judge disbarred an attorney from practicing before the bankruptcy court in the Eastern District. Although the district court reversed the disbarment order for lack of due process due to insufficient notice, excessiveness of the sanction, and because no statute, rule, decision or other authority was given by the bankruptcy judge for his decision, the district court opinion makes it exceedingly clear that the bankruptcy judge does have authority to disbar one from practicing before the bankruptcy court.

In *In re BBQ Resources, Inc.*, 237 B.R. 639 (Bankr. E.D. Ky. 1999), an order was entered authorizing the employment of counsel for the debtor-in-possession. It later turned out that counsel had an adverse interest and was disqualified. Counsel sought compensation for the period of time prior to disqualification. The bankruptcy judge held that there was no discretion to do so under § 327(a). The court cited a number of Sixth Circuit cases in support of that ruling, including *In re Middleton Arms Limited Partnership*, 934 F.2d 723 (1991); *In re Eagle-Picher Industries, Inc.*, 999 F.2d 969 (1993); and *In re Federal Department Stores, Inc.*, 44 F.3d 1310 (1995). The bankruptcy judge rejected the Ninth Circuit Bankruptcy Appellate Panel's ruling to the contrary in *In re CIC Investment Corp.*, 192 B.R. 549 (1996).

This brings to mind the resolution of the House of Delegates of the American Bar Association in 1991 which sought a rule establishing safe harbor in such situations. However, the Advisory Committee on Bankruptcy Rules declined to propose such a rule since several of its members believed it would have been a substantive change not permitted under the Rules Enabling Act, 28 U.S.C. § 2075 ("Rules shall not abridge, enlarge, or modify any substantive right.")

In an interesting Michigan state court case, the Michigan Court of Appeals affirmed the imposition of sanctions by the trial court for the filing of a bankruptcy petition in bad faith "in an attempt to reach a nominal settlement in this case through misrepresentation" or to otherwise delay the state court suit and burden the plaintiff and the court "under circumstances where the defendants had no intention of following through with the bankruptcy." *Prince v. MacDonald*, No. 204615, 1999 Mich. App. Lexis 222, decided August 3, 1999. The defendants argued that state courts did not have authority to sanction parties for abuse of bankruptcy proceedings relying on *Koffman v. Osteoimplant Technology, Inc.*, 182 B.R. 115 (Bankr. Md. 1995). That case had held that state law claims for abuse of process and malicious prosecution were preempted by the Bankruptcy Code. In contrast with the situation as to unsuccessful involuntary petitions, there is no express statutory provision like 11 U.S.C. § 303(i), and the Michigan Court of Appeals concluded that Bankruptcy Rule 9011 was not a basis for preemption. See generally *Matter of Graffy*, 233 B.R. 894 (Bankr. M.D. Fla., Tampa Div., 1999) (bad faith filing of petition sanctioned by bankruptcy court under Rule 9011).

In *In re Napoleon*, 233 B.R. 910 (B. Ct. D.N.J. 1999), a useful decision which should result in financial savings system-wide, the bankruptcy court in New Jersey held that the employment of experts by special counsel were not subject to the approval process. The court distinguished those who assist in the administration of the case.

He or she must also play an integral role in the administration of the bankruptcy case. The professional could assist the trustee with important activities, such as obtaining post-petition financing, negotiating creditor claims or formulating a plan of reorganization. It is these types of activities that rise to the level necessary to be considered a 'professional person' under § 327(a). In the instant case, the experts employed by Special Counsel merely assisted her with the prosecution of the State Court Action. These experts in



no way assisted the trustee with the administration of the bankruptcy case.

*Id.* at 913.

The recent decision of Bankruptcy Judge Hillman in *In re Filene's Basement, Inc.*<sup>163</sup> granting a motion for reconsideration of his order approving the employment of Price Waterhouse Coopers, LLP and vacating the prior order approving employment of Price Waterhouse and denying the application to employ Price Waterhouse is another interesting example of the uncertainty in this area. In its verified statement, Price Waterhouse simply stated that it "has provided and/or may continue to provide, services for various entities shown on Exhibit A who are involved in the Debtors' case, which services are not related to the Debtors' case."<sup>164</sup> The verified statement also asserted that it had no other connection with the debtors, creditors, other parties-in-interest or their attorneys or accountants, except that it did state that it was possible that it was providing professional services in wholly unrelated matters "in which attorneys or accountants of the Debtors, creditors or other parties in interest also serve as professional services provider."<sup>165</sup> It was also disclosed by Price Waterhouse that Coopers & Lybrand, a predecessor firm, did serve as auditors from January, 1989 through January, 1996. In addition, it was disclosed that Price Waterhouse had been retained as an expert witness in litigation against the debtors, but when retained by the debtor, it withdrew from that engagement. it also established "information barriers."<sup>166</sup> Judge Hillman suppressed considerable surprise and concern at the fact that the name of the plaintiff employing Price Waterhouse was not disclosed and the plaintiff was not identified in Exhibit A.

Price Waterhouse took the position that "[u]nder applicable accounting standards and federal decisions, the pre-petition engagement . . . [by the plaintiff in the litigation against the debtors] and the simultaneous engagement of [Price Waterhouse] thereafter by [the Debtors] was entirely proper."<sup>167</sup> Judge Hillman disposed of the argument by pointing out that it "misses the point entirely; the issue in the first instance is not the ethical correctness of PwC's multiple representations by the standards of any profession."<sup>168</sup> Since Judge Hillman found that there was a failure to properly disclose, he denied retention on that basis and did not reach the issue whether Price Waterhouse could have been retained. Judge Hillman did allow the filing of an application for reimbursement of actual and necessary expenses incurred, although he gave no indication whether it would be granted. In another decision in *In re Filene's Basement, Inc.*, Judge Hillman granted a motion for reconsideration of the approval of the employment of Hale

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<sup>163</sup> 239 B.R. 845 (Bankr. D. Mass. 1999).

<sup>164</sup> *Id.* at 847.

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.* at 849.

<sup>168</sup> *Id.*

& Dorr as counsel for the debtor-in-possession, vacated the prior order and denied the application.<sup>169</sup>

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<sup>169</sup> *In re Filene's Basement, Inc.*, 239 B.R. 850 (Bankr. D. Mass. 1999).



**RECOMMENDATION REGARDING NATIONAL ADMISSION TO PRACTICE  
AMENDING LOCAL BANKRUPTCY RULES OR PRACTICE REQUIREMENTS  
GOVERNING SPECIAL ADMISSION OF ATTORNEYS TO BANKRUPTCY COURTS**

National Bankruptcy Review Commission Final Report  
Chapter 3: Jurisdiction, Procedure and Administration  
October 20, 1997

**BANKRUPTCY: THE NEXT  
TWENTY YEARS**

National Bankruptcy  
Review Commission  
Final Report

October 20, 1997

### 3.3.4 National Admission to Practice

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure.

The Recommendation will not affect requirements (if any) to associate with local counsel. Similarly, the Recommendation will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The Recommendation will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located to appear in a particular bankruptcy case.

Bankruptcy courts exist in the various federal judicial districts to supervise cases commenced under the Bankruptcy Code and adjudicate disputes arising in such cases. Attorneys who practice in the bankruptcy courts are required, at a minimum, to be admitted to practice in their home districts. Often attorneys appear in bankruptcy courts in other districts because their clients are involved as parties in bankruptcy cases in such out-of-town districts. In order to represent such clients, these attorneys must be admitted specially in the bankruptcy court where the case is pending, usually on motion of a local attorney. These special admission requirements are particularly burdensome on creditors (both private and government) and their counsel who usually receive notice of bankruptcy proceedings with little time to prepare and are often called to distant fora to defend claims and interests of their clients.

Admission of nonresident<sup>270</sup> attorneys to practice before a particular district court generally applies to the bankruptcy court in that district.<sup>271</sup> The local rules of the bankruptcy court in each district (with a few exceptions) provide the admission terms for attorneys to participate in a particular case when they are not admitted to the district court bar of the district where the bankruptcy court is located.<sup>272</sup> For the most part, these local rules closely follow the admission rules for the district court where the bankruptcy court is located.<sup>273</sup> While these rules vary widely among the ninety-four districts, there are distinct similarities that are worth noting. Virtually all of the bankruptcy courts provide for either (1) admission to practice in a particular case after meeting certain requirements (usually a certificate of good standing from another federal court or the highest court in a state and the payment of a fee), or (2) appearance by *pro hac vice* motion. Additionally, a considerable number of bankruptcy courts waive the special admission requirements for attorneys representing the United States government or any of its agencies when appearing in a particular bankruptcy case.<sup>274</sup> Very few bankruptcy courts, however, waive the special admission

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<sup>270</sup> The term "nonresident" is used throughout this Recommendation to mean an attorney (i) who is not a resident of the state in which the bankruptcy court sits, and (ii) who has not been admitted to the district court bar in the relevant district.

<sup>271</sup> See, e.g., Bankr. Ct. S.D.N.Y. LBR 2090-1(a) ("An attorney who may practice in the District Court pursuant to General Rule 2(a) and (b) of the District Rules may practice in this Court."); Bankr. Ct. D. MD. 4(a) ("except as otherwise provided, ... only members of the Bar of the District Court may appear as counsel.").

<sup>272</sup> The local bankruptcy rules that do not provide for the admission of nonresident attorneys generally incorporate by reference the local rule of the district court. See, e.g., Bankr. D. Conn. Local Rule 2 ("Only persons admitted to practice in the United States District Court for the District of Connecticut or admitted as visiting lawyers pursuant to the Local Rules of Civil Procedure shall practice in the Bankruptcy Court.").

<sup>273</sup> The local bankruptcy rules often refer as well as conform to the district rule governing admission of attorneys. See, e.g., Bankr. Ct. N.D. Fla. Rule 106 A ("Except as provided herein, Local Rule 11.1 of the United States District Court for the Northern District of Florida governs the admission and appearance of nonresident attorneys before the Bankruptcy Court."); Bankr. Ct. N.D. W. Va. Rule 5.205(a) (adopting the applicable district court's rule governing admission of nonresident attorneys).

<sup>274</sup> See notes 2277-79 and accompanying text, *infra*.

provisions for nonresident state attorneys representing state agencies<sup>2275</sup> outside the state in which the bankruptcy court sits.<sup>2276</sup>

Certain district courts and the bankruptcy courts within those districts admit attorneys who are members of the bar in another U.S. court to appear in a particular case.<sup>2277</sup> These districts generally require (1) the submission of a certificate of good standing; (2) knowledge of, and consent to abide by, the disciplinary rules in the district; and (3) payment of a fee.<sup>2278</sup> Most districts that admit attorneys based on admission in other districts require the attorney to associate with local counsel.<sup>2279</sup>

The vast majority of bankruptcy courts have provisions for admission of a nonresident attorney by *pro hac vice* motion.<sup>2280</sup> Despite its popularity, *pro hac*

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<sup>2275</sup> See Bankr. Ct. N.D. Ill. Local Rule 600(c) (waiving the trial bar admission requirements for "the attorney general or other highest legal officer of any state").

<sup>2276</sup> Some courts, however, waive admission requirements for attorneys appearing on behalf of the state in which the bankruptcy court sits. See, e.g., Bankr. N.D. Ill. Local Rule 600(C) (waiving the trial bar admission requirements for, among others, "the state's attorney of any county in the State of Illinois."); Bankr. S.D. Fla. Local Rule 910(F) (waiving admission requirement for attorney appearing on behalf of the state of Florida).

<sup>2277</sup> Bankr. D. Ariz. (admitted to practice in any federal court); Bankr. E.D. Ark. (member of bar in state of residence and admitted in any other federal court); Bankr. D. Conn. (same); Bankr. D. Mont. (same); Bankr. W.D. Pa. (admitted in U.S. Supreme Court or any district court); Bankr. E & S.D.N.Y. (admitted in district court in N.J., Conn. or Vt. and state bar of relevant district court); Bankr. S.D. Tex. (admitted in any district court); Bankr. D. Vt. (admitted in any district court within the First or Second Circuits).

<sup>2278</sup> See, e.g., Bankr. D. Ariz. (submit application attesting to having read local disciplinary rules, attach certificate of good standing, and pay \$50 fee); Bankr. D. Conn. (member of bar must sponsor visiting attorney's admission; must be a member in good standing and attorney nor any member of attorney's firm can have been denied admission to bar or disciplined under local rule 3; and include \$25 fee).

<sup>2279</sup> In Connecticut, for example, the sponsoring attorney may be excused from further attendance in court upon granting of the motion to admit a non-resident attorney. Despite being excused from attending hearings, the sponsoring attorney is not excused from any other obligation of an appearing attorney. D. Conn. Rule 2(d).

<sup>2280</sup> In fact, a study done by the Federal Judicial Center found that ninety out of ninety-four (96%) of the federal districts permit *pro hac vice* appearances. The four districts that do not have these provisions (D. Ariz., E.D. Mich., W.D. Pa., & E.D. Wis.) have adopted alternative admissions procedures that make *pro hac vice* provisions unnecessary. See Marie Cordisco, Eligibility Requirements for, and Restrictions on, Practice Before the Federal District Courts, Federal Judicial

*vice* admission has its limitations, which vary depending on the local requirements. These limitations run the gamut. Some courts require foreign attorneys to associate with local counsel to make the motion, while other courts require counsel to file a written motion. Still other courts require counsel to file the motion with the clerk of the district court, in addition some require payment of a fee, and others require the motion to be filed three days prior to the hearing for which admission is requested.

A fair percentage of local bankruptcy rules waive the admission requirements for attorneys appearing on behalf of the federal government and its agencies.<sup>2281</sup> Very few local rules waive the admission requirements for attorneys representing state governments, even for attorneys representing the state in which the bankruptcy court sits.

The Commission has heard (both in testimony and by correspondence) that creditor participation in bankruptcy cases is very low. Disenfranchisement of creditors due to a bankruptcy filing in an inconvenient forum was the single most cited reason in favor of a Proposal to amend the venue provisions of 28 U.S.C. § 1408(1).<sup>2282</sup> The cost to creditors of defending their claims in bankruptcy is also part of the low creditor participation equation. While the Recommendation does not eliminate the costs of participation, it does reduce some of the expense of defending a claim in a nonlocal forum.

Bankruptcy proceedings also differ considerably from ordinary civil litigation. "Appearance" by counsel in a bankruptcy proceeding (as opposed to a district court proceeding) is often less formal and may be only for discrete hearings on issues that may affect the interests of that counsel's client. Accordingly, admission procedures and rules should conform to these differences. For example,

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Center (Nov. 7, 1995).

<sup>2281</sup> See, e.g., Bankr. N.D. Ala. Local Rule 83.1 (waiving admission requirement for federal government attorneys); Bankr. S.D. Ala. Local Rule 3 (waiving *pro hac vice* requirement for federal government attorneys but requiring written certification that attorney read local rules); Bankr. D. Ak. (no *pro hac vice* requirements for federal government attorneys); Bankr. M.D. Fla. Local Rule 1.07(b) (same); Bankr. D. Idaho Local Rule 105(a) (same); Bankr. W.D. Mo. Local Rule 9.010 (same).

<sup>2282</sup> The Commission received numerous letters supporting an amendment to the venue provisions of 28 U.S.C. § 1408(1) to eliminate place of incorporation as a permissible venue. Many of these letters cited creditor disenfranchisement and the cost of defending a claim in a distant forum as the reason for low creditor participation. National Bankruptcy Review Commission Database, Jurisdiction and Procedure, Venue (1997).

the Middle and Southern Districts of Florida distinguish between an attorney's appearance for administrative bankruptcy matters and an appearance for contested or adversary proceedings.<sup>223</sup>

For many creditors, both private and government creditors, bankruptcy is a national practice. They may retain legal representation from parts of the country other than the judicial district where a case under the Bankruptcy Code is pending. If an attorney has been admitted in any bankruptcy court pursuant to the rules of admission for that court, which generally involves being admitted to practice in the federal district court for that district, the admission should enable the attorney to appear in any other bankruptcy court. This would obviate the need for special admission or admission by *pro hac vice* motion. Under the Recommendation, however, it would not, however, eliminate the need for local counsel where required by local rule. The Recommendation also contemplates a Bankruptcy Code provision requiring attorneys who appear under this provision to read the applicable local rules and to submit to the disciplinary authority of the court where the case is pending.

National admission will also greatly assist attorneys who appear in bankruptcy cases on behalf of government entities, particularly state governments. Governmental entities are often brought into the bankruptcy court on short notice (often in injunctive matters) and, accordingly, government attorneys have very little time to coordinate admission with other attorneys in the district where the bankruptcy case is pending. Government entities should be able to appear with the least obstructions possible. National admission will streamline the appearance process for governmental entities.

The Recommendation does not alter local counsel requirements. To the extent that the local rules in a particular jurisdiction require the association of local counsel to participate in a case, those requirements are not altered by the Recommendation. The Recommendation eliminates special admission procedures in an effort to reduce the costs of participating in a bankruptcy case. Increasing creditor participation by reducing creditors' costs to participate in the bankruptcy process is consistent with a number of the Commission's Proposals. In particular, the proposal to eliminate place of incorporation as a permissible bankruptcy venue

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<sup>223</sup> See Bankr. M.D. Fla. Local Rule 1.07(b) (providing that an attorney residing outside the state of Florida and not admitted to the district court may appear without special admission in the following circumstances: 1. Filing a notice of appearance and a request for notices; 2. Preparation and filing of a proof of claim; 3. Attending and participating in the § 341 meeting; and 4. "[A]ttendance and representation of a creditor at a hearing that has been noticed to all creditors generally except the representation of a party in a contested matter or adversary proceeding.").

will reduce creditor disenfranchisement due to a bankruptcy filing in a distant forum.<sup>224</sup>

*Competing Considerations.* The concept of nationwide admission is new and might seem to impair the local autonomy of courts. It may also be seen, however inappropriately, as a limitation of the supervisory control over attorneys by the courts before whom attorneys practice. As demonstrated above, courts already admit nonresident attorneys under a variety of requirements and still maintain disciplinary control of bankruptcy proceedings. Some local courts presently charge a fee (often about \$75) for special admission which may be used for federal bar purposes, the fee could be lost if there was nationwide admission. The Recommendation, however, will reduce the participation costs for creditors and other parties in interest. The beneficial result may be an increase in creditor participation.

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<sup>224</sup> See Commission Recommendation 3.1.4 to Amend Venue Provisions of 28 U.S.C. § 1408.

RECOMMENDATIONS FOR AMENDMENT TO  
THE FEDERAL RULES OF BANKRUPTCY PROCEDURE CONCERNING DISCLOSURES BY  
AND COMPENSATION OF PROFESSIONALS IN BANKRUPTCY PROCEEDINGS

-- Including Suggested Attorney Declaration Form --

Proposed by the Ethics Subcommittee, Business Bankruptcy Committee  
American Bar Association Section of Business Law  
and formally adopted by The American Bar Association Section of Business Law

PROPOSED AMENDMENT TO BANKRUPTCY RULE 2014

(c) Attorney Declaration. The attorney declaration required by subsection (a) of this rule shall disclose all connections of the attorney or his firm with the debtor, creditors, or any other parties in interest, whether or not such connections would constitute a basis for disqualification, including whether the attorney, the attorney's firm or any other attorney in the firm:

1. represented the debtor within one year of the petition filing, including a description of the services, and dates performed and paid;
2. is a creditor of the debtor, including by reason of unpaid fees for prepetition services, and the amount, security held, and other particulars of any such claim;
3. holds any direct or indirect equity interest in the debtor, including stock, stock warrants, a partnership interest in a debtor partnership or right to acquire such an interest;
4. is or has served as an officer, director or employee of the debtor within two years before the petition filing;
5. is in control of the debtor or is a relative of a general partner, director, officer or person in control of the debtor;

6. is a general or limited partner of a partnership in which the debtor is also a general or limited partner;
7. is or has served as an officer, director, or employee of a financial advisor which has been engaged by the debtor in connection with the offer, sale, or issuance of a security of the debtor within two years before the filing of the petition;
8. has represented a financial advisor of the debtor in connection with the offer, sale, or issuance of a security of the debtor within three years before the filing of the petition;
9. presently represents a creditor, holder of 5 percent or more of any equity securities of a debtor having 300 or more equity security holders, equity security holder of any other debtor, general partner, lessor, lessee, party to an executory contract of the debtor, or person otherwise adverse or potentially adverse to the debtor or the estate, on any matter whether such representation is related or unrelated to the debtor or the estate, describing or attaching any waivers of conflicts obtained from such clients;
10. previously represented a creditor, holder of 5 percent or more of any equity securities of a debtor having 300 or more equity security holders, equity security holder of any other debtor, general partner,



lessor, lessee, party to an executory contract, or person who is otherwise adverse or potentially adverse to the debtor or the estate, on any matter substantially related to the bankruptcy case, describing or attaching any waivers of conflicts obtained from such former clients;

11. represents an affiliate or insider of the debtor, describing the affiliate's or insider's relationship with the debtor, including intercompany claims, asset transfers, overlapping creditors, creditor guarantees and subordination agreements, jointly-owned assets, shared officers, directors or owners;

12. has been paid fees prepetition or holds a security interest, guarantee or other assurance of compensation for services performed and to be performed in the case, with an explanation of the source, amount, and terms of any such arrangement;

13. has any agreement or understanding with anyone else for sharing compensation for services rendered in or in connection with the case, describing the particulars of any arrangement other than those within the attorney's own firm;

14. has any other connection with the debtor, creditors, United States trustee or any employee of that office, or any other parties in interest; and

15. has any other interest, direct or indirect, which may be affected by the proposed representation.

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(d) Initial Employment. The court shall evaluate the disclosure pursuant to subsection (c), which may or may not be indicia of disqualification. It may approve employment of counsel for a debtor in possession or trustee on an interim basis, without notice and a hearing.

(e) Continued Employment. The court may authorize continued employment by counsel for a debtor in possession or trustee after notice and a hearing. The attorney shall serve on the committee of unsecured creditors, if appointed, any other committees appointed in the case, the creditors on the list required by rule 1007(d), the United States trustee, any trustee appointed in the case, and such other parties in interests as the court may direct:

- (1) the application to approve employment;
- (2) the attorney declaration;
- (3) the initial employment order; and
- (4) either a notice of a hearing on further employment, or a notice of a date by which objections to further employment shall be filed and served on interim counsel, as the court directs.

Any hearing on continued employment shall be set not less than 20 days after notice of the hearing is served, and shall take place within 45 days of the application

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filing. Any bar date for objections to further employment shall be set not less than 20 days after service of the notice, and shall provide that the court will set a hearing to consider any timely objections.

(f) Supplemental Attorney Declaration. A supplemental attorney declaration shall be filed within 15 days after the occurrence of any event, or the discovery of any fact, which is subject to disclosure pursuant to subsections (a) and (c) of this rule. Such supplemental verified statement shall be served on the parties listed in subsection (e) and such other parties in interest as the court may direct.

PROPOSED AMENDMENT TO BANKRUPTCY RULE 2016

(c) If an attorney's employment is terminated, the court shall nevertheless determine compensation for services and reimbursement of expenses from the estate under otherwise applicable standards, provided the attorney declaration accompanying the application for employment and any supplemental attorney declaration were filed by the attorney with the good faith belief, formed after inquiry appropriate to the circumstances of the case, that he disclosed all material facts and met all requirements for representation of the debtor in possession or trustee. Termination of the attorney's employment does not mean an attorney declaration was not filed in good faith.

**PROPOSED ATTORNEY DECLARATION FORM**

[Attorney], a partner in [firm], submits the following statement in compliance with 11 U.S.C. § 328(a) and 329(a) and Bankruptcy Rules 2014 and 2016.

1. [Firm] represented the debtor during the past year in [describe generally]. In connection with that representation, [describe when services were rendered and when payment was received].

2. [Firm] holds a retainer balance of \$ \_\_\_\_\_ in connection with the prior representation/or is owed \$ \_\_\_\_\_ for these prepetition services, and holds a guarantee by \_\_\_\_\_, who is related to the debtor as \_\_\_\_\_, or holds a security interest in \_\_\_\_\_ which is owned by \_\_\_\_\_, obtained on \_\_\_\_\_.

3. No attorney in [firm] holds a direct or indirect equity interest in the debtor [including stock, stock warrants, a partnership interest in a debtor partnership] or has a right to acquire such an interest, except \_\_\_\_\_.

4. No attorney in the firm is or has served as an officer, director or employee of the debtor within two years before the petition filing, except \_\_\_\_\_.

5. No attorney in the firm is in control of the debtor or is a relative of a general partner, director, officer or person in control of the debtor, except \_\_\_\_\_.

6. No attorney in the firm is a general or limited partner of a partnership in which the debtor is also a general or limited partner, except \_\_\_\_\_.

7. No attorney in the firm is or has served as an officer, director, or employee of a financial advisor which has been engaged by the debtor in connection with the offer, sale, or issuance of a security of the debtor within two years before the filing of the petition, except \_\_\_\_\_.

8. No attorney in the firm has represented a financial advisor of the debtor in connection with the offer, sale, or issuance of a security of the debtor within three years before the filing of the petition, except \_\_\_\_\_.

9. No attorney in the firm presently represents a creditor, holder of 5 percent or more of any equity securities of a debtor having 300 or more equity security holders, equity security holder of any other debtor, general partner, lessor, lessee, party to an executory contract of the debtor, or person otherwise adverse or potentially adverse to the debtor or estate, on any matter, whether such representation is related or

unrelated to the debtor or the estate, except \_\_\_\_\_  
[describe or attach any waivers of conflicts obtained  
from such clients].

10. No attorney in the firm has previously  
represented a creditor, holder of 5 percent or more of  
any equity securities of a debtor having 300 or more  
equity security holders, equity security holder of any  
other debtor, general partner, lessor, lessee, party to  
an executory contract, or person who is otherwise adverse  
or potentially adverse to the debtor or the estate, on  
any matter substantially related to the bankruptcy case,  
except \_\_\_\_\_ [describe or attach any waivers of  
conflicts obtained from such former clients].

11. No attorney in the firm represents an insider of  
the debtor or the debtor's parent, subsidiary, or other  
affiliate, except \_\_\_\_\_ [if any such representation,  
describe that client's relationship with the debtor,  
including intercompany claims, asset transfers,  
overlapping creditors, creditor guarantees and  
subordination agreements, jointly-owned assets, shared  
officers, directors or owners].

12. No attorney in the firm has been paid fees  
preparation or holds a security interest, guarantee or  
other assurance of compensation for services performed  
and to be performed in the case, except \_\_\_\_\_

[explain the source, amount, and terms of any such  
arrangement].

13. There is no agreement of any nature, other than  
the partnership agreement of [firm] as to the sharing of  
any compensation to be paid to [firm], except  
\_\_\_\_\_.

14. No attorney in the firm has any other connection  
with the debtor, creditors, United States Trustee or any  
employee of that office, or any other parties in  
interest, except \_\_\_\_\_.

15. No attorney in the firm has any other interest,  
direct or indirect, which may be affected by the proposed  
representation, except \_\_\_\_\_.

[Where appropriate, the attorney may state the nature  
and scope of the inquiry upon which the declaration  
statements are made. Any pertinent information which  
counsel believes will satisfy any concerns of  
disqualification also may be included.]

I declare under penalty of perjury under the  
laws of the United States of America that the foregoing  
is true and correct. Executed on [date].

\_\_\_\_\_  
Signature

GENERAL INFORMATION FORM

To Be Appended to Reports with Recommendations

Submitting Entity: Section of Business Law

Submitted By: Chair of the Business Bankruptcy Committee  
of the Section of Business Law

1. Summary of Recommendation(s).

Amend Bankruptcy Code to allow debtor's traditional counsel to continue to serve debtor after commencement of bankruptcy proceedings by eliminating "disinterested person" proviso currently in Bankruptcy Code; and to recommend Bankruptcy Rule changes providing for enhanced disclosure.

2. Approval by Submitting Entity.

Approved by the Section of Business Law at its full Council meeting on Saturday, January 19, 1991.

3. Previous Submission to the House or Relevant Association Position.

None known.

4. Need for Action at This Meeting.

"Disinterestedness" has been held by certain bankruptcy judges to disqualify a debtor's historic counsel, or as a basis for refusing to pay fees after service as counsel to debtor in bankruptcy proceedings. It is believed that the proposal will bring Bankruptcy Code provisions in line with ABA Model Rules of Professional Conduct.

5. Status of Legislation. (If applicable.)

Not yet introduced.

6. Cost to the Association. (Both direct and indirect costs.)

Possible indirect cost of monitoring and reporting by the ABA Governmental Affairs Office.

7. Disclosure of Interest. (If applicable.)

Virtually all lawyers in general practice firms, including bankruptcy lawyers in those firms, support the legislation. A few lawyers in "bankruptcy boutiques" oppose, as do a few bankruptcy judges. The proposal was overwhelmingly approved by the Business Bankruptcy Committee (with a dissent noted by one bankruptcy judge) and by the Council of the Section of Business Law.

8. Referrals. (List the entities to which the Report has been referred, and give the date of the referral.)

Forwarded on June 4, 1991, to Task Force on Bankruptcy, Tort and Insurance Practice Section; Bankruptcy Committee, General Practice Section; Creditors' Rights Litigation Committee, Litigation Section; and Standing Committee on Ethics and Professional Responsibility.

9. Contact Person. (Prior to meeting.)

Nathan B. Feinstein, Chair, Business Bankruptcy Committee, ABA Section of Business Law, c/o Piper & Marbury, 1200 Nineteenth St., N.W., Washington, D.C. 20036; telephone (202)861-3977; Fax (202)223-2085.

10. Contact Person. (Who will present the report to the House.)

Elliott Goldstein, Senior Section Representative to ABA House of Delegates, c/o Powell, Goldstein, Fraser & Murphy, 1100 Citizen & Southern Bank Building, 35 Broad Street, Atlanta, GA 30335; telephone (404)572-6605, Fax (404)572-6999.

## Proposed Rule 1.6 - Public Discussion Draft

Ethics 2000 Commission  
March 23, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### CONFIDENTIALITY OF INFORMATION

(a) A lawyer shall not reveal information relating to the representation of a client or a ~~former client~~ unless the client ~~consents after consultation, except for disclosures that are given informed consent.~~ the disclosure is impliedly authorized in order to carry out the representation, ~~and except as stated in or the disclosure is permitted by paragraph (b) or required by paragraph (c).~~

(b) A lawyer may reveal ~~such~~ information relating to the representation of a client or a former client to the extent the lawyer reasonably believes necessary:

(1) ~~to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent~~ reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is likely to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to rectify or mitigate substantial injury to the financial interests or property of another resulting from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules; or

(2) (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client.

(c) A lawyer shall reveal information relating to the representation of a client or a former client to the extent required by law or court order or when necessary to comply with these Rules.

#### Comment

[1] ~~The lawyer is part of a judicial system charged with upholding the law. One of the lawyer's functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights.~~

[2] ~~The observance of the ethical obligation of a lawyer to hold inviolate confidential information of the client not only facilitates the full development of facts essential to proper representation of the client but also encourages people to seek early legal assistance.~~

[3] ~~Almost without exception, clients come to lawyers in order to determine what their rights are and what is, in the maze of laws and regulations, deemed to be legal and correct. The common law recognizes that the client's confidences must be protected from disclosure.~~

Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[1] This Rule governs the disclosure by a lawyer of information relating to the representation of a client both during and after the lawyer's representation of the client. See Rules 1.8(b) and 1.9(c) with respect to the use of such information to the disadvantage of clients and former clients.

[4] [2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer maintain confidentiality of ~~must not reveal~~ information relating to the representation. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[5] [3] The principle of client-lawyer confidentiality is given effect in two by related bodies of law, the attorney-client privilege, (which includes the work product doctrine) in the law of evidence, and the rule of confidentiality established in professional ethics. The attorney-client privilege applies in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not merely only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

[6] The requirement of maintaining confidentiality of information relating to representation applies to government lawyers who may disagree with the policy goals that their representation is designed to advance.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of hypotheticals to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

#### Authorized Disclosure

[7] [5] A Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation, except to the extent that the client's instructions or special circumstances limit that authority. In litigation some situations, for example, a lawyer may disclose information by admitting be impliedly authorized to admit a fact that cannot properly be disputed or, in negotiation by making to make a disclosure that facilitates a satisfactory conclusion to a matter. [8] Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

#### Disclosure Adverse to Client

[9] [6] The Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. In becoming privy to

information about a client, a lawyer may foresee that the client intends serious harm to another person. However, to the extent a lawyer is required or permitted to disclose a client's purposes, the client will be inhibited from revealing facts which would enable the lawyer to counsel against a wrongful course of action. The public is better protected if full and open communication by the client is encouraged than if it is inhibited. Paragraph (b)(1) recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Substantial bodily harm includes life-threatening or debilitating injuries and illnesses and the consequences of child sexual abuse. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town's water supply may reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer's disclosure is necessary to eliminate the threat or reduce the number of victims.

[10] Several situations must be distinguished.

[11] First, the lawyer may not counsel or assist a client in conduct that is criminal or fraudulent. See Rule 1.2(d). Similarly, a lawyer has a duty under Rule 3.3(a)(4) not to use false evidence. This duty is essentially a special instance of the duty prescribed in Rule 1.2(d) to avoid assisting a client in criminal or fraudulent conduct.

[12] Second, the lawyer may have been innocently involved in past conduct by the client that was criminal or fraudulent. In such a situation the lawyer has not violated Rule 1.2(d), because to "counsel or assist" criminal or fraudulent conduct requires knowing that the conduct is of that character.

[13] Third, the lawyer may learn that a client intends prospective conduct that is criminal and likely to result in imminent death or substantial bodily harm. As stated in paragraph (b)(1), the lawyer has professional discretion to reveal information in order to prevent such consequences. The lawyer may make a disclosure in order to prevent homicide or serious bodily injury which the lawyer reasonably believes is intended by a client. It is very difficult for a lawyer to "know" when such a heinous purpose will actually be carried out, for the client may have a change of mind.

[14] The lawyer's exercise of discretion requires consideration of such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. Where practical, the lawyer should seek to persuade the client to take suitable action. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to the purpose. A lawyer's decision not to take preventive action permitted by paragraph (b)(1) does not violate this Rule.

#### Withdrawal

[15] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1).

[16] After withdrawal the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise provided in Rule 1.6. Neither this rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like.

[17] [7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that enables the lawyer to reveal information to the extent necessary to prevent the client from committing a crime or fraud that is likely to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer's services. Such a serious abuse of the client-lawyer relationship by the client forfeits the

protection of this Rule. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client's misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer's obligation or right to withdraw from the representation of the client in such circumstances. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct in connection with this Rule, the lawyer may make inquiry within the organization as indicated in Rule 1.13(b).

[8] Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client's crime or fraud until after it has been consummated and substantial loss has been suffered by the victim. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to attempt to recoup their losses.

[9] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (b)(4) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

#### Dispute Concerning a Lawyer's Conduct

[18] [10] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, or professional disciplinary proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person; for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(2)(5) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend, of course, applies where a proceeding has been commenced. ~~Where practicable and not prejudicial to the lawyer's ability to establish the defense, the lawyer should advise the client of the third party's assertion and request that the client respond appropriately. In any event, disclosure should be no greater than the lawyer reasonably believes is necessary to vindicate innocence, the disclosure should be made in a manner which limits access to the information to the tribunal or other persons having a need to know it, and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.~~

[19] [11] ~~If the lawyer is charged with wrongdoing in which the client's conduct is implicated, the rule of confidentiality should not prevent the lawyer from defending against the charge. Such a charge can arise in a civil, criminal or professional disciplinary proceeding, and can be based on a wrong allegedly committed by the lawyer against the client, or on a wrong alleged by a third person; for example, a person claiming to have been defrauded by the lawyer and client acting together. A lawyer entitled to a fee is permitted by paragraph (b)(2)(5) to prove the services rendered in an action to collect it. This aspect of the Rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary. As stated above, the lawyer must make every effort practicable to avoid unnecessary disclosure of information relating to a representation, to limit disclosure to those having the need to know it, and to obtain protective orders or make other arrangements minimizing the risk of disclosure.~~

[12] Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[13] Paragraph (b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (b)(1) - (5). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction, and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule.

#### **Disclosure Otherwise Required or Authorized**

[20] The attorney-client privilege is differently defined in various jurisdictions. If a lawyer is called as a witness to give testimony concerning a client, absent waiver by the client, paragraph (a) requires the lawyer to invoke the privilege when it is applicable. The lawyer must comply with the final orders of a court or other tribunal of competent jurisdiction requiring the lawyer to give information about the client.

[24] [14] The Rules of Professional Conduct in various circumstances permit or require a lawyer to disclose information relating to the representation. See Rules 2.2, 2.3, 3.3, and 4.1. In addition to these provisions, a lawyer may be obligated or permitted by other provisions of law to give information about a client. Whether another provision of law supersedes Rule 1.6 is a matter of interpretation beyond the scope of these Rules, but a presumption should exist against such a supersession.

[15] A lawyer must also comply with lawful orders of a tribunal, an administrative or executive agency, or a legislative body. If a lawyer is called as a witness to give testimony concerning a client or is otherwise ordered to reveal information relating to the client's representation, the lawyer must, absent informed consent of the client to do otherwise, assert on behalf of the client all non-frivolous claims that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer should consult with the client about the possibility of appeal. See Rule 1.4. Unless an appeal is taken, the lawyer must comply with the order.

#### **Acting Competently to Preserve Confidentiality**

[16] A lawyer must act competently to safeguard information relating to the representation of a client against inadvertent or unauthorized disclosure by the lawyer or by other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See Rules 1.1, 5.1, and 5.3.

[17] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule.

#### **Former Clients**

[22] [18] The duty of confidentiality continues after the client-lawyer relationship has terminated. Thus, Rule 1.6(a) prohibits the disclosure of information relating to the representation of a former client. See Rule 1.9(c) for the prohibition against using such information to the disadvantage of the former client.



## Proposed Rule 1.7 - Public Discussion Draft

Ethics 2000 Commission  
March 23, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### CONCURRENT CONFLICT OF INTEREST: GENERAL RULE

- (a) ~~A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:~~
- ~~(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and~~
  - ~~(2) each client consents after consultation.~~
- (b) ~~A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:~~
- ~~(1) the lawyer reasonably believes the representation will not be adversely affected; and~~
  - ~~(2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.~~
- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a conflict of interest. A conflict of interest exists if
- (1) the representation of one client will be directly adverse to another client; or
  - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's duties to another client or to a former client or by the lawyer's own interests or duties to a third person.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a), a lawyer may represent a client if each affected client gives informed consent in writing and

- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
- (2) the representation is not prohibited by law; and
- (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation.

#### Comment

##### Loyalty to a Client and Independent Judgment

[1] Loyalty is an independent judgment an essential element elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's own interests or from the lawyer's responsibilities to another client, a former client, or a third person. Resolution of a conflict of interest problem under this Rule requires the lawyer to:

- 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e.,

whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent in writing. For specific rules regarding certain concurrent conflicts of interest, see Rule 1.8. For former client conflicts of interest, see Rule 1.9.

[2] ~~An impermissible~~ A conflict of interest may exist before representation is undertaken, in which event the representation should must be declined, unless the lawyer obtains the informed written consent of each client under the conditions of paragraph (b). The To determine whether a conflict of interest exists, a lawyer should must adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the parties persons and issues involved and to determine whether there are actual or potential conflicts of interest. As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.

[2] [3] ~~If such a conflict arises after representation has been undertaken, the lawyer should must withdraw from the representation, unless the lawyer obtains the informed written consent of each client under the conditions of paragraph (b). See Rule 1.16. Where more than one client is involved and the lawyer withdraws because a conflict arises after representation, whether the lawyer may continue to represent any of the clients is determined both by the lawyer's ability to comply with duties owed to the former client and by the lawyer's ability to represent adequately the remaining client or clients, given the lawyer's duties to the former client. See Rule 1.9. See also Rule 2.2(c). As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.~~

##### Identifying Conflicts of Interest: Direct Adversity and Material Limitation

[3] [4] ~~As a general proposition, loyalty Loyalty to a client prohibits undertaking representation directly adverse to that client without that client's consent. Paragraph (a) expresses that general rule. Thus, absent consent, a lawyer ordinarily may not act as an advocate in one matter against a person the lawyer represents in some other matter, even if it is when the matters are wholly unrelated. The client being sued is likely to feel betrayed, and the resulting damage to the lawyer-client relationship is likely to impair the lawyer's ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client's case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer's interest in retaining the current client. Similarly, a lawyer acts directly adversely to a client if it will be necessary for the lawyer to cross-examine a client who appears as a witness in a lawsuit against another client. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only generally economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not constitute a conflict of interest and thus does not require consent of the respective clients. Paragraph (a) applies only when the representation of one client would be directly adverse to the other.~~

[4] [5] ~~Loyalty to a client is also impaired when Even where there is no direct adversity, a conflict of interest exists if there is a significant risk that a lawyer cannot lawyer's ability to consider, recommend, or carry out an appropriate course of action for the client because will be materially limited as a result of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client. Paragraph (b) addresses such situations. A possible conflict The mere possibility of subsequent harm does not itself preclude the representation require disclosure and consent. The critical questions are the likelihood that a conflict difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client. Consideration should be given to whether the client wishes to accommodate the other interest involved.~~

##### Consultation and Consent Prohibited Representations

[5] [6] A client Ordinarily, clients may consent to representation notwithstanding a conflict. However, as indicated in paragraph (a)(1) with respect to representation directly adverse to a client, and paragraph (b)(1) with respect to material limitations on representation of a client, when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, some conflicts are non-consentable, meaning that the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent. When the lawyer is representing more than one client is involved, the question of conflict consentability must be resolved as to each client. Moreover, there may be circumstances where it is impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent.

[7] Consentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest. Thus, under paragraph (b)(1), representation is prohibited if in the circumstances the lawyer cannot reasonably conclude that the lawyer will be able to provide competent and diligent representation. See Rule 1.1 (competence) and Rule 1.3 (diligence). The concern is that a client who is asked to consent in such a matter, particularly one who is unsophisticated in retaining lawyers, may not be adequately informed or may not adequately appreciate the risks of the conflict. In determining whether a multiple client conflict is non-consentable, one factor to be considered is whether the representation will be provided by a single lawyer or by different lawyers in the same firm. Cf. Rule 1.10.

[8] Paragraph (b)(2) describes conflicts that are non-consentable because the representation is prohibited by applicable law. For example, in some states substantive law provides that the same lawyer may not represent more than one defendant in a capital case, even with the consent of the clients, and under federal criminal statutes, certain representations by a former government lawyer are prohibited, despite the informed consent of the former client. In addition, decisional law in some states limits the ability of a governmental client, such as a municipality, to consent to a conflict of interest.

[9] Paragraph (b)(3) describes conflicts that are non-consentable because of the institutional interest in vigorous development of each client's position when the clients are aligned directly against each other in the same litigation. Whether clients are aligned directly against each other within the meaning of this paragraph requires examination of the context of the litigation.

#### **Informed Consent**

[10] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.4(c) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty and confidentiality, and the advantages and risks involved. See Comments [29] and [30] (effect of joint representation on confidentiality). Under some circumstances it may be impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent.

[11] Paragraph (b) requires the lawyer to obtain the informed consent of the client in writing. If it is not feasible to obtain the writing at the time the client gives informed consent, then the lawyer must obtain it within a reasonable time thereafter. The requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client,

to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client an opportunity to raise questions and concerns. Rather, the writing is required in order to impress upon clients the seriousness of the decision the client is being asked to make and to resolve disputes or ambiguities that might later occur by virtue of there being no writing. The writing need not take any particular form; it should, however, include disclosure of the relevant circumstances and reasonably foreseeable risks of the conflict of interest, as well as the client's agreement to the representation despite such risks.

[12] Like any other client, a client who has given consent to a conflict may revoke the consent and terminate the lawyer's representation at any time. Whether revoking consent to the client's own representation precludes the lawyer from continuing to represent other clients depends on the circumstances, including the nature of the conflict, whether the client revoked consent because of a material change in circumstances, and whether material detriment to the other clients or lawyer would result.

[13] Whether a lawyer may properly request a client to waive conflicts that might arise in the future is subject to the test of paragraph (b). If the consent is general and open-ended (i.e., the client agrees to consent to any future conflict that might arise), then the consent ordinarily will be ineffective because it is not reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is a sophisticated user of the legal services involved and agrees to consent to a particular type of conflict with which the client is already familiar, then the consent should be effective with regard to that type of conflict. For example, a bank that hires a lawyer to defend it in litigation might be willing to agree in advance to have the lawyer represent borrowers in loan transactions but not in resisting collection proceedings brought by the bank. The propriety of the client's consent must be determined not only at the time it is first given but also at the time when the waiver is sought to be implemented to determine if the circumstances at the time of the conflict are what were earlier expected.

#### **Lawyer's Own Interests and Duties to Third Persons**

[14] In addition to conflicts with other current clients, a lawyer's duties of loyalty and independence may be materially limited by duties owed to former clients under Rule 1.9, by the lawyer's own interests, or by the lawyer's duties to other persons, such as fiduciary duties arising from a lawyer's service as a trustee, executor, or corporate director.

[6] [15] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. For example, a lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee. See Rules 1.1 and 1.5. If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. A Similarly, a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial interest. See Rule 1.8 for specific rules pertaining to a number of personal interest conflicts, including business transactions with clients.

[16] Although most personal interest conflicts are consentable, some are not. For example, if the lawyer has a 50% ownership in a company the client wants to sue and the client's recovery is likely to affect significantly the value of the lawyer's investment, then the lawyer cannot reasonably conclude that the representation will be competent and diligent; therefore, under paragraph (b) the lawyer may not request the client to consent to the conflict.

[17] Lawyers are prohibited from engaging in sexual relationships with clients unless the sexual relationship predates the formation of the lawyer-client relationship. See Rule 1.8(k).

#### **Interest of Person Paying for a Lawyer's Service**

[40] [18] A lawyer may be paid from a source other than the client, including a co-client, if

the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). For example, when an insurer and its insured have conflicting interests in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's professional independence. So also, when a corporation and its directors or employees are involved in a controversy in which they have conflicting interests, the corporation may provide funds for separate legal representation of the directors or employees, if the clients give their consent after consultation and the arrangement ensures the lawyer's professional independence. If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's duties to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b), as well as the requirements of Rule 1.8(f), before accepting the representation, including determining that the conflict is consentable and that the client has adequate information about the material risks of the representation.

### **Organizational Clients**

[19] A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, or there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.

[20] Unforeseeable developments, such as changes in corporate and other organizational affiliations, may create direct adversity conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. In these circumstances the lawyer may withdraw from one of the representations in order to avoid the direct adversity conflict. Ordinarily, the lawyer should withdraw from the representation of the client who will be least harmed by the lawyer's withdrawal. The lawyer must seek court approval where necessary and take steps to minimize harm to the clients. See Rule 1.16. The lawyer must continue to protect the confidences of the client from whose representation the lawyer has withdrawn. See Rule 1.6.

[14] [21] A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board, and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise.

### **Conflict Charged by an Opposing Party**

[15] Resolving questions of conflict of interest is primarily the responsibility of the lawyer undertaking the representation. In litigation, a court may raise the question when there is reason to infer that the lawyer has neglected the responsibility. In a criminal case, inquiry by the court is generally required when a lawyer represents multiple defendants. Where the conflict is such as clearly to call in question the fair or efficient administration of justice, opposing counsel may properly raise the question. Such an objection should be viewed with caution, however, for it can be misused as a technique of harassment. See Scope.

### **Conflicts in Litigation**

[7] [22] Paragraph (a) (b)(3) prohibits representation of opposing parties in the same litigation, regardless of the clients' consent. Simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (b) not uncommon. An impermissible conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party, or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests in civil litigation is proper if the risk of adverse effect is minimal and the requirements of paragraph (b) are met. Compare Rule 2.2 involving intermediation between clients.

[8] Ordinarily, a lawyer may not act as advocate against a client the lawyer represents in some other matter, even if the other matter is wholly unrelated. However, there are circumstances in which a lawyer may act as advocate against a client. For example, a lawyer representing an enterprise with diverse operations may accept employment as an advocate against the enterprise in an unrelated matter if doing so will not adversely affect the lawyer's relationship with the enterprise or conduct of the suit and if both clients consent upon consultation. By the same token, government lawyers in some circumstances may represent government employees in proceedings in which a government agency is the opposing party. The propriety of concurrent representation can depend on the nature of the litigation. For example, a suit charging fraud entails conflict to a degree not involved in a suit for a declaratory judgment concerning statutory interpretation.

[9] A lawyer may represent parties having antagonistic positions on a legal question that has arisen in different cases, unless representation of either client would be adversely affected. Thus, it is ordinarily not improper to assert such positions in cases pending in different trial courts, but it may be improper to do so in cases pending at the same time in an appellate court.

[23] Ordinarily a lawyer may take inconsistent legal positions in different tribunals at different times on behalf of different clients. The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer's action in behalf of one client will materially limit the lawyer's effectiveness in representing another client in a different case; for example, when a decision favoring one client will create a precedent likely to seriously weaken the position taken on behalf of the other client. Factors relevant in determining whether the clients need to be advised of the risk include: where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved, and the clients' reasonable expectations in retaining the lawyer. If there is significant risk of material limitation, then absent informed consent of the affected clients, the lawyer must refuse one of the representations or withdraw from one or both matters.

[24] When a lawyer represents or seeks to represent a class of plaintiffs or defendants in a class action lawsuit, unnamed members of the class are ordinarily not considered to be clients of the lawyer for purposes of applying paragraph (a)(1) of this Rule. Thus, the lawyer does not typically need to get the consent of such a person before representing a client suing the person in an unrelated matter. Similarly, a lawyer seeking to represent an opponent in a class action does not typically need the consent of an unnamed member of the class who the lawyer represents in an unrelated matter.

### **Other Conflict Situations Non-Litigation Conflicts**

~~111~~ [25] Conflicts of interest in contexts other than litigation sometimes may be difficult to assess. Relevant factors in determining whether there is significant potential for adverse effect material limitation include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that ~~actual conflict disagreements~~ will arise, and the likely prejudice to the client from the conflict ~~if it does arise~~. The question is often one of proximity and degree.

~~113~~ [26] ~~Conflict~~ For example, ~~conflict~~ questions may also arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may ~~arise be present, as when one spouse owns significantly more property than the other or has children by a prior marriage~~. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. ~~The~~ In order to comply with conflict of interests rules, the lawyer should make clear the lawyer's relationship to the parties involved.

~~112~~ [27] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest, or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication, or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

#### Special Considerations in Joint Representation

[28] In considering whether to represent clients jointly in the same matter, a lawyer should be mindful that if the joint representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment, and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the joint representation fails. In some situations the risk of failure is so great that joint representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, joint representation is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adjusted by joint representation is not very good. Other relevant factors are whether the lawyer subsequently will represent both parties on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.

[29] A particularly important factor in determining the appropriateness of joint representation is the effect on lawyer-client confidentiality and the attorney-client privilege. With regard to the evidentiary attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. Hence it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

[30] As to the duty of confidentiality, joint representation will almost certainly be inadequate if one client attempts to keep something in confidence between the lawyer and that client, which is not to be disclosed to the other client. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and to expect

that the lawyer will use that information to that client's benefit. See Rule 1.4. The lawyer should, at the outset of the joint representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

[31] When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances and, thus, that the clients may be required to assume greater responsibility for decisions than when each client is separately represented. Any limitations on the scope of the representation made necessary as a result of the joint representation should be fully explained to the clients at the outset of the representation. See Rule 1.2(c).

[32] Subject to the above limitations, each client in the joint representation has the right to loyal and diligent representation and the protection of Rule 1.9 concerning the obligations to a former client. The client also has the right to discharge the lawyer as stated in Rule 1.16.

## Proposed Rule 1.9 - Public Discussion Draft

March 23, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### CONFLICT OF INTEREST: FORMER CLIENT

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client ~~consents after consultation~~ gives informed consent to the representation.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter;

unless the former client ~~consents after consultation~~ gives informed consent to the representation.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter ~~use~~ information relating to the representation to the disadvantage of the former client except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client, or when the information has become generally known ~~or~~

~~(2) reveal information relating to the representation except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client.~~

### Comment

[1] After termination of a client-lawyer relationship, a lawyer may not represent another client except in conformity with this Rule, except that in the case of a government or former government lawyer, Rule 1.11, not this Rule, applies. The principles in Rule 1.7 determine whether the interests of the present and former client are adverse. Thus Under this Rule, a lawyer could not properly seek to rescind on behalf of a new client a contract drafted on behalf of the former client. So also a lawyer who has prosecuted an accused person could not properly represent the accused in a subsequent civil action against the government concerning the same transaction. Nor could a lawyer who had represented clients jointly in a matter represent one of the clients against the others in the same or a substantially related matter after a dispute arose among the clients.

[2] The scope of a "matter" for purposes of this Rule may depend on the facts of a particular situation or transaction. The lawyer's involvement in a matter can also be a question of degree. When a lawyer has been directly involved in a specific transaction, subsequent representation of other clients with materially adverse interests clearly is prohibited. On the other hand, a lawyer who recurrently handled a type of problem for a former client is not precluded from later representing another client in a wholly distinct problem of that type even though the subsequent representation involves a position adverse to the prior client. Similar considerations can apply to the reassignment of military lawyers between defense and prosecution functions within the same military jurisdictions. The underlying question is whether the lawyer was so involved in the matter that the subsequent representation can be

justly regarded as a changing of sides in the matter in question.

[3] Interests are "materially adverse" for purposes of this Rule if actions to the advantage of the present client will diminish the interests of the former client.

[4] Matters are "substantially related" for purposes of this Rule if the subsequent representation involves the same work the lawyer performed for the former client or if there is a substantial risk that confidential information obtained in the prior matter would materially advance the client's position in the subsequent matter. For example, a lawyer who has represented a business person and learned extensive private financial information about that person may not then represent that person's spouse in seeking a divorce. Similarly, a lawyer who has previously represented a client in securing environmental permits to build a shopping center would be precluded from representing neighbors seeking to oppose rezoning of the property but would not be precluded, on the grounds of substantial relationship, from defending a tenant of the completed shopping center in resisting eviction for non-payment of rent. A former client may not be required to reveal the confidential information learned by the lawyer in order to establish a substantial risk that the lawyer has confidential information to use in the subsequent matter. A conclusion about the possession of such information may be based on the general nature of the services the lawyer provided the former client and information that would in ordinary practice be learned by a lawyer providing such services. In the case of an organizational client, general knowledge of the former client's business policies, practices, or officials will not ordinarily be disqualifying because it will not be sufficient to materially advance the client's position in the subsequent representation.

### Lawyers Moving Between Firms

[3] [5] When lawyers have been associated within a firm but then end their association, the question of whether a lawyer should undertake representation is more complicated. There are several competing considerations. First, the client previously represented by the former firm must be reasonably assured that the principle of loyalty to the client is not compromised. Second, the Rule should not be so broadly cast as to preclude other persons from having reasonable choice of legal counsel. Third, the Rule should not unreasonably hamper lawyers from forming new associations and taking on new clients after having left a previous association. In this connection, it should be recognized that today many lawyers practice in firms, that many lawyers to some degree limit their practice to one field or another, and that many move from one association to another several times in their careers. If the concept of imputation were applied with unqualified rigor, the result would be radical curtailment of the opportunity of lawyers to move from one practice setting to another and of the opportunity of clients to change counsel.

[4] Reconciliation of these competing principles in the past has been attempted under two rubrics. One approach has been to seek per se rules of disqualification. For example, it has been held that a partner in a law firm is conclusively presumed to have access to all confidences concerning all clients of the firm. Under this analysis, if a lawyer has been a partner in one law firm and then becomes a partner in another law firm, there may be a presumption that all confidences known by the partner in the first firm are known to all partners in the second firm. This presumption might properly be applied in some circumstances, especially where the client has been extensively represented, but may be unrealistic where the client was represented only for limited purposes. Furthermore, such a rigid rule exaggerates the difference between a partner and an associate in modern law firms.

[5] The other rubric formerly used for dealing with disqualification is the appearance of impropriety proscribed in Canon 9 of the ABA Model Code of Professional Responsibility. This rubric has a two-fold problem. First, the appearance of impropriety can be taken to include any new client-lawyer relationship that might make a former client feel anxious. If that meaning were adopted, disqualification would become little more than a question of subjective judgment by the former client. Second, since "impropriety" is undefined, the term "appearance of impropriety" is question-begging. It therefore has to be recognized that

## Ethics 2000 Commission Proposed Rule 1.10 - Public Discussion Draft

the problem of disqualification cannot be properly resolved either by simple analogy to a lawyer practicing alone or by the very general concept of appearance of impropriety.

### Confidentiality

[8] [6] Paragraph (b) operates to disqualify the lawyer only when the lawyer involved has actual knowledge of information protected by Rules 1.6 and 1.9(b). Thus, if a lawyer while with one firm acquired no knowledge or information relating to a particular client of the firm, and that lawyer later joined another firm, neither the lawyer individually nor the second firm is disqualified from representing another client in the same or a related matter even though the interests of the two clients conflict. See Rule 1.10(b) for the restrictions on a firm once a lawyer has terminated association with the firm.

[6] [7] Preserving confidentiality is a question of access to information. Access to information, in turn, is essentially a question of fact in Application of paragraph (b) depends on a situation's particular circumstances facts, aided by inferences, deductions, or working presumptions that reasonably may be made about the way in which lawyers work together. A lawyer may have general access to files of all clients of a law firm and may regularly participate in discussions of their affairs; it should be inferred that such a lawyer in fact is privy to all information about all the firm's clients. In contrast, another lawyer may have access to the files of only a limited number of clients and participate in discussions of the affairs of no other clients; in the absence of information to the contrary, it should be inferred that such a lawyer in fact is privy to information about the clients actually served but not those of other clients. In such an inquiry, the burden of proof should rest upon the firm whose disqualification is sought.

[7] Application of paragraph (b) depends on a situation's particular facts. In such an inquiry, the burden of proof should rest upon the firm whose disqualification is sought.

[9] [8] Independent of the question of disqualification of a firm, a lawyer changing professional association has a continuing duty to preserve confidentiality of information about a client formerly represented. See Rules 1.6 and 1.9(c). With regard to Rules applicable to lawyers serving in or formerly serving in government agencies, see Rule 1.11.

### Adverse Positions

[10] The second aspect of loyalty to a client is the lawyer's obligation to decline subsequent representations involving positions adverse to a former client arising in substantially related matters. This obligation requires abstention from adverse representation by the individual lawyer involved, but does not properly entail abstention of other lawyers through imputed disqualification. Hence, this aspect of the problem is governed by Rule 1.9(a). Thus, if a lawyer left one firm for another, the new affiliation would not preclude the firms involved from continuing to represent clients with adverse interests in the same or related matters, so long as the conditions of paragraphs (b) and (e) concerning confidentiality have been met.

[11] [9] Information Paragraph (c) provides that information acquired by the lawyer in the course of representing a client may not subsequently be used or revealed by the lawyer to the disadvantage of the client. Neither may the information be revealed, see Rule 1.6. However, the fact that a lawyer has once served a client does not preclude the lawyer from using generally known information about that client when later representing another client.

[12] [10] Disqualification from subsequent representation is The provisions of this Rule are for the protection of former clients and can be waived by them. A waiver is effective only if there is disclosure of the circumstances, including the lawyer's intended role in behalf of the new client with informed consent. [13] With regard to an opposing party's raising a question of conflict of interest, see Comment to Rule 1.7. With regard to disqualification of a firm with which a lawyer is or was formerly associated, see Rule 1.10.

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### IMPUTED DISQUALIFICATION: GENERAL RULE

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when the lawyer knows or reasonably should know that any one of them practicing alone would be prohibited from doing so by Rules 1.7, 1.8(e), or 1.9 ~~or 2.2~~, unless the prohibition is based on a personal interest of the prohibited lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm.

(b) When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer and not currently represented by the firm, unless:

(1) the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

(2) any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(c) that is material to the matter.

(c) A disqualification prescribed by this rule may be waived by the affected client under the conditions stated in Rule 1.7.

### Comment

#### Definition of "Firm"

[1] For purposes of the Rules of Professional Conduct, the term "firm" includes lawyers in a private firm, and law partnership, professional corporation, sole proprietorship or other association, or in a legal services organization; lawyers in the legal department of a corporation or other organization, ~~or in a~~ who render legal services to that organization or to others to advance the interests or objectives of that organization; or lawyers who share office facilities without adequate measures to protect confidential information so that it will not be available to other lawyers in the shared facilities. Whether two or more lawyers constitute a firm within this definition can depend on the specific facts. For example, two practitioners who share office space and occasionally consult or assist each other ordinarily would not be regarded as constituting a firm unless they fail to take adequate measures to protect confidential information of the clients of each. However, if they present themselves to the public in a way suggesting that they are a firm or conduct themselves as a firm, they should be regarded as a firm for purposes of the Rules. The terms of any formal agreement between associated lawyers are relevant in determining whether they are a firm, ~~as is the fact that they have mutual access to information concerning the clients they serve.~~ Furthermore, it is relevant in doubtful cases to consider the underlying purpose of the rule that is involved. A group of lawyers could be regarded as a firm for purposes of the rule that the same lawyer should not represent opposing parties in litigation, while it might not be so regarded for purposes of the rule that information acquired by one lawyer is attributed to another.

[2] With respect to the law department of an organization, there is ordinarily no question that the members of the department constitute a firm within the meaning of the Rules of Professional Conduct. However, there can be uncertainty as to the identity of the client. For



example, it may not be clear whether the law department of a corporation represents a subsidiary or an affiliated corporation, as well as the corporation by which the members of the department are directly employed. A similar question can arise concerning an unincorporated association and its local affiliates.

[3] Similar questions can also arise with respect to lawyers in legal aid. Lawyers employed in the same unit of a legal service organization constitute a firm, but not necessarily those employed in separate units. As in the case of independent practitioners, whether the lawyers should be treated as associated with each other can depend on the particular rule that is involved, and on the specific facts of the situation.

[4] Where a lawyer has joined a private firm after having represented the government, the situation imputation is governed by Rule 1.11(a) and (b), not this Rule; similarly, where a lawyer represents the government after having served private clients in private practice or nongovernmental employment, the situation imputation is governed by Rule 1.11(c)(1). The individual lawyer involved is bound by the Rules generally, including Rules 1.6, 1.7, and 1.9(c).

~~[5] Different provisions are thus made for movement of a lawyer from one private firm to another and for movement of a lawyer between a private firm and the government. The government is entitled to protection of its client confidences, and therefore to the protections provided in Rules 1.6, 1.9, and 1.11. However, if the more extensive disqualification in Rule 1.10 were applied to former government lawyers, the potential effect on the government would be unduly burdensome. The government deals with all private citizens and organizations, and thus, has a much wider circle of adverse legal interests than does any private law firm. In these circumstances, the government's recruitment of lawyers would be seriously impaired if Rule 1.10 were applied to the government. On balance, therefore, the government is better served in the long run by the protections stated in Rule 1.11.~~

#### Principles of Imputed Disqualification

[6] [5] The rule of imputed disqualification stated in paragraph (a) gives effect to the principle of loyalty to the client as it applies to lawyers who practice in a law firm. Such situations can be considered from the premise that a firm of lawyers is essentially one lawyer for purposes of the rules governing loyalty to the client, or from the premise that each lawyer is vicariously bound by the obligation of loyalty owed by each lawyer with whom the lawyer is associated. Paragraph (a) operates only among the lawyers currently associated in a firm. When a lawyer moves from one firm to another, the situation is governed by Rules 1.9(b) and 1.10(b).

[6] The rule in paragraph (a) does not prohibit representation where neither questions of client loyalty nor protection of confidential information are presented. Where one lawyer in a firm could not effectively represent a given client because of strong political beliefs, for example, but that lawyer will do no work on the case, the firm should not be disqualified. Likewise, if a firm that employs one lawyer represents a client in a matter adverse to a party represented by a firm employing the lawyer's spouse, paragraph (a) ordinarily would not prohibit representation of the clients by the lawyer's firms so long as neither spouse participates in the representation. See Rule 1.8(i). On the other hand, if an opposing party in a case were owned by a lawyer in the law firm and others in the firm would be materially limited in pursuing the matter because of loyalty to that lawyer, the personal disqualification of the lawyer would be imputed to all others in the firm.

[7] The rule in paragraph (a) also does not prohibit representation by others in the law firm where the person prohibited from involvement in a matter is a non-lawyer, such as a paralegal or legal secretary. Nor does paragraph (a) prohibit representation if the lawyer is prohibited from acting because of events before the person became a lawyer, for example, work that the person did while a law student. Such persons, however, ordinarily must be screened from any personal participation in the matter to avoid communication to others in the firm of confidential information that both the non-lawyers and the firm have a legal duty

to protect. See Rules 1.11(a) and 5.3.

[7] [8] Rule 1.10(b) operates to permit a law firm, under certain circumstances, to represent a person with interests directly adverse to those of a client represented by a lawyer who formerly was associated with the firm. The Rule applies regardless of when the formerly associated lawyer represented the client. However, the law firm may not represent a person with interests adverse to those of a present client of the firm, which would violate Rule 1.7. Moreover, the firm may not represent the person where the matter is the same or substantially related to that in which the formerly associated lawyer represented the client and any other lawyer currently in the firm has material information protected by Rules 1.6 and 1.9(c).

[9] Rule 1.10(c) removes imputation with the informed consent of the affected client or former client under the conditions stated in Rule 1.7. The conditions stated in Rule 1.7 require the lawyer to determine that the representation is not prohibited by Rule 1.7(b) and that each affected client or former client has given informed consent to the representation. Such consent may be conditional. For example, consent might be conditioned on procedures being adopted and followed to assure both that no information material to the representation will be exchanged between the personally disqualified lawyer and others in the firm and that the personally disqualified lawyer will be apportioned no part of the fee from the representation. See Rule 1.11. In some cases, the risk may be so severe that the conflict may not be cured by client consent.



## Proposed Rule 1.5 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### FEEs

(a) ~~A lawyer's fee~~ lawyer shall be reasonable not make an agreement for, charge, or collect an unreasonable fee. The factors to be considered in determining the reasonableness of a fee include the following:

- (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
- (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
- (3) the fee customarily charged in the locality for similar legal services;
- (4) the amount involved and the results obtained;
- (5) the time limitations imposed by the client or by the circumstances;
- (6) the nature and length of the professional relationship with the client;
- (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) whether the degree of risk assumed by the lawyer when the fee is fixed or contingent on the outcome of a matter.

(b) When the lawyer has not regularly represented the client, the scope of the representation, the basis or rate of the fee and disbursements for which the client will be responsible shall be communicated to the client, ~~preferably~~ preferably in writing, before or within a reasonable time after commencing the representation. Any changes in these terms of the engagement shall also be communicated in writing.

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in writing and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(d) A lawyer shall not enter into an arrangement for, charge, or collect:

- (1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof; or
- (2) a contingent fee for representing a defendant in a criminal case.

**PROPOSED CHANGES TO THE MODEL RULES OF PROFESSIONAL CONDUCT  
BY THE ETHICS 2000 COMMISSION**

- Release of Additional Proposed Rules for Public Comment, November 1999 -



(e) A division of a fee between lawyers who are not in the same firm may be made only if:

- (1) the division is in proportion to the services performed by each lawyer or, by written agreement with the client, each lawyer assumes joint responsibility for the representation;
- (2) the client is advised of and does not object gives informed consent in writing to the participation of all the lawyers involved; and
- (3) the total fee is reasonable.

#### Comment

#### Basis or Rate of Fee

[1] When the lawyer has regularly represented a client, they ordinarily will have evolved an understanding concerning the basis or rate of the fee. If so, then both lawyer and client may rely on that understanding until they agree that it will be changed. In a new client-lawyer relationship, however, as a written understanding as to the fee should must be promptly established. It is not necessary to recite all the factors that underlie the basis of the fee, but only those that are directly involved in its computation. It is sufficient, for example, to state that the basic rate is an hourly charge or a fixed amount or an estimated amount, or to identify the factors that may be taken into account in finally fixing the fee. The writing must also describe the work expected to be performed by the lawyer for the fee, disbursements for which the client will be liable and the method of calculating charges for such disbursements. When developments occur during the representation that render an earlier description of the engagement or estimate of the fee substantially inaccurate, a revised description or estimate should must be provided to the client. A written statement concerning the fee terms of the engagement reduces the possibility of misunderstanding. Furnishing the client with a simple memorandum or a copy of the lawyer's customary fee schedule is sufficient if the basis or rate of the fee is set forth.

[2] Contingent fees, like any other fees, are subject to the reasonableness standard of paragraph (a) of this Rule, including consideration of the degree of risk assumed by the lawyer at the outset of the representation. Reasonableness of a contingent fee should ordinarily be determined based on the facts known at the time the fee agreement was reached. The amount of a contingent fee may be unreasonable if there was a high likelihood of substantial recovery by trial or settlement so that the lawyer bore little risk of nonpayment, or if the client's recovery was so large that the lawyer's fee would clearly exceed a sum appropriate in light of the services performed and risks assumed. Applicable law also may impose limitations on contingent fees, such as a ceiling on the percentage allowable.

#### Terms of Payment

[2] [3] A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d). A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8(j). However, a fee paid in property instead of money may be subject to special scrutiny because it involves questions concerning both the value of the services and the lawyer's special knowledge of the value of the property the requirements of Rule 1.8(a) because such fees often have the essential qualities of a business transaction with the client.

[3] [4] An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest. For example, a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client. Otherwise, the client might have to bargain for further assistance in the midst of a proceeding or transaction. However, it is proper to define the extent of services in light of the client's ability to pay. A lawyer should not exploit a fee arrangement based primarily on hourly charges by using wasteful procedures. When there is doubt whether a contingent fee is consistent with the client's best interest, the lawyer should offer the client alternative bases for the fee and explain their implications. Applicable law may impose limitations on contingent fees, such as a ceiling on the percentage.

#### Division of Fee

[4] [5] A division of fee is a single billing to a client covering the fee of two or more lawyers who are not in the same firm. A division of fee facilitates association of more than one lawyer in a matter in which neither alone could serve the client as well, and most often is used when the fee is contingent and the division is between a referring lawyer and a trial specialist. Paragraph (e) permits the lawyers to divide a fee on either the basis of the proportion of services they render or by agreement between the participating lawyers if all assume responsibility for the representation as a whole and the client is advised and does not object gives informed consent to the arrangement. It does not require disclosure to the client of the share that each lawyer is to receive. Joint Assuming joint responsibility for the representation entails the obligations stated in Rule 5.1 for purposes of the matter involved requires each lawyer to assume civil liability for any malpractice of the others in the matter.

[6] Paragraph (e) does not prohibit or regulate division of fees to be received in the future for work done when lawyers were previously associated in a law firm.

#### Disputes over Fees

[5] [7] If a procedure has been established for resolution of fee disputes, such as an arbitration or mediation procedure established by the bar, the lawyer should conscientiously consider submitting to it. Law may prescribe a procedure for determining a lawyer's fee, for example, in representation of an executor or administrator, a class or a person entitled to a reasonable fee as part of the measure of damages. The lawyer entitled to such a fee and a lawyer representing another party concerned with the fee should comply with the prescribed procedure.



## Proposed Rule 4.4 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### RESPECT FOR RIGHTS OF THIRD PERSONS

(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.

(b) In communicating with third persons, a lawyer shall not seek to obtain information that the lawyer knows or reasonably should know is subject to an evidentiary or other privilege of another.

(c) A lawyer who receives a document and has reason to believe that the document was inadvertently sent shall promptly notify the sender.

#### Comment

[1] Responsibility to a client requires a lawyer to subordinate the interests of others to those of the client, but that responsibility does not imply that a lawyer may disregard the rights of third persons. It is impractical to catalogue all such rights, but they include legal restrictions on methods of obtaining evidence from third persons.

[2] Third persons sometimes have documents or other information that are protected by an evidentiary or other privilege of another person. For example, present or former organizational employees or agents may have information protected by the attorney-client evidentiary privilege or the work product doctrine of the organization itself. If the person contacted by the lawyer has no authority to waive the privilege, it would be unfair to permit the lawyer to deliberately seek to obtain the information in this manner.

[3] Paragraph (c) recognizes that lawyers sometimes receive documents that were mistakenly sent or produced by opposing parties or their lawyers. If a lawyer has reason to know that a document was sent inadvertently, then this Rule requires the lawyer to promptly notify the sender in order to permit that person to take protective measures. Whether the lawyer is required to take additional steps, such as returning the original document, is a matter of law beyond the scope of these Rules, as is the question of whether the privileged status of a document has been waived. Similarly, this Rule does not address the legal duties of a lawyer who receives a document that the lawyer knows or reasonably believes may have been wrongfully obtained by the sending person. For purposes of this Rule, a document@ includes e-mail or other electronic mode of transmission subject to being read or put into readable form.

[4] As a matter of professional courtesy, some lawyers may choose to return a document unread, for example, when the lawyer learns before receiving the document that it was inadvertently sent to the wrong address. The decision to voluntarily return such a document is a matter of professional judgment ordinarily reserved to the lawyer. See Rules 1.2 and 1.4.

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## Proposed Rule 5.3 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### RESPONSIBILITIES REGARDING NONLAWYER ASSISTANTS

With respect to a nonlawyer employed or retained by or associated with a lawyer:

(a) a partner in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the person's conduct is compatible with the professional obligations of the lawyer;

(b) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer; and

(c) a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:

(1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner in the law firm in which the person is employed, or has direct supervisory authority over the person, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

#### Comment

[1] Lawyers generally employ assistants in their practice, including secretaries, investigators, law student interns, and paraprofessionals. Such assistants, whether employees or independent contractors, act for the lawyer in rendition of the lawyer's professional services. A lawyer ~~should~~ must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product. The measures employed in supervising nonlawyers should take account of the fact that they do not have legal training and are not subject to professional discipline.

[2] Paragraph (a) requires each law firm to establish internal systems giving reasonable assurance that nonlawyers in the firm will act in a way compatible with the Rules of Professional Conduct. Paragraphs (b) and (c) impose personal responsibility on lawyers who have supervisory authority over the performance of nonlawyers in the firm.



## Proposed Rule 1.15 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### SAFEKEEPING PROPERTY

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of [five years] after termination of the representation.

(b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this Rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(c) When in the course of representation a lawyer is in possession of property in which ~~both two or more persons (one of whom may be the lawyer and another person)~~ both two or more persons claim interests, the property shall be kept separate by the lawyer until ~~there is an accounting and severance of their interests. If a dispute arises concerning their respective interests, the portion in dispute shall be kept separate by the lawyer until the any dispute about the interests is resolved.~~ there is an accounting and severance of their interests. If a dispute arises concerning their respective interests, the portion in dispute shall be kept separate by the lawyer until the any dispute about the interests is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

#### Comment

[1] A lawyer should hold property of others with the care required of a professional fiduciary. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property which is the property of clients or third persons, including prospective clients, should must be kept separate from the lawyer's business and personal property and, if monies, in one or more trust accounts. Separate trust accounts may be warranted when administering estate monies or acting in similar fiduciary capacities.

[2] Lawyers often receive funds from ~~third parties from which the lawyer's fee will be paid. If there is risk that the client may divert the funds without paying the fee, the~~ third parties from which the lawyer's fee will be paid. ~~The lawyer is not required to remit the portion from which funds to the fee is to be paid client that the lawyer reasonably believes represent fees owed.~~ However, a lawyer may not hold funds to coerce a client into accepting the lawyer's contention. The disputed portion of the funds should must be kept in a trust account and the lawyer should suggest means for prompt resolution of the dispute, such as arbitration. The undisputed portion of the funds shall be promptly distributed.

[3] ~~Third Paragraph (c) also recognizes that third parties, such as a client's creditors, may have just lawful~~ Third Paragraph (c) also recognizes that third parties, such as a client's creditors, may have just lawful claims against funds or other property in a lawyer's custody. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client, and ~~accordingly may in such cases must~~ accordingly may in such cases must refuse to surrender the property to the client until the claims are resolved. ~~However, a~~ However, a lawyer should not unilaterally assume to arbitrate a dispute between the client and the third party, but the lawyer may file an action to have a court resolve the claims.

[4] The obligations of a lawyer under this Rule are independent of those arising from activity other than

rendering legal services. For example, a lawyer who serves as an escrow agent is governed by the applicable law relating to fiduciaries even though the lawyer does not render legal services in the transaction.

[5] A ~~"clients' security lawyers' fund"~~ "clients' security lawyers' fund" for client protection provides a means through the collective efforts of the bar to reimburse persons who have lost money or property as a result of dishonest conduct of a lawyer. Where such a fund has been established, a lawyer should participate.



## Proposed Rule 5.1 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### RESPONSIBILITIES OF A PARTNER OR SUPERVISORY LAWYER

(a) A partner in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

### Comment

[1] Paragraphs (a) and (b) refer to lawyers who have supervisory authority over the professional work of a firm or legal department of a an enterprise or government agency. This includes members of a partnership and the shareholders in a law firm organized as a professional corporation; lawyers having supervisory authority in the law department of an enterprise or government agency; and lawyers who have intermediate managerial responsibilities in a firm.

[2] Paragraph (a) requires each law firm to establish internal systems giving reasonable assurance that all lawyers in the firm will conform to the Rules of Professional Conduct. Systems required include those for determining conflicts of interest, identifying the dates by which required actions must be taken in each case, accounting for client funds and property, and assuring that inexperienced lawyers are properly supervised.

[3] Paragraph (b) imposes personal responsibilities on lawyers who have direct supervisory authority over the professional work of one or more other lawyers. The measures required to fulfill the responsibility prescribed in paragraphs (a) and (b) can depend on the firm's structure and the nature of its practice. In a small firm of experienced lawyers, informal supervision and ~~occasional admonition~~ periodic review of compliance with the required systems ordinarily ~~might be sufficient~~ will suffice. In a large firm, or in practice situations in which intensely difficult ethical problems frequently arise, more elaborate ~~procedures~~ measures may be necessary. Some firms, for example, have a procedure whereby junior lawyers can make confidential referral of ethical problems directly to a designated senior partner or special committee. See Rule 5.2. Firms, whether large or small, may also rely on continuing legal education in professional ethics. In any event, the ethical atmosphere of a firm can influence the conduct of all its members and a lawyer having authority over the work of another may not assume that the subordinate lawyer will inevitably conform to the Rules.

[4] [4] Paragraph (c)(1) expresses a general principle of personal responsibility for acts of another. See also Rule 8.4(a).

[4] [5] Paragraph (c)(2) defines the duty of a lawyer having direct supervisory authority over performance of specific legal work by another lawyer. Whether a lawyer has such supervisory authority in particular

circumstances is a question of fact. Partners of a private firm have at least indirect responsibility for all work being done by the firm, while a partner in charge of a particular matter ordinarily has direct authority over other firm lawyers engaged in the matter. Appropriate remedial action by a partner would depend on the immediacy of the partner's involvement and the seriousness of the misconduct. The supervisor is required to intervene to prevent avoidable consequences of misconduct if the supervisor knows that the misconduct occurred. Thus, if a supervising lawyer knows that a subordinate knowingly misrepresented a matter to an opposing party in negotiation, the supervisor as well as the subordinate has a duty to correct the resulting misapprehension.

[5] [6] Professional misconduct by a lawyer under supervision could reveal a violation of paragraph (b) on the part of the supervisory lawyer even though it does not entail a violation of paragraph (c) because there was no direction, ratification or knowledge of the violation.

[6] [7] Apart from this Rule and Rule 8.4(a), a lawyer does not have disciplinary liability for the conduct of a partner, associate or subordinate. Whether a lawyer may be liable civilly or criminally for another lawyer's conduct is a question of law beyond the scope of these Rules.



## Proposed Rule 5.2 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

### RESPONSIBILITIES OF A SUBORDINATE LAWYER

(a) A lawyer is bound by the Rules of Professional Conduct notwithstanding that the lawyer acted at the direction of another person.

(b) A subordinate lawyer does not violate the Rules of Professional Conduct if that lawyer acts in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty.

#### Comment

[1] Although a lawyer is not relieved of responsibility for a violation by the fact that the lawyer acted at the direction of a supervisor, that fact may be relevant in determining whether a lawyer had the knowledge required to render conduct a violation of the Rules. For example, if a subordinate filed a frivolous pleading at the direction of a supervisor, the subordinate would not be guilty of a professional violation unless the subordinate knew of the document's frivolous character.

[2] When lawyers in a supervisor-subordinate relationship encounter a matter involving professional judgment as to ethical duty, the supervisor may assume responsibility for making the judgment. Otherwise a consistent course of action or position could not be taken. If the question can reasonably be answered only one way, the duty of both lawyers is clear and they are equally responsible for fulfilling it. However, if the question is reasonably arguable, someone has to decide upon the course of action. That authority ordinarily reposes in the supervisor, and a subordinate may be guided accordingly. For example, if a question arises whether the interests of two clients conflict under Rule 1.7, the supervisor's reasonable resolution of the question should protect the subordinate professionally if the resolution is subsequently challenged.

Center for Professional Responsibility

## Proposed Rule 1.4 - Public Discussion Draft

Ethics 2000 Commission  
March 23, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### COMMUNICATION AND INFORMED CONSENT

(a) A lawyer shall keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

(c) As used in these Rules, "informed consent" denotes the agreement of a person to a proposed course of conduct after the lawyer has communicated reasonably adequate information and explanation regarding the material risks of and reasonably available alternatives to the proposed course of conduct.

#### Comment

[1] The client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued, to the extent the client is willing and able to do so. For example, a lawyer negotiating on behalf of a client should provide the client with facts relevant to the matter, inform the client of communications from another party and take other reasonable steps that permit the client to make a decision regarding a serious offer from another party. A lawyer who receives from opposing counsel an offer of settlement in a civil controversy or a proffered plea bargain in a criminal case should promptly inform the client of its substance unless prior discussions with the client have left it clear that the proposal will be unacceptable. See Rule 1.2(a). Even when a client delegates authority to the lawyer, the client should be kept advised of the status of the matter.

[2] Adequacy of communication depends in part on the kind of advice or assistance involved. For example, in negotiations where there is time to explain a proposal, the lawyer should review all important provisions with the client before proceeding to an agreement. In litigation a lawyer should explain the general strategy and prospects of success and ordinarily should consult the client on tactics that might injure or coerce others. On the other hand, a lawyer ordinarily cannot be expected to describe trial or negotiation strategy in detail. The guiding principle is that the lawyer should fulfill reasonable client expectations for information consistent with the duty to act in the client's best interests, and the client's overall requirements as to the character of representation.

[3] Ordinarily, the information to be provided is that appropriate for a client who is a comprehending and responsible adult. However, fully informing the client according to this standard may be impracticable, for example, where the client is a child or suffers from mental disability. See Rule 1.14. When the client is an organization or group, it is often impossible or inappropriate to inform every one of its members about its legal affairs; ordinarily, the lawyer should address communications to the appropriate officials of the organization. See Rule 1.13. Where many routine matters are involved, a system of limited or occasional reporting may be arranged with the client. Practical exigency may also require a lawyer to act for a client without prior consultation.

#### Withholding Information

[4] In some circumstances, a lawyer may be justified in delaying transmission of

## Proposed Rule 1.8 - Public Discussion Draft

Ethics 2000 Commission  
March 23, 1999

Material added to the current Model Rule has been underlined; deletions from the current Model Rule have been ~~struck through~~.

### CONCURRENT CONFLICT OF INTEREST:

#### PROHIBITED TRANSACTIONS SPECIFIC RULES

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing ~~to the client~~ in a manner ~~which that~~ can be reasonably understood by the client;

(2) the client ~~is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in~~ is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in on the transaction; and

(3) the client ~~consents gives informed consent in writing thereto to the essential terms of the transaction and the lawyer's role in the transaction.~~

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client ~~consents after consultation gives informed consent~~, except as permitted or required by Rule 1.6 [or Rule 3.3].

(c) A lawyer shall not solicit any substantial gift from a client or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer as parent, child, sibling, or spouse any substantial gift from a client, including a testamentary gift, except where the client unless the lawyer or other recipient of the gift is related to the donee client.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(f) A lawyer shall not accept compensation or direction for representing a client from one other than the client unless:

(1) the client ~~consents after consultation gives informed consent in writing under the conditions stated in Rule 1.7;~~

(2) there is no interference with the lawyer's independence of

information when the client would be likely to react imprudently to an immediate communication. Thus, a lawyer might withhold a psychiatric diagnosis of a client when the examining psychiatrist indicates that disclosure would harm the client. A lawyer may not withhold information to serve the lawyer's own interest or convenience or the interests of another person. Rules or court orders governing litigation may provide that information supplied to a lawyer may not be disclosed to the client. Rule 3.4(c) directs compliance with such rules or orders.

#### Informed Consent

[5] Many of the Rules of Professional Conduct require the lawyer to obtain the informed consent of a client or other person before accepting or continuing representation or pursuing a course of conduct. See, e.g., Rules 1.6-1.12. The communication necessary to obtain such consent will vary according to the Rule involved and the circumstances giving rise to the need for disclosure. The lawyer must make reasonable efforts to assure that the client possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client of the material advantages and disadvantages of the proposed course of conduct, and a discussion of the client's options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client to seek the advice of other counsel. A lawyer need not inform a client of facts or implications already known to the client; nevertheless, a lawyer who does not personally inform the client assumes the risk that the client is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client is sophisticated in legal matters generally and in making decisions of the type involved and whether the client is independently represented by other counsel in giving the consent.

[6] Paragraph (c) will usually require an affirmative response by the client or other person. In general, a lawyer may not assume consent from a client's silence. Unless written consent is required, however, consent may be inferred from the conduct of a client who has reasonably adequate information about the matter.

professional judgment or with the lawyer-client relationship; and

(3) information relating to representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client ~~consents after consultation, including gives informed consent in writing that includes~~ disclosure of the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice ~~unless permitted by law and the client is independently represented in making the agreement;~~ or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client ~~without first advising unless that person is advised~~ in writing ~~that of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent representation is appropriate~~ legal counsel in connection therewith.

(i) A lawyer related to another lawyer as parent, child, sibling, or spouse ~~or by a cohabitating relationship closely approximating marriage~~ shall not represent a client in a representation directly adverse to a person whom the lawyer knows is represented in the same or in a substantially related matter by the other lawyer except upon unless each affected client gives informed consent by the client after consultation regarding the relationship in writing under the conditions stated in Rule 1.7.

(j) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien ~~granted~~ authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

(k) ~~A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the lawyer-client relationship commenced.~~

#### Comment

#### Business Transactions between Client and Lawyer

[1] ~~As a general principle, all transactions between client and lawyer should be fair and reasonable to the client. In such transactions a review by independent counsel on behalf of the client is often advisable. Furthermore, a lawyer may not exploit information relating to the representation to the client's disadvantage. For example, a lawyer who has learned that the client is investing in specific real estate may not, without the client's consent, seek to acquire nearby property where doing so would adversely affect the client's plan for investment. Paragraph (a) A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property, or financial transaction with a client, for example, loan and sales transactions and lawyers making investments for clients. The requirements of paragraph (a) must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a will for a client learns that the client needs money for unrelated expenses and offers to make a loan to the client. The Rule does not, however, apply to standard commercial transactions between the~~

lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable. The Rule applies to lawyers engaged in the sale of goods or services ancillary to the practice of law, for example, the sale of title insurance or investment services to existing clients of the lawyer's legal practice. See Rule 5.7. It also applies to lawyers purchasing property from estates they represent. It does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business as payment of all or part of a fee.

[2] ~~Paragraph (a)(1) requires that the transaction itself be fair to the client and that its essential terms be communicated to the client, in writing, in a manner that can be reasonably understood. Paragraph (a)(2) requires that the client also be advised, in writing, of the desirability of seeking the advice of independent legal counsel. It also requires that the client be given a reasonable opportunity to obtain such advice. Paragraph (a)(3) requires that the lawyer obtain the client's informed consent, in writing, both to the essential terms of the transaction and the lawyer's role. When necessary, the lawyer should discuss both the material risks of the proposed transaction, including risk presented by the lawyer's involvement, and the existence of reasonably available alternatives, and should explain why the advice of independent legal counsel is desirable. See Rule 1.4 (definition of informed consent).~~

[3] ~~The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with the requirements of paragraph (a), but also with the requirements of Rule 1.7. Under that Rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that Rule 1.7 will preclude the lawyer from seeking the client's consent to the transaction.~~

#### Use of Information Related to Representation

[4] ~~Use of information relating to the representation to the disadvantage of the client violates the lawyer's duty of loyalty. Paragraph (b) applies when the information is used to benefit either the lawyer or a third person, such as another client or business associate of the lawyer. For example, if a lawyer learns that a client intends to purchase and develop several parcels of land, the lawyer may not use that information to purchase one of the parcels in competition with the client or to recommend that another client make such a purchase. The Rule does not prohibit uses that do not disadvantage the client. For example, a lawyer who learns a government agency's interpretation of trade legislation during the representation of one client may properly use that information to benefit other clients.~~

#### Gifts to Lawyers

[2] [5] A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If a client offers the lawyer a more substantial gift, paragraph (c) does not prohibit the lawyer from accepting it, although such a gift may be voidable by the client under the doctrine of undue influence, which treats client gifts as presumptively fraudulent. In any event, due to concerns about overreaching and imposition on clients, a lawyer may not suggest that a substantial gift be made to the lawyer or for the lawyer's benefit, except where the lawyer is related to the client. For purposes of this Rule, persons related to the lawyer include a spouse, child, grandchild, parent, grandparent, or other relative or person with whom the lawyer maintains a close, familial relationship.

[6] If effectuation of a substantial gift requires preparing a legal instrument such as a will or conveyance, however, the client should have the detached advice that another lawyer can provide. Paragraph (e) recognizes an The sole exception to this Rule is where the client is a relative of the donee or the gift is not substantial, as described in [5] above.

[7] This Rule does not prohibit a lawyer from seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position. Nevertheless, such appointments will be subject to the general conflict of interest provision in Rule 1.7 when there is a significant risk that the lawyer's interest in obtaining the appointment will materially limit the lawyer's independent professional judgment in advising the client concerning the choice of an executor or other fiduciary. In obtaining the client's informed written consent to the conflict, the lawyer should advise the client concerning the nature and extent of the lawyer's financial interest in the appointment, as well as the availability of alternative candidates for the position.

#### Literary Rights

[3] [8] An agreement by which a lawyer acquires literary or media rights concerning the conduct of the representation creates a conflict between the interests of the client and the personal interests of the lawyer. Measures suitable in the representation of the client may detract from the publication value of an account of the representation. Paragraph (d) does not prohibit a lawyer representing a client in a transaction concerning literary property from agreeing that the lawyer's fee shall consist of a share in ownership in the property, if the arrangement conforms to Rule 1.5 and paragraph paragraphs (a) and (j).

#### Financial Assistance

[9] Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. These dangers do not warrant a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help insure access to the courts. Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

#### Person Paying for a Lawyer's Services Third-Party Payment or Direction

[4] Paragraph (f) requires disclosure of the fact that the lawyer's services are being paid for by a third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest. Where the client is a class, consent may be obtained on behalf of the class by court-supervised procedure.

[10] Lawyers are frequently asked to represent a client under circumstances in which a third person will compensate the lawyer, in whole or in part. The third person might be a relative or friend, an indemnitor (such as a liability insurance company), or a co-client (such as a corporation sued along with one or more of its employees). Because third-party payers frequently have interests in conflict with the client, including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless there is informed consent from the client and the lawyer reasonably determines that the representation will be competent and diligent and that the lawyer's loyalty to the client will not be compromised. See Rule 1.7.

[11] Sometimes, it will be sufficient for the lawyer to obtain the client's informed consent regarding the fact of the payment and the identity of the third-party payer. If, however, the fee arrangement creates a conflict of interest for the lawyer, then the lawyer must comply

with Rule 1.7. The lawyer must also conform to the requirements of Rule 1.6 concerning confidentiality. Under Rule 1.7(a), a conflict of interest exists if the lawyer's representation of the client may be materially limited by the lawyer's own interest in the fee arrangement or by the lawyer's responsibilities to the third-party payer (for example, when the third party-payer is a co-client). Under Rule 1.7(b), the lawyer may accept or continue the representation with the informed consent of each affected client, unless the conflict is non-consentable under that paragraph. Under Rule 1.7(c), the informed consent must be confirmed in a writing signed by the client.

[12] Just as when the client is paying his or her own legal fees, the client can always designate an agent to make decisions on the client's behalf, and that agent could be the person compensating the lawyer. For example, a client planning to be out of the country could designate a close relative to make decisions on the client's behalf, regardless of whether the relative is a third-party payer. In these situations both the lawyer and the agent are obligated to act solely in the client's interests; thus, the lawyer may not accept direction from the agent that would disadvantage the client or interfere with the lawyer's exercise of independent professional judgment on the client's behalf.

[13] In some cases, the third party may have assumed obligations to the client, such as the obligation to indemnify the client against any judgment rendered, that give the third party an interest in the outcome of a matter. In such cases, the lawyer may accept direction from the third party that is reasonable in scope and character and consistent with the client's interests.

[14] It is not always easy for the lawyer to determine when following the direction of a third party protecting its own interests will interfere with the lawyer's independent professional judgment on behalf of the client. For example, an insurance company that pays the lawyer to defend an insured in an action under a liability policy may direct the lawyer not to take an additional deposition. If the lawyer reasonably believes that failure to take the deposition will not harm the client's interests, then the lawyer may comply with the direction without further consultation with the client. If, however, the lawyer has reason to believe that the client may be harmed, as when the deposition is critical and there is significant risk of a judgment in excess of the policy limits, then the lawyer must refuse to comply with the direction unless the client gives informed consent under the conditions stated in Rule 1.7(b).

[15] Similar problems arise when an employer agrees to pay for the legal expenses of an employee, particularly when the employer is also a client. Before agreeing to representation under these circumstances, the lawyer must consider whether the fee arrangement is likely to undermine the lawyer's ability to provide competent and diligent representation, as when the lawyer believes there is a significant likelihood that the employer will want to avoid criminal liability by providing information incriminating to the employee. Even when the potential liability is civil and the employer has agreed to indemnify the employee, the lawyer should consider whether the employee's interests in reputation or continued employment may conflict with the employer's desire to settle the case or terminate the employment relationship. Once the lawyer determines that the representation is consentable under the conditions stated in Rule 1.7, the lawyer should obtain the informed consent of both employer and employee. If, as the representation proceeds, circumstances pose additional significant risks to the employee, then the lawyer must withdraw when required or consult further with the client before continuing the representation under the direction of the employer.

#### Aggregate Settlements

[16] Differences in willingness to make or accept an offer of settlement are among the risks of joint representation of multiple clients by a single lawyer. Under Rule 1.7 this is one of the risks that should be discussed before undertaking the representation, as part of the process of obtaining the clients' informed consent. In addition, Rule 1.2(a) protects each client's right to have the final say in deciding whether to accept or reject an offer of settlement and in deciding whether to enter a guilty or nolo contendere plea in a criminal case. The rule stated in this paragraph is a corollary of both these Rules and provides that



before any settlement offer or plea bargain is made or accepted on behalf of multiple clients, the lawyer must inform each of them about all the material terms of the settlement, including what the other clients will receive or pay if the settlement or plea offer is accepted. See also Rule 1.4 (keeping the client informed). Lawyers representing a class of plaintiffs or defendants, or those proceeding derivatively, may not have a full client-lawyer relationship with each member of the class; nevertheless, such lawyers must comply with applicable rules regulating notification of class members and other procedural requirements designed to ensure adequate protection of the entire class.

#### **Limiting Liability and Settling Malpractice Claims**

[5] Paragraph (h) is not intended to apply to customary qualifications and limitations in legal opinions and memoranda.

[17] Agreements prospectively limiting a lawyer's liability for malpractice are prohibited because they are likely to undermine competent and diligent representation. Also, many clients are unable to evaluate the desirability of making such an agreement before a dispute has arisen, particularly if they are then represented by the lawyer seeking the agreement. This paragraph does not, however, prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement. Nor does this paragraph limit the ability of lawyers to practice in the form of a limited liability entity, where permitted by law, provided that each lawyer remains personally liable to the client for his or her own conduct and the firm complies with any conditions required by law, such as provisions requiring client notification or maintenance of adequate liability insurance. Nor does it prohibit an agreement in accordance with Rule 1.2 that defines the scope of the representation, although a definition of scope that makes the obligations of representation illusory will amount to an attempt to limit liability.

[18] Agreements settling a claim or a potential claim for malpractice are not prohibited by this Rule. Nevertheless, in view of the danger that a lawyer will take unfair advantage of an unrepresented client or former client, the lawyer must first advise such a person in writing of the appropriateness of independent representation in connection with such a settlement. In addition, the lawyer must give the client or former client a reasonable opportunity to find and consult independent counsel.

#### **Lawyer's Family Relationships between Lawyers**

[6] [19] Paragraph (i) applies to related lawyers who are in different firms. Related lawyers in the same firm are governed by Rule 1.7, 1.9, and 1.10. The disqualification stated in paragraph (i) is personal and is not imputed to members of firms with whom the lawyers are associated unless there is a significant risk that the representation of one or more of the clients may be materially limited as a result of the conflict. See Rule 1.10.

[20] When lawyers on opposite sides of a dispute are closely related by blood or marriage or by a cohabitating relationship closely approximating marriage there is a significant risk that client confidences may be revealed and that the lawyers' personal relationship may interfere with both loyalty and independent professional judgment. As a result, each client is entitled to know of the existence and implications of the relationship between the lawyers before the lawyer agrees to accept the representation. In some cases, the risk may be so severe that the representation is prohibited even with the clients' consent. See Rule 1.7.

[21] Similar concerns may arise in circumstances not covered by Rule 1.8(i). For example, related lawyers may be asked to represent clients with interests that differ, although they are not directly adverse, as when the prospective clients are forming a business. Or, a lawyer representing a client in litigation may be involved in a dating relationship with a lawyer representing the opposing client. Even if Rule 1.8(i) does not apply, if there is a significant risk that the representation of a client will be materially and adversely affected by the lawyer's own interests, then the representation is governed by Rule 1.7.

#### **Acquisition of Acquiring Proprietary Interest in Litigation**

[7] [22] Paragraph (j) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. This Like paragraph (e), the general rule, which has its basis in common law champerty and maintenance, and is designed to avoid giving the lawyer too great an interest in the representation. In addition, when the lawyer acquires an ownership interest in the subject of the representation, it will be more difficult for a client to discharge the lawyer if the client so desires. The Rule is subject to specific exceptions developed in decisional law and continued in these Rules, such as the exception for reasonable contingent fees set forth in Rule 1.5 and the exception for certain advances of the costs of litigation set forth in paragraph (e). The exception for certain advances of the costs of litigation is set forth in paragraph (e). In addition, paragraph (j) sets forth exceptions for liens authorized by law to secure the lawyer's fees or expenses and contracts for reasonable contingent fees. There are two types of liens that are authorized by law. The first are liens granted by law in which the lawyer need take no further action. The second are those that a lawyer acquires by contract with the client. When a lawyer acquires by contract a security interest in property other than that recovered through the lawyer's efforts in the litigation, such an acquisition is a business or financial transaction with a client and is governed by the requirements of paragraph (a). Contracts for contingent fees in civil cases are governed by Rule 1.5.

#### **Client-Lawyer Sexual Relationships**

[23] The relationship between lawyer and client is a fiduciary one in which the lawyer occupies the highest position of trust and confidence. The relationship is almost always unequal; thus, a sexual relationship between lawyer and client can involve unfair exploitation of the lawyer's fiduciary role, in violation of the lawyer's basic ethical obligation not to use the trust of the client to the client's disadvantage. In addition, such a relationship presents a significant danger that, because of the lawyer's emotional involvement, the lawyer will be unable to represent the client without impairment to the exercise of independent professional judgment. Moreover, a blurred line between the professional and personal relationship may make it difficult to predict to what extent client confidences will be protected by the attorney-client evidentiary privilege, since client confidences are protected by privilege only when they are imparted in the context of the client-lawyer relationship. Because of the significant danger of harm to client interests and because the client's own emotional involvement renders it unlikely that the client could give adequate informed consent, this Rule prohibits the lawyer from having sexual relations with a client regardless of whether the relationship is consensual and regardless of the absence of prejudice to the client.

[24] Sexual relationships that predate the client-lawyer relationship are not prohibited. Issues relating to the exploitation of the fiduciary relationship and client dependency are diminished when the sexual relationship existed prior to the commencement of the client-lawyer relationship. However, before proceeding with the representation in these circumstances, the lawyer should consider whether the lawyer's ability to represent the client will be materially limited by the relationship. See Rule 1.7.



## Proposed Rule 1.18 - Public Discussion Draft

Ethics 2000 Commission  
November 15, 1999

New material is underlined. (This draft Rule is an addition to the current Model Rules.)

### DUTIES TO A PROSPECTIVE CLIENT

(a) A person who consults with a lawyer concerning the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

(b) Even when no client-lawyer relationship ensues, a lawyer who has consulted with a prospective client shall not use or reveal information learned in the consultation, except as Rules 1.6 and 1.9 would permit or require with respect to information of a client or former client.

(c) Neither a lawyer subject to paragraph (b) nor a lawyer to whom disqualification is imputed under Rule 1.10 shall represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d).

(d) Representation is permissible if either:

(1) both the affected client and the prospective client have given informed consent in writing to the representation, or

(2) the lawyer who received the confidential information took reasonable steps to avoid exposure to more information than was necessary to determine whether to represent the prospective client and that lawyer is screened as provided in Rule 1.11.

### Comment

[1] Prospective clients, like clients, may disclose information to a lawyer, place documents or other property in the lawyer's custody, or rely on the lawyer's advice. A lawyer's discussions with a prospective client usually are limited in time and depth and leave both the prospective client and the lawyer free (and sometimes required) to proceed no further. Hence, prospective clients should receive some but not all of the protection afforded clients.

[2] It is often necessary for a prospective client to reveal information during an initial consultation prior to the decision about formation of a client-lawyer relationship. The lawyer often must learn such information to determine whether there is a conflict of interest with an existing client and whether the matter is one that the lawyer is willing to undertake. Paragraph (b) prohibits the lawyer from using or revealing that information, except as permitted or required by Rules 1.6 or 1.9, even if the client or lawyer decides not to proceed with the representation. The duty exists regardless of how brief the initial conference may be.

[3] In order to avoid acquiring disqualifying information from a prospective client, a lawyer considering whether or not to undertake a new matter should limit the initial interview to only such information as reasonably appears necessary for that purpose. Where the information indicates that a conflict of interest or other reason for non-representation exists, the lawyer should so inform the prospective client or decline the representation. If the prospective client wishes to retain the lawyer, and if consent is possible under Rule 1.7, then consent from all affected present or former clients must be obtained before accepting the representation.

[4] A lawyer may condition conversations with a prospective client on the person's informed consent that no information disclosed during the consultation will prohibit the lawyer from representing a different client in

the matter. If the agreement expressly so provides, the prospective client may also consent to the lawyer's subsequent use of information received from the prospective client.

[5] Even in the absence of an agreement, under paragraph (c), the lawyer is not prohibited from representing a client with interests adverse to those of the prospective client in the same or a substantially related matter unless the lawyer has received from the prospective client information that could be significantly harmful if used against the prospective client in the matter.

[6] The prohibition in this Rule is imputed to other lawyers as provided in Rule 1.10, but, under paragraph (d)(2), imputation may be avoided if all disqualified lawyers are screened as provided in Rule 1.11.

[7] With the informed, written consent of both the prospective and affected clients, under paragraph (d)(1), the lawyer and members of the lawyer's firm may represent the affected client without screening.

[8] For the duty of competence of a lawyer who gives assistance on the merits of a matter to a prospective client, see Rule 1.1. For a lawyer's duties when a prospective client entrusts valuables or papers to the lawyer's care, see Rule 1.15.



**SURVEY COMMENTS INDICATING THAT  
STATUTORY STANDARDS FOR RESOLVING BANKRUPTCY-RELATED  
ISSUES OF ATTORNEY CONDUCT ARE INADEQUATE**

**Received in Connection with the Federal Judicial Center Survey of Bankruptcy Judges  
Concerning Standards Governing Attorney Conduct in the Bankruptcy Courts**

- March 1999 -



**Standards Governing  
Attorney Conduct in the Bankruptcy Courts**

**Report to the Judicial Conference  
Advisory Committee on Bankruptcy Rules**

**Marie Leary**

***With the advice and assistance of  
Bob Niemic & Melissa Deckman***

**Federal Judicial Center  
March 1999**

Comments Indicating Statutory Standards  
for Resolving Bankruptcy-Related Issues of  
Attorney Conduct Were Not Adequate

- The statutory attorney conduct standards for conflicts of interest are not adequate because:
  - (1) The statutory standards are not articulated in a specific or detailed enough manner to provide the necessary guidance to attorneys, usually causing more problems than they solve (especially the disinterestedness standard under § 327(a)). The vagueness of § 327(a) requires the court to make difficult decisions concerning whether conflicts are such as to disqualify a professional. (Summary of comments from 7 bankruptcy judges.)
  - (2) The statutory standards are too strict (specifically the definition of disinterested persons under 11 U.S.C. § 327(a)) and do not provide enough flexibility or allow for judicial discretion in their application. (Summary of comments from 6 bankruptcy judges.)
  - (3) The statutory standards should be clarified as to related corporate debtors. Representation of multiple, related entities ordinarily should be allowed if all were operated as an integrated group with one decision-maker. There needs to be a better definition of the conflict rule pertaining to the debtor and the principal of a debtor entity represented by the same attorney. (Summary of comments from 3 bankruptcy judges.)
  - (4) The multi-party nature of bankruptcy, and the fact that bankruptcy cases often involve a multitude of separate legal transactions unlike a single civil action or criminal case, often makes it difficult to tell when a conflict or potential conflict is likely because the potential for conflict or overreaching is constantly shifting and is often obscure or obscured. Also, it is unrealistic to require disclosure of all conflicts to the parties-in-interest because there can be so many of them. (Summary of comments from 2 bankruptcy judges.)
  - (5) The disinterestedness concept in the Code does not work in reality because it is incomplete. For example, the remoteness of conflicts that may exist across a large firm are not addressed, nor are problems arising in closely held corporations. Further, it is not clear what duty an attorney for a chapter 11 debtor-in-possession has when he or she is acting in her own interest other than the interest of the bankruptcy estate.
  - (6) The statutory standards should be clearer on issues of multiple representation: that is, an attorney representing two related debtors; an attorney representing a debtor corporation or a debtor subsidiary corporation; or debtor partner and debtor partnership.
  - (7) The statutory standards should be clearer on issues arising from representation of a pre-bankruptcy debtor and a debtor-in-possession.
- The statutory standards do not cover a broad enough range of attorney conduct issues, forcing judges to turn to other standards to supplement them such as the ABA Model Rules and state supreme court rules. The statutory standards mostly address conflict

issues affecting only attorneys paid by the estate (trustees' and creditors' committees' attorneys and chapters 7 and 13 debtors' attorneys), leaving many other issues such as those listed in this questionnaire unaddressed. The statutory standards are not specific enough in most situations because they do not address all aspects of attorney conduct toward the court, clients, or other parties in interest. For example, the statutory standards fail to set forth adequate criteria for the limitation of the scope of representation of chapters 7 and 13 debtors. (Summary of comments from 16 bankruptcy judges).

- The statutory standards govern the attorneys' conduct but provide little guidance for dealing with that conduct—such as whether bankruptcy judges have authority to suspend attorneys from practicing before a bankruptcy court. Sua sponte contempt powers should be expanded because referral of attorney misconduct to the U.S. trustee, U.S. Attorney, or state bar association often results in no action and no report back to the court. Also, there is a wide divergence of enforcement among bankruptcy districts, causing attorneys to expect lax enforcement in certain districts. The "honor system" does not work. There needs to be a policing and enforcement mechanism other than denial of fees once a conflict becomes known. Sanctions and contempt should be clearly authorized. (Summary of comments from 7 bankruptcy judges.)
- The statutory disclosure standards are too lax and used perfunctorily by too many major firms. They can be interpreted by the lawyer required to make the disclosure in ways that lead to opposite conclusions about whether disqualification is required. (Summary of comments reported by 2 bankruptcy judges.)
- The Code and Rules are not adequate because they do not cover compensating an attorney who submits an employment application in good faith, immediately performs services, and is then disqualified in a "close call." Should the attorney be able to recover for services that benefit the estate during this "gap" period?
- The Code and Rules are not adequate because they fail to recognize the "realities" connected with attorney representation of consumer debtors. These clients simply cannot pay a lawyer a fee adequate to allow for competent representation.
- Section 1927 of Title 28 should be amended to permit clear use by bankruptcy and magistrate judges.
- The statutory standards should be applicable to all professionals in a case, including those representing parties other than the trustee/debtor in possession.

**SURVEY COMMENTS INDICATING THAT  
NON-STATUTORY STANDARDS FOR RESOLVING BANKRUPTCY-RELATED  
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Comments Indicating Non-Statutory  
Standards for Resolving Bankruptcy-Related Issues of  
Attorney Conduct Were Not Adequate

- The non-statutory standards that are employed (e.g., state ethics codes and model rules) are not adequate because they are not geared to issues unique to bankruptcy such as the fiduciary duties bankruptcy imposes, the disclosures bankruptcy mandates and issues of dual representation. (Summary of responses from 3 bankruptcy judges).
- Unlike the state courts, bankruptcy courts do not conduct investigations and must rely on the state bar grievance committee to take action on bankruptcy complaints and their decisions are far too lax. (Summary of responses from 3 bankruptcy judges).
- The non-statutory standards are not readily available to or known by practitioners (since they are located in the local district court rules.) Education as to the existence and content of the non-statutory rules is needed. (Summary of responses from 2 bankruptcy judges).
- The non-statutory standards are not applied uniformly and they lack clarity.
- The bankruptcy court in each district should have authority to conduct formal disciplinary proceedings for attorney misconduct that occurs in the bankruptcy court, instead of the current situation where the district court does so which delays the process. In addition, the district court may have insufficient understanding of issues of bankruptcy procedure to make correct judgements. Bankruptcy courts should be permitted to disbar or suspend attorneys that practice in bankruptcy court.
- The state's code of professional conduct is inadequate because it is applied in one-on-one situations despite the fact that bankruptcy requires consideration of multiple parties and relative interests that are not comprehensively addressed in the non-statutory standards.
- The non-statutory standards dealing with conflicts are unclear when applied to prior representation in an unrelated matter of creditors who are peripheral to the case. The standards do not adequately define a "potential" conflict that is non-disqualifying, or how and when disclosure should be given when the situation has "ripened" to an actual conflict. And non-statutory conflicts standards do not identify what remedy is appropriate when a major chapter 11 is at the plan confirmation stage and counsel for the debtor-in-possession develops a conflict.
- The non-statutory standards are inadequate because they are too cumbersome to prevent an attorney with multiple infractions from continuing to represent entities in bankruptcy court. An individual judge should be able to issue an order preventing ongoing violations and representation, subject to immediate review.
- The non-statutory standards are inadequate because: (1) an attorney working for the bankruptcy estate has fiduciary duties to the estate that an attorney outside of bankruptcy does not have; (2) the California Code of Professional Responsibility and the ABA ethics rules on potential conflict and actual conflict have never worked well either in or outside of the bankruptcy context.

**SURVEY COMMENTS REPORTING**  
**PROBLEMATIC INCONSISTENCIES EXISTING BETWEEN**  
**STATUTORY AND NON-STATUTORY ATTORNEY CONDUCT STANDARDS**

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**Comments Reporting Problematic Inconsistencies  
between Statutory and Non-Statutory  
Attorney Conduct Standards**

- The inconsistencies between the disinterestedness standard of 11 U.S.C. § 327(a) and the provisions for multiple representations in the ABA Model Rule and Code are frequently encountered and problematic because:
  - (1) § 327 broadly disqualifies without regard to the degree of disinterestedness (i.e., small unpaid fee) and does not permit knowing, intelligent waivers of conflicts as do state rules (such as DR 5-105) under which it is possible to represent two parties that have a potential or actual conflict as long as an appropriate client waiver is obtained.
  - (2) The disinterestedness requirement works a hardship on small business debtors and is often impractical.
  - (3) A professional person owed pre-petition debt automatically fails the disinterestedness test under the statute but not under any application of attorney conduct rules.
  - (4) Multiple-member law firms and accounting firms represent parties who are adverse in some cases and justify this by describing the matters as not “related” when in reality these firms are friendly with both sides.
  - (5) An attorney should not be disqualified from representing a debtor simply because the attorney is owed fees for pre-petition representation.  
(Summary of comments from 10 bankruptcy judges.)
- The inconsistencies between statutory and non-statutory attorney conduct standards are problematic because attorneys look to state law which is loosely enforced. The conflict of interest standards under the ABA and state rules of conduct are sometimes not very useful when attempting to apply them within the bankruptcy context because the conflicts arising in bankruptcy cases can be more numerous and complex.  
(Summary of comments from 3 bankruptcy judges).
- The inconsistencies are problematic because trustee employment of the trustee and the trustee’s law firm is statutorily permissible but presents conduct problems.  
(Summary of comments from 2 bankruptcy judges.)
- The inconsistencies are problematic because the ABA model ethics principles do not contemplate that the client (debtor) is a fiduciary toward parties with adverse interests (creditors), and the statutory rules are ambiguous or often too vague. (Summary of comments from 2 bankruptcy judges.)
- The inconsistencies are problematic because of the difficulties created by the blur between situations presenting an “actual” conflict versus a non-disqualifying “potential” conflict. Notwithstanding the Code, I find either an actual, or a perception of, a conflict of interest when a trustee also practices in cases under the same chapter for other clients.

- The inconsistencies regarding confidentiality can present difficulties because the trustee can waive the attorney client privilege for corporate debtors while it is less clear whether the corporate debtor or an individual debtor can do so.

**SURVEY COMMENTS REPORTING THAT  
BANKRUPTCY-SPECIFIC ATTORNEY CONDUCT ISSUES  
ARE NOT COVERED BY ETHICAL RULES**

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Comments Reporting Bankruptcy-Specific  
Attorney Conduct Issues Not Covered by Rules

- An issue that arises only in bankruptcy courts and is not adequately covered by existing attorney conduct standards is conflict of interest issues:
  - (1) The conflict of interest standards under the ABA and state rules of conduct are sometimes not very useful when attempting to apply them within the bankruptcy context because the conflicts arising in bankruptcy cases can be more numerous and complex (for example, potential conflicts due to the vast number of creditors affected.).
  - (2) It is unrealistic to require disclosure of all connections to the parties in interest because there can be so many of them.
  - (3) The Bankruptcy Code and Rules do not provide enough flexibility or allow for judicial discretion in their application. Strict enforcement and application of the Bankruptcy Code and Rules is often impracticable.
  - (4) The disinterestedness requirement of 11 U.S.C. § 327(a) needs to be defined more precisely and not applied so strictly, especially in a smaller community.
  - (5) The conflict issue that results from an attorney representing a client pre-bankruptcy and then seeking to represent the debtor or debtor-in-possession is not adequately addressed.
  - (6) Conflict issues relating to fee disclosures are not adequately covered by existing standards.  
(Summary of responses from 16 bankruptcy judges.)
- An issue that is not covered by our attorney conduct standards is the absence of guidance on whether the bankruptcy judge has the power to discipline attorneys by, for example, barring them from practicing before the bankruptcy court. I often feel frustrated by the lack of mechanisms available to me to protect the debtor from his or her attorney's incompetence in bankruptcy court representation. I have had many cases where clients were ill-advised to file or to reaffirm debts or where lawyers ignored deadlines, or did not communicate with clients. Bankruptcy Rule 2090 should specifically provide that bankruptcy judges have the authority to impose sanctions against lawyers and parties. (Summary of responses from 5 bankruptcy judges.)
- A bankruptcy case triggers considerations of many competing and countervailing interests unlike traditional two-party lawsuits. For example, creditors' committees may employ professionals who are confronted with special provisions under 11 U.S.C. § 1103(b) when multidisciplinary issues are involved.
- Other areas/issues unique to bankruptcy courts and not adequately covered by existing standards include:
  - (1) conduct violating or allegedly violating disclosure requirements of 11 U.S.C. § 329(a) or Bankruptcy Rules 2014 or 2016.
  - (2) whether one counsel can represent affiliated corporations in chapter 11s.
    - (3) the tension between an attorney's need for advance payment in bankruptcy and the prohibitions against an attorney receiving payment in advance for post-petition work.
    - (4) an attorney's refusal to represent a debtor client where the client is sued by a creditor to prevent dischargeability of particular debts.
    - (5) A Chapter 11 attorney for a debtor-in-possession has an inherent conflict between representing the reorganization needs of the debtor and requiring the debtor-in-possession to be a fiduciary.
    - (6) Trustees who employ their own firms as counsel have a problem in determining what is "trustee work" and included in their statutory fees and what they can be separately compensated for.
    - (7) Attorneys who own paralegal mill operations.
    - (8) Attorneys who seeks to "limit" responsibilities to a consumer debtor client, i.e., preparing the schedules and statement of affairs but not appearing as attorney of record.
    - (9) Conflict in representing a corporation and its principals, especially in closely-held corporations. The distinction is problematic because the owner provides the authority for the attorney who represents the debtor-in-possession.
    - (10) Bankruptcy attorneys who abuse the system by filing multiple bankruptcies for debtors that are not warranted under the law or facts.
    - (11) Attorneys who do a poor job of advising debtors and seeing that schedules and other documents are accurate.
- Many attorneys for debtors do not understand or recognize their fiduciary duties. The Bankruptcy Rules should clarify that a trustee or debtor in possession is a fiduciary to the estate but the lawyer for the estate is not the fiduciary. The lawyer is an officer of the court and has ethical duties to the client, who is the fiduciary. Recognition of an attorney's duty of candor to the tribunal often places an attorney between a rock and a hard place. Another fiduciary relationship not understood is the fiduciary relationship of the attorney in Chapter 11 to the creditors. (Summary of responses from 11 bankruptcy judges.)
- Individual Chapter 7 debtors may be represented by counsel when they file a petition. However, that counsel "frequently" has not been retained to file motions to lift the stay, to make objections to claims or exemptions or for adversary proceedings involving dischargeability. Unless at least mail communication is made directly to the debtor by the moving party, the debtor may not learn of these matters timely. Thus, communication needs to be tailored so they go to both attorneys and the debtor until represented status is clarified.
- Allowing Chapters 7 and 13 trustees to represent debtors in bankruptcy court encourages the "you-do-a-favor for me today and I'll do the same for you tomorrow" syndrome. "Trustee shopping" is common. More trustees are needed. Further, trustees should be prohibited from retaining themselves (or their law firms) as counsel to trustee. Double billing and duplicative services are encouraged by this risky practice.

- Requests for withdrawal of counsel by counsel for debtors, particularly when representing individuals unable to retain new counsel due to financial constraints. With insolvent debtors, by definition and in fact, they do not have the resources to pay for adversary proceedings in which they may have a meritorious defense. (Summary of responses from 2 bankruptcy judges.)
- It is essential that multiple representations be permitted for cost reasons even where there are potential conflicts.
- Some conflicts that cannot be waived in bankruptcy courts, but they may be waivable in non-bankruptcy matters.
- Our district recognizes "limited appearances" for debtors' attorneys in Chapter 7's and 13's. This creates a problem because other attorneys in these cases do not readily know when they can communicate directly with parties.
- There needs to be clarity on issues arising from representation of pre-bankruptcy debtor and debtor-in-possession. Also, there needs to be clarity on issues arising from representation by the same debtor's counsel of related debtors (parent and subsidiaries, etc.) and when that representation may become a conflict. (Summary of responses from 5 bankruptcy judges.)
- Fee splitting is allowed in some states, but strictly prohibited in the bankruptcy context. Practitioners must be educated and/or the standard be made uniform.



**SURVEY COMMENTS ON**  
**THE INADEQUATE DISCLOSURE REQUIREMENTS**  
**OF BANKRUPTCY RULE 2014**

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**Comments on Inadequate Disclosure  
Requirements of Bankruptcy Rule 2014**

- Bankruptcy Rule 2014 requires more detail in consumer cases to disclose fees paid in prior cases where debtors are multiple filers. This is especially necessary in chapter 13 cases. The multiple filings are frequently driven by attorney's fees. Also, Rule 2014 does not apply to Chapter 13 cases, but it should.
- Bankruptcy Rule 2014 should include a much clearer requirement to show prior experience in representing debtors in small chapter 11 cases, and to show the level of success in confirming plans or negotiating structured dismissals within the prior 3 to 5 years.
- Bankruptcy Rule 2014 should require an affidavit by the person who made (or should have made) the conflicts check as to exactly what effort was made and require disclosure of every representation within a prior period (perhaps 2 years before the bankruptcy filing date), and the nature, beginning and end dates of every entity that is or becomes a creditor or equity holder in the debtor-in-possession. The Rule should require regular amendments as "new" conflicts arise. Model Rule 1.7(a)(1) should be totally abrogated in bankruptcy in favor of full disclosure.
- Bankruptcy Rule 2014 should provide more specific examples of entities falling into the category of "parties in interest" so as to allow less wiggle room.
- Bankruptcy Rule 2014's provision "all of the person's connections" is arguably vague. I would suggest some specific examples that would not limit the scope of this language but rather would demonstrate the expansive intent behind this limitation to representation. It would help eliminate the many excuses we get in this area.
- Bankruptcy Rule 2014 could provide for more strict enforcement in chapter 11's. (Summary of responses of 2 bankruptcy judges.)
- Bankruptcy Rule 2014 should require that the fee agreement be attached to the application.
- Bankruptcy Rule 2014 should specifically require details of client representations by all members of a firm, with a requirement of action of disqualification by the court if not done or if details indicate a conflict of interest.
- Bankruptcy Rule 2014 should include a provision that the attorney disclose the source of funds for a retainer and future payment.
- We have supplemented the disclosure requirements of Rule 2014 with a local bankruptcy court rule.

- Often the question of inadequate disclosure results from the applicant's failure to fully consider all the possible ramifications or subtleties associated with the requirements of being "disinterested" and/or holding no "materially adverse interest." In this district, we have tried to minimize this problem through a local rule which supplements the disclosure requirements of Rule 2014.
- Bankruptcy Rule 2014 or local rules should require more than just a conclusory statement. There should be some requirement to describe the steps or procedures undertaken to determine whether a conflict may exist.
- Bankruptcy Rule 2014 should require disclosure of all payments made by the debtor to the attorney within one year prior to filing, as well as a description of any retainer paid.
- We have addressed the inadequacies by specific disclosure required by my standards, my court's local rules and U.S. trustee guidelines.
- Three bankruptcy judges indicated that the problems they've experienced with Rule 2014 stem from attorneys' failure to follow the provisions of the Rule.