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Since the Bankruptcy Code became effective on October 1, 1979, the United States
Supreme Court has issued hundreds of opinions relating to bankruptcy. To celebrate the Code’s
fortieth birthday, renowned constitutional scholar and Supreme Court commentator Erwin
Chemerinsky sat down with the National Conference of Bankruptcy Judges to share his list of the
“top ten” bankruptcy opinions issued by the Supreme Court since the Code went into effect.
Chemerinsky studies, writes, and lectures on constitutional law, federal jurisdiction, and civil
procedure, so naturally his top ten focus on those topics. Specifically, the cases fall into several
categories, including statutory interpretation, federalism, civil procedure, and constitutional law.
Fittingly, however, the list begins with a case that examines the very source of a court’s power—
jurisdiction.


In the case appearing at the top of Chemerinsky’s list, *Northern Pipeline Construction Co. v. Marathon Pipe Line Company*, the Supreme Court held that the Bankruptcy Reform Act of 1978
(now commonly referred to as the Bankruptcy Code) was unconstitutional in so far as it authorized
bankruptcy courts to issue final judgments on state law claims. 458 U.S. 50, 84-87 (1982).

In a six-to-three opinion authored by Justice Brennan, the Court expressed concern over
the Act’s broad grant of judicial power to bankruptcy courts. Specifically, the Act provided that
bankruptcy courts had jurisdiction over all “civil proceedings arising under title 11 [the Bankruptcy
title] or arising in or related to cases under title 11.” *Id.* at 54 (quoting 28 U.S.C. § 1471(b) (1976
ed., Supp. IV)). The Act also established that judges presiding over bankruptcy courts would be
appointed to fourteen-year terms, subject to removal for “incompetency, misconduct, neglect of
duty or physical or mental disability” and entitled to salaries “set by statute and . . . subject to
adjustment . . . .” *Id.* at 53 (citing 28 U.S.C. §§ 153(b) & 154 (1976 ed., Supp. IV)).

The Supreme Court took issue with the newly created bankruptcy court system because
“[t]he judicial power of the United States must be exercised by courts having the attributes
prescribed in Art. III.” *Id.* at 59. Namely, Article III provides that “[t]he Judges, both of the
supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall, at stated
Times, receive for their Services, a Compensation, which shall not be diminished during their
Continuance in Office.” *Id.* (quoting U.S. Const. art. III, § 1). In the Court’s view, the system
established by the new bankruptcy statute was directly at odds with the constitutional mandate that
the judicial power of the United States must be exercised only by judges with life tenure and

*This article was prepared by Ryan Chapin and Naomi Kogan Dein, law clerks to the Honorable Janet S. Baer, United
States Bankruptcy Judge for the Northern District of Illinois. The article summarizes a film segment featuring Erwin
Chemerinsky, the Jesse H. Choper Distinguished Professor of Law and Dean of the University of California Berkeley
School of Law. The segment was filmed on May 15, 2019 in preparation for the 2019 Annual Conference of the
National Conference of Bankruptcy Judges to be held from October 30, 2019 to November 2, 2019 in Washington,
D.C. Excerpts of the film will be aired during the Broken Bench program at the Annual Conference on October 31,
2019 at 9:15 a.m. (Eastern), and the full film will be made available for viewing during the Annual Conference.*
salaries not subject to diminution—an attribute that is essential to the independence of the judiciary.

H. Northern Pipeline’s core holding, that the Bankruptcy Reform Act of 1978 violated Article III of the Constitution, created enormous confusion. The decision ultimately led to the Bankruptcy Amendments and Federal Judgeship Act of 1984, which established the two-tier referral structure that still governs bankruptcy court jurisdiction to this day.

Some were perplexed by the Court’s decision. Chemerinsky asks: “What’s objectionable about having a bankruptcy court decide state law claims? Who usually decides state law claims?” His answer, of course, is: “State court judges[, and] they don’t have life tenure either.” Chemerinsky makes sense of this conundrum by putting the case in historical context. Around the time the Supreme Court heard Northern Pipeline, he says, there were many proposals that would have restricted federal court jurisdiction over matters like abortion, busing, and school prayer. Chemerinsky theorizes that the Court’s concern in Northern Pipeline was not about non-Article III bankruptcy courts but, rather, about sending “a message to Congress that restrictions on federal jurisdiction would be declared unconstitutional.”


Following directly from Northern Pipeline, albeit almost thirty years and several amendments later, is the case of Stern v. Marshall. In a five-to-four decision, split along ideological lines, Chief Justice Roberts, writing for the Court, held that bankruptcy courts lack constitutional authority to enter final judgments on state common law counterclaims. Stern v. Marshall, 564 U.S. 462, 469 (2011). Employing a two-step analysis, the Court concluded that, although 28 U.S.C. § 157(b)(2)(C) permits bankruptcy courts to enter final judgments on counterclaims, Article III of the Constitution does not. Id. at 482. Chief Justice Roberts echoed the rationale in Northern Pipeline, explaining that the Supreme Court has “long recognized that, in general, Congress may not withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty” and that “the responsibility for deciding [suits of that nature] rests with Article III judges in Article III courts.” Id. at 484 (internal quotations omitted).

Like Northern Pipeline, the Court’s decision in Stern v. Marshall caused widespread confusion in the bankruptcy community. Many scholars, including Chemerinsky, wrote articles analyzing the case, and dozens of lower courts wrestled with the decision’s impact. It didn’t take long, however, for the Supreme Court to back away from its ruling in Stern v. Marshall in a case that shares the number two spot on Chemerinsky’s list.

In Wellness International Network, Ltd. v. Sharif, the Supreme Court held that “Article III is not violated when the parties knowingly and voluntarily consent to adjudication by a bankruptcy judge.” 135 S. Ct. 1932, 1939 (2015). In this six-to-three decision, Justices Kennedy and Alito, members of the Stern v. Marshall majority, joined the Stern v. Marshall dissenters to limit the earlier ruling by permitting jurisdiction by consent.
Chemerinsky hypothesizes that the Court recognized the problems that Stern v. Marshall would cause in connection with the jurisdiction of both bankruptcy courts and magistrate courts. Indeed, Justice Sotomayor acknowledged the importance of judges in those courts in the second paragraph of the Wellness decision, writing that “it is no exaggeration to say that without the distinguished service of these judicial colleagues, the work of the federal court system would grind nearly to a halt.” Id. at 1938-39.

After summarizing the historical and statutory framework of bankruptcy court jurisdiction, the Court reminded its readers that “[a]djudication by consent is nothing new.” Id. at 1942. According to the Court, a party may consent to entry of a final judgment by a non-Article III court on a claim as long as the personal right to Article III adjudication is waived and the constitutional principle of separation of powers is not implicated. Id. at 1942-46. “‘Separation of powers concerns are diminished’ when, as [in the context of bankruptcy court adjudications], ‘the decision to invoke [a non-Article III] forum is left entirely to the parties and the power of the federal judiciary to take jurisdiction’ remains in place.” Id. at 1945 (quoting Commodity Futures Trading Comm’n v. Schor, 478 U.S. 833, 855 (1986)).

Thus, when the parties are entitled to adjudication of a claim by an Article III court, a bankruptcy court may enter final judgment on the claim as long as the parties consent and “Article III courts retain supervisory authority over the process.” Id. at 1944. According to Chemerinsky, Wellness did not go so far as to overrule Stern v. Marshall, but it very much lessened its practical significance. With bankruptcy court jurisdiction being somewhat settled for the time being, Chemerinsky’s list now shifts its focus to another fundamental principle that is inherent in bankruptcy law—statutory construction.


It should come as no surprise that many Supreme Court decisions involving bankruptcy require the interpretation of the Code. A major debate among commentators, and even the justices themselves, focuses on how federal statutes should be interpreted. That is, should courts be guided by the underlying purpose of a statute? Or should their primary focus be on the plain language of the text? One case in which that “tension play[s] out” is Marrama v. Citizens Bank of Massachusetts. There, Chemerinsky notes, the Court focused on the underlying purpose of the Bankruptcy Code and held that “bankruptcy courts have inherent power to deal with fraudulent debtors”—in this case, by prohibiting a dishonest debtor from converting his case from chapter 7 to chapter 13. 549 U.S. 365, 368-75 (2007).

Writing for a five-to-four majority, Justice Stevens delivered the opinion of the Court. At the outset of the decision, the Court acknowledged that “[t]he principal purpose of the Bankruptcy Code is to grant a ‘fresh start’ to the ‘honest but unfortunate debtor.’” Id. at 367 (quoting Grogan v. Garner, 498 U.S. 279, 286 (1991)). Then, although nothing in the text of § 706(a) prohibits conversion from chapter 7 to 13 if a debtor has acted in bad faith, the Court reasoned that a debtor does not have an absolute right to convert because § 1307(c) permits dismissal for bad faith. Id. at 373-74. The practical effect of a case’s eventual dismissal, the Court said, “is tantamount to a ruling that the individual does not qualify as a debtor under Chapter 13.” Id. at 374. Thus, if bad faith precludes an individual from qualifying for chapter 13, a bankruptcy court may prohibit conversion of an individual’s case from chapter 7 to 13.
Looking to other sources to bolster its holding, the Court noted that § 105(a) of the Code authorizes bankruptcy courts to take any action that is necessary or appropriate “to prevent an abuse of process.” Id. at 375 (quoting 11 U.S.C. § 105(a)). Furthermore, the Court stated that, even without § 105(a), “the inherent power of every federal court to sanction ‘abusive litigation practices[,]’... might well provide adequate justification for a prompt, rather than delayed, ruling on an unmeritorious attempt to qualify as a debtor under Chapter 13.” Id. at 375–76 (quoting Roadway Express, Inc. v. Piper, 447 U.S. 752, 765 (1980)).

According to Chemerinsky, the Marrama opinion was guided primarily by the Code’s underlying purpose because the statute’s text does not provide bankruptcy courts with any inherent power to deal with fraudulent debtors in the manner employed by the Court. This perspective is particularly evident, Chemerinsky says, when Marrama is compared to the next case on his list.


In a more recent decision, Law v. Siegel, the Supreme Court unanimously held that a bankruptcy court may not sanction a dishonest debtor by denying an exemption that is provided under the Bankruptcy Code. 571 U.S. 415, 428 (2014). The chapter 7 trustee in Law v. Siegel had engaged in extensive litigation, incurring substantial attorney’s fees along the way, in a dispute over the validity of a lien on the debtor’s residence. Id. at 418-20. After the bankruptcy court invalidated the lien because the debtor had created it fraudulently, the court permitted the trustee to “surcharge” its attorney’s fees and costs as an administrative expense over the debtor’s homestead exemption. Id. at 420.

In an opinion authored by Justice Scalia, the Court marched through the applicable statutory provisions and concluded that a bankruptcy court may not rely on powers either inherent or provided by § 105(a) to contravene express provisions of the Code. Id. at 421. The pertinent provision, § 522, both vested the debtor with the right to claim a homestead exemption in his residence and protected such exempt property from being used to fund administrative expenses. 11 U.S.C. § 522(k).

In reaching its holding, the Court focused solely on the language of the Code without giving any attention to the statute’s underlying purpose. For that reason, Chemerinsky finds it impossible to reconcile Law v. Siegel with Marrama v. Citizens Bank of Massachusetts, the latter interpreting the statute primarily by examining its underlying purpose. The difference, Chemerinsky argues, is the result of a general shift in the Court that is also reflected in other bankruptcy decisions.


The Supreme Court issued its decision in the next case on Chemerinsky’s list, Butner v. United States, after the Bankruptcy Reform Act of 1978 had been passed, but before it became effective. Butner addressed yet another fundamental issue—federalism—and it laid a foundation for analyzing the federal-state law issues that Chemerinsky says often “play themselves out” in bankruptcy cases.

The parties in Butner disputed whether the federal rule of equity or state law should govern a party’s interest in rents collected from a property in foreclosure. 440 U.S. 48, 52-54 (1979). In a unanimously opinion authored by Justice Stevens, the Supreme Court resolved a circuit split over
the issue by holding that property interests in bankruptcy cases are governed by state law, unless federal law specifically provides otherwise. *Id.* at 55. To Chemerinsky, *Butner* stands for the broader principle that courts must rely on state law to determine substantive rights, unless there is a specific federal statute to the contrary.


The Supreme Court revisited the issue of federalism in *BFP v. Resolution Trust Corporation*, this time in the context of interpreting a specific provision of the Bankruptcy Code. After employing several basic canons of statutory interpretation, the Court held that, when determining whether property has been sold at foreclosure for a “reasonably equivalent value” for purposes of fraudulent transfer analysis under § 548(a)(2)(A), bankruptcy courts are required to inquire “into whether the foreclosed property was sold for a price that approximated its worth at the time of sale.” *BFP v. Resolution Tr. Corp.*, 511 U.S. 531, 538-39 (1994). Having found no federal statutory provision to the contrary, the Court deferred to applicable state foreclosure law and procedures. *Id.* at 544. Doing so provided certainty and prevented “the title of every piece of realty purchased at foreclosure [from being] under a federally created cloud.” *Id.* at 544. In Chemerinsky’s view, the Court said once more that “reliance on state law is permissible in determining substantive outcomes in the bankruptcy context.”


Another one of Chemerinsky’s favorite topics, federal civil procedure, often makes its way to the Supreme Court through bankruptcy cases. In one such case, *Granfinanciera, S.A. v. Nordberg*, the Court held that notwithstanding the Code’s designation of fraudulent conveyance actions as “core proceedings,” the Seventh Amendment guarantees the right to a jury trial in such actions because they deal with the recovery of money and are therefore legal (as opposed to equitable) in nature. 492 U.S. 33, 36-49 (1989).

*Granfinanciera* is notable to Chemerinsky, however, because the Court also held that neither the Bankruptcy Code nor the Constitution guarantees a right to a jury trial when there are “public rights” at issue. *Id.* at 53. In such cases, Congress has the power to eliminate jury trials. *Id.* Chemerinsky points out that *Granfinanciera* raised questions that continue to arise decades after the issuance of the Court’s decision. Among those is the meaning of “public rights.” Does that phrase mean that there is a claim by or against the United States or that there is some larger public interest at stake? While *Granfinanciera* provided some guidance, see *id.* at 51, 54-56, the scope of the “public rights” doctrine remains the subject of much debate.


Also on the subject of civil procedure, *Commodity Futures Trading Commission v. Weintraub* made its way onto Chemerinsky’s top ten because it flips the general rule that a client, not an attorney, has the power to waive the attorney-client privilege. In an opinion written by Justice Thurgood Marshall, the Court unanimously held that the trustee of a chapter 7 debtor corporation has the power to waive the attorney-client privilege as to pre-petition communications. *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 358 (1985). In reaching its decision, the Court found that the trustee could exercise control of the debtor’s attorney-client
privilege because a trustee acts as manager of the corporation in a way that is analogous to managers, directors, and officers outside of bankruptcy. *Id.* at 351-55.


The last case on Chemerinsky’s list to focus on procedure, *Bullard v. Blue Hills Bank, fka Hyde Park Savings Bank*, addressed the presumption against interlocutory appeals in federal court. This time, however, the Supreme Court did not veer from the general rule and held that an order denying confirmation of a debtor’s reorganization plan is not a final order subject to immediate appeal. *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 1692-96 (2015). The Court’s analysis focused on the consequences of a bankruptcy court denying plan confirmation—that is, as long as the denial is without prejudice, the status quo is generally maintained and the parties’ rights and obligations remain unsettled. *Id.* at 1693. Until an order confirming the plan or dismissing the case is entered, the word “[f]inal’ does not describe [the] state of affairs.” *Id.*


Although the bankruptcy court’s denial order may not have been “final” in *Hyde Park Savings Bank*, the next case on Chemerinsky’s list is. The tenth and final case to make the list shifts the focus from civil procedure to a topic less likely to appear in a bankruptcy case—freedom of speech. In *Milavetz, Gallop & Milavetz, P.A. v. United States*, the Supreme Court addressed several First Amendment issues implicated by the most recent large-scale revision of bankruptcy law, the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”). After the enactment of BAPCPA, but before the Court handed down the *Milavetz* decision, Chemerinsky and the Honorable Samuel L. Bufford co-wrote an article extensively analyzing BAPCPA. Samuel L. Bufford & Erwin Chemerinsky, *Constitutional Problems in the 2005 Bankruptcy Amendments*, 82 Am. Bankr. L.J. 1 (2008). The article questioned whether several provisions withstood constitutional scrutiny under the First Amendment. *Id.*

In response to the question of whether BAPCPA violated the First Amendment by (1) prohibiting attorneys from advising clients to take on additional debt under certain circumstances, and (2) requiring attorneys who represent consumer debtors to identify themselves as “debt relief agencies,” the Court answered with a resounding “no.” In a unanimous opinion, the Court first read the statute narrowly, holding that § 526(a)(4) is not impermissibly vague and that an attorney violates the section “when the impetus of the advice to incur more debt is the expectation of filing for bankruptcy and obtaining [a discharge].” *Milavetz, Gallop & Milavetz, P.A. v. United States*, 559 U.S. 229, 248 (2010). In addition, the Court upheld the constitutionality of the § 528 disclosure requirements, including the mandate that debt relief agencies identify themselves as such in advertisements, because such requirements are “reasonably related to the [Government’s] interest in preventing deception of consumers[.]” *Id.* at 253.

Notwithstanding the Court’s ruling, Chemerinsky stands by the position taken in his article, arguing that the BAPCPA provisions at issue in *Milavetz* compel attorneys to make statements and prohibit attorneys from giving advice. Such compelled speech is often inaccurate, he says, and it can hinder an attorney’s ability to give advice that is in the client’s best interests.
****

If there is one thing about the Bankruptcy Code on which the justices of the Supreme Court can certainly agree, it is that the Code has been and will continue to be the source of lively debate and interest for years to come. The cases summarized above just scratch the surface of important bankruptcy decisions handed down by the Court since the Code’s enactment. In the next forty years, bankruptcy will undoubtedly be the topic of many more important Supreme Court cases, several of which will likely revisit the fundamental topics addressed by Chemerinsky’s top ten.
LEGISLATIVE HISTORY OF THE
NEW BANKRUPTCY LAW

Kenneth N. Klee*

In 1978, a new federal bankruptcy law was enacted. Problems of statutory interpretation will undoubtedly arise with respect to this law. In an attempt to assist the legal community in solving such problems, the author has presented the legislative history of Public Law No. 95-598 and provided a step-by-step format to be used in researching this legislative history.

On November 6, 1978, the fifth bankruptcy law of the United States, promulgated under Congress' power to enact uniform laws on the subject of bankruptcies, was signed by the President. Although the law is properly cited as Public Law No. 95-598 and does not have an official short title, it is not uncommon to find the law referred to as the "Edwards Act."*

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1. Each of the four earlier bankruptcy laws of the United States has been referred to as a "Bankruptcy Act." The Bankruptcy Act of 1800, 2 Stat. 19, provided for involuntary bankruptcy proceedings against merchants and was repealed in 1803. The Bankruptcy Act of 1841, 5 Stat. 440, provided for voluntary or involuntary bankruptcy proceedings against individuals, whether or not they were merchants, and permitted a discharge of an individual's debts if the requisite percentage of his creditors consented. That law was repealed in 1843. The Bankruptcy Act of 1867, 14 Stat. 517, extended bankruptcy relief to corporations for the first time. It was repealed in 1878. The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, has remained in effect longer than the other three bankruptcy acts combined. It was amended several times on a piecemeal basis and revised substantially by the Chandler Act in 1938, 52 Stat. 840. The Bankruptcy Act of 1898 was repealed effective October 1, 1979, though it remains in effect with respect to cases pending on September 30, 1979. See note 8 infra.

2. U.S. Const. art. I, § 8, cl. 4 states: "The Congress shall have Power ... To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States ...."


4. For the complete citation see note 3 supra.

5. A short title is frequently given in the first section of a law and becomes the official name by which the law may be referenced.

6. Congressman Don Edwards was the floor manager of the bankruptcy legislation in the House of Representatives. He devoted more than eight years of his life to the new law, far more time than any other legislator. Senator Quentin Burdick and Congressman M. Caldwell Butler also devoted many years to the development of the new law. Senators Dennis DeConcini and Malcolm Wallop also contributed to the bankruptcy law revision. See H.R. 16643, 93d Cong., 2d Sess., A Bill to establish a uniform Law on the subject of Bankruptcies (1974); H.R. 10792, 93d Cong., 1st Sess., A Bill to establish a uniform Law on the subject of Bankruptcies (1973); and notes 21, 22, and 23 infra.
or the "Bankruptcy Reform Act of 1978." Pub. L. No. 95-598 became effective, for the most part, on October 1, 1979, the date on which the former Bankruptcy Act was officially repealed.

Whenever a new statute becomes effective, problems arise concerning interpretation of statutory provisions. Courts and legal scholars often look to the legislative history of the statute in order to determine the precise meaning of certain words or provisions. Consistent with such a process of interpretation, this Article will examine the legislative procedures followed in enacting Pub. L. No. 95-598. It will also propose a helpful method of using the law's legislative history to interpret the statutory provisions.

**Making the New Law**

Like each of the previous bankruptcy laws of the United States, the legislative history of Pub. L. No. 95-598 is surrounded by controversy and intrigue. The new law is unique, however, in that it is the only bankruptcy law of the United States adopted absent the impetus of a severe economic depression or panic. Pub. L. No. 95-598 is the culmination of ten years of effort involving hundreds of participants.

The legislative history of Pub. L. No. 95-598 began in 1968 when Senator Quentin Burdick chaired hearings conducted by a subcommittee of the Senate Judiciary Committee to determine whether a commission to review the bankruptcy laws of the United States should be formed. Those hearings prompted congressional action, and two years later the Commission on the...
Bankruptcy Laws of the United States was formed to study, analyze, evaluate, and recommend changes in the substance and administration of the bankruptcy laws of the United States. The Commission, initiating operations in June, 1971, conducted four public hearings and deliberated a total of forty-four days. Finally, a two-part report was filed with Congress on July 30, 1973. The first part of the report contained the recommendations and findings of the Commission, while the second part embodied a proposed statute complete with explanatory notes.

After submission of the Commission's report, it became Congress' responsibility to continue the process of formulating a new bankruptcy law. The Commission's statutory proposal was introduced as a bill in the House of Representatives by Congressmen Don Edwards and Charles Wiggins in 1973. A comparable bill was also introduced in the Senate by Senator Quentin Burdick, supported by Senator Marlow Cook. In 1974, Congressmen Edwards and Wiggins introduced in the House a competing bill proposed by the National Conference of Bankruptcy Judges. The only

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the Commission shall be composed of the following members appointed as follows:

1) three members appointed by the President of the United States, one of whom shall be designated as Chairman by the President;
2) two Members of the Senate, one from each of the two major political parties, appointed by the President of the Senate;
3) two Members of the House of Representatives, one from each of the two major political parties, appointed by the Speaker of the House of Representatives; and
4) two appointed by the Chief Justice of the United States.

16. Id.


18. Id. pt. 1, at 1-301. The Commission made major recommendations with respect to: 1) administrative structure; 2) consumer proceedings; 3) business bankruptcies; and 4) rehabilitation of businesses.

19. Id. pt. 2, at 1-300. The statute defines terms as they are used throughout the Bankruptcy Act of 1973.

20. Although the Commission’s explanatory notes are not authoritative legislative history, they are useful in understanding portions of Pub. L. No. 95-598, supra note 3, which are derived from the Commission’s draft statute. Part III of the Commission’s report, containing several studies prepared by the Commission’s staff, was never published as an official document.


22. S. 4026, 93d Cong., 1st Sess. (1973) was the counterpart of H.R. 10782, supra note 21. Senators Burdick and Cook were also members of the Commission.

23. H.R. 16643, 93d Cong., 2d Sess. (1974). No counterpart of H.R. 16643 was introduced in the Senate during the 93d Congress. H.R. 16643 amplifies the plans for debtors with regular incomes, including provisions relating to the claims of creditors, discharge of the debtor, and status of the property of the estate. Id. at ch. 6. This bill also added a section regarding the administration of the case. Id. at ch. 8.

formal legislative action taken during the 93rd Congress was one day of hearings, held on December 10, 1973, conducted by Congressmen Edwards' Subcommittee on Civil and Constitutional Rights. This relative inactivity was due to the Judiciary Committee's preoccupation with the possible impeachment proceedings of Richard M. Nixon.

In contrast, intensive study of the bankruptcy legislation in both the House and Senate occurred during the 94th Congress. Congressmen Edwards and Wiggins reintroduced both the statutory proposal of the Commission in the House of Representatives as H.R. 31 and the competing proposal of the bankruptcy judges in the Senate as H.R. 32. Senator Burdick reintroduced in the Senate the Commission's proposal as S. 236 and the alternative drafted by the National Conference of Bankruptcy Judges as S.235. Between May of 1975 and May of 1976, Congressman Edwards presided over thirty-five days of hearings on H.R. 31 and H.R. 32 as Chairman of the Subcommittee on Civil and Constitutional Rights. By his side in this bipartisan process was Congressman M. Caldwell Butler, the new ranking minority member of the subcommittee. The extensive House hearings produced over 2,700 pages of testimony from more than 100 witnesses. Senator Burdick pursued an ambitious schedule, presiding over the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary during twenty-one days of hearings on S. 235 and S. 236 between February and November of 1975.

At the House and Senate hearings during the 94th Congress, several groups testified regarding the commission's bill and the judges' bill, offering new ideas. Congressman Edwards encouraged groups with divergent views, such as the National Bankruptcy Conference and the National Con-

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27. H.R. 31, 94th Cong., 1st Sess. (1975) [hereinafter cited as the commission's bill].
32. Id. An extensive committee print comparing H.R. 31 and H.R. 32 with present law is reproduced in the appendix to the House Hearings 31 & 32, supra note 31.
34. The only group that refused to contribute, orally or in writing, during the hearing process of the 94th Congress was the Judicial Conference of the United States, which did not take action until two months after the introduction of H.R. 6 in January of 1977. See H.R. REP. No. 95-595, 95th Cong., 1st Sess. 19 (1977) [hereinafter cited as the House Report].
35. The National Bankruptcy Conference is a nonprofit organization comprised of law professors, attorneys, and judges interested in bankruptcy law. The conference has assisted Con-
ference of Bankruptcy Judges, to resolve their differences. Although these groups did resolve major differences, they did not present a uniform statutory proposal to Congress.

As the House hearings drew to a close, one witness questioned the constitutionality of the commission's bill and the judges' bill insofar as they both provided for bankruptcy judges who would not have the "life tenure" guarantee of serving during good behavior under article III of the constitution. This testimony prompted Congressman Rodino, Chairman of the House Judiciary Committee, to consult several constitutional experts concerning the constitutionality of these two bills. Nine distinguished experts responded to Chairman Rodino's written request with several different conclusions.

Congressman Edwards then requested the staff of the Subcommittee on Civil and Constitutional Rights to research and report on the issue of constitutionality. In addition, he instructed the staff, in consultation with various bankruptcy experts, to formulate a proposal resolving the hundreds of differences between the commission's bill and judges' bill. The staff then prepared a subcommittee print dated November 10, 1976, which served as a discussion draft for meetings with bankruptcy experts which took place from November 6, 1976, through February 25, 1977. Before the conclusion of these meetings, the discussion draft was further refined and formulated into a bill which was then offered to the subcommittee for introduction in the 95th Congress.

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36. See House Hearings 31 & 32, supra note 31, at 1410 & 1835. 37. See note 23 supra. 38. See House Hearings 31 & 32, supra note 31, at 2081. The two groups proposed that a court be established for bankruptcy proceedings. The Commission on the Bankruptcy Laws of the United States proposed that judges be appointed by the President for fifteen-year terms. The National Conference of Bankruptcy Judges proposed that the judges be appointed by the circuit court which governs the district in which the judge would preside. Id. 39. Testimony of William T. Plumb, Jr., Esq., House Hearings 31 & 32, supra note 31, at 2035, 2081-84, & 2090-92. Article III of the constitution states in part: "The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office." U.S. Const. art. III, § 1, cl. 2. 40. See House Hearings 31 & 32, supra note 31, at 2082-84. 41. Id. at 2882-2706. The nine experts of the Robert Morris Associates' Task Force on Proposed Changes to the Bankruptcy Act include: Bruce M. Clagett, Esq., of Jones, Day, Reavis & Pogue; Ervin N. Crosbold of Georgetown University Law Center; Professor Thomas K. Kratennaker of University of Chicago Law School; Professor Jo Dasha Lucas of University of California—Berkeley; Professor Paul J. Mishkin of University of California—Berkeley; Professor Terrance Sandalow of University of Michigan Law School; Professor David L. Shapiro of Harvard University Law School; Herbert Wechsler, Columbia University; and Professor Charles Alan Wright of University of Texas at Austin.
On January 4, 1977, Congressmen Don Edwards and M. Caldwell Butler introduced this bill as H.R. 6 in the House of Representatives. 42 This bill was a congressional product representing a conglomeration of ideas proposed in the commission’s bill, the judges’ bill, House hearings, and various meetings. Among the provisions included in the legislation was one which required the establishment of an independent tenured bankruptcy court. 43 H.R. 6 was then circulated to the bench, the bar, and academicians who forwarded numerous comments to the subcommittee. 44 From these and other sources, the staff of the Subcommittee on Civil and Constitutional Rights assembled extensive briefing materials in preparation for “markup,” the legislative procedure during which a subcommittee holds business meetings to consider legislation and offer amendments.

On March 21, 1977, the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary commenced marking up H.R. 6. 45 As a result of several briefing sessions in which the comments of the bench, the bar, and academicians were evaluated, an amendment in the nature of a substitute to H.R. 6 was formulated. The amendment was offered by Congressman Robert F. Drinan, a member of the subcommittee, on March 21, 1977, and became the legislative template for the balance of the markup sessions. By the time markup was concluded on May 16, 1977, the subcommittee had convened in twenty-two separate meetings and heard forty-two hours of debate examining the Drinan substitute line by line. 46 Over 120 amendments were considered and more than 100 were adopted. 47 Before markup concluded, the staff had prepared over thirty memoranda including a draft report entitled *Constitutional Bankruptcy Courts* dated May 16, 1977. On that day, the subcommittee also voted 7-0 to report out a clean bill incorporating the Drinan substitute into H.R. 6, as amended. 48 One week later, on May 23, 1977, the clean bill was introduced as H.R. 7330, 49 sponsored by all seven members of the Subcommittee on Civil and Constitutional Rights. 50 Thereafter, H.R. 7330 was further

42. H.R. 6, 95th Cong., 1st Sess. (1977) [hereinafter cited as H.R. 6]. No companion bill was introduced in the Senate.
43. Id. at § 201 (proposing 28 U.S.C. §§ 151-60 (1977)).
44. See *House Report*, supra note 34, at 3.
46. Id.
47. Id.
48. Id.
50. During the 95th Congress, the seven members of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary were Representatives Don Edwards, M. Caldwell Butler, John Seiberling, Robert F. Drinan, Harold L. Volkmer, Anthony C. Beilenson, and Robert McClory.
improved as a result of technical comments received from the bench, the bar, and academicians. The result was that a new clean bill, H.R. 8200, superseded H.R. 7330 and was introduced by the members of the subcommittee on July 11, 1977, for consideration by the full House Judiciary Committee.

Meanwhile, in the latter part of May, 1977, Congressmen Edwards and Butler directed their subcommittee staff to prepare briefing materials for the full committee. A 700-page briefing notebook was circulated to all members of the House Judiciary Committee in preparation for full committee markup. In addition, an unofficial table was prepared comparing H.R. 8200 with the commission’s bill and the Bankruptcy Act. On June 13, 1977, the staff of the Subcommittee on Civil and Constitutional Rights also completed its report entitled Constitutional Bankruptcy Courts. This report concluded that because the bankruptcy court contemplated by the subcommittee’s bill would be exercising the judicial power of the United States, the constitution required that the bankruptcy judges serve during good behavior. The conclusion reached in this report was at odds with a paper published by a special committee on H.R. 6 of the Judicial Conference of the United States, a resolution of the judicial conference opposing H.R. 6, and the concepts of tenured bankruptcy judges and a separate bankruptcy court. Two issues, the independence of bankruptcy courts and the status of bankruptcy judges, dominated the debate concerning the bankruptcy legislation for the balance of the 95th Congress.

The House Judiciary Committee commenced markup of H.R. 8200 on July 14, 1977. The committee met on three different days and adopted six amendments to H.R. 8200. Detailed minutes of the meetings were kept and a transcript was prepared. On July 19, 1977, H.R. 8200, as

51. See note 50 supra.
56. Id. at 38.
60. Id. See House Report, supra note 34, at 1-2. These amendments involve various technical, drafting, and style changes.
amended, was ordered reported by a roll call vote of 26-3, with one member voting present. 62

On the same day, Congressman Al Ullman, Chairman of the powerful House Ways and Means Committee, wrote a letter to Chairman Peter W. Rodino, Jr., of the House Judiciary Committee informing him of a potential jurisdictional conflict with Ullman's committee relating to certain tax provisions in the bankruptcy legislation. 63 The two committee chairmen met and reached an agreement obviating the need for a sequential referral 64 of H.R. 8200 to the House Ways and Means Committee. 65 Under the agreement, the House Judiciary Committee was to reconsider the bill in order to limit the scope of four special tax provisions 66 to cover only state and local taxes. Therefore, on September 8, 1977, the House Judiciary Committee voted to reconsider its vote of July 19, 1977, ordering H.R. 8200 reported, and adopted an amendment in the nature of a substitute to the bill which contained limited special tax provisions. 67 H.R. 8200, as amended, was then ordered reported by a roll call vote of 23-8, 68 and Congressman Don Edwards immediately filed his 535-page committee report to accompany the bill. 70

Once the jurisdictional problem with the Ways and Means Committee was resolved and H.R. 8200 was reported out by the House Judiciary Committee, the bankruptcy legislation was ripe for floor action in the House of Representatives. Like most legislation, however, H.R. 8200 was sent to the House Rules Committee as a prerequisite to floor consideration. 71 A rule regulating the procedure under which H.R. 8200 would be considered was granted by the House Rules Committee on October 12, 1977. 72

64. A sequential referral is a procedure by which one committee obtains jurisdiction over a bill reported out by another committee. Unless the referral is limited, the committee to which the bill is sequentially referred may adopt a committee amendment to any part of the bill. See notes 99-101 infra where the Senate Finance Committee even amended parts of S. 2266 over which it did not have jurisdiction.
68. Id. at 1-3.
69. Id. at 3. The increased opposition to H.R. 8200, as compared with the vote of July 19, 1977, was due to opposition to article III bankruptcy judges and the United States Trustee System. See House Report, supra note 34, at 539-42 (separate views).
70. 123 CONG. REC. H9,957 (1977).
71. Other means of access to the floor of the House, such as unanimous consent, placing the bill on the consent calendar or suspension calendar, or waiting for "calendar Wednesday," are rarely used for major legislation. The least onerous of these alternative procedures, suspension of the rules, requires a two-thirds vote on final passage instead of the ordinary majority vote.
72. H. Res. 826, 95th Cong., 1st Sess., 123 CONG. REC. D1,475 (1977). The rule provided for two hours of debate. There were no unusual restrictions on the amendments that could be
Congressmen Edwards and Butler were hopeful that floor consideration of H.R. 8200 would be conducted in the middle of the week; the greatest number of congressmen usually are present and voting at that time. They knew that several floor amendments would be offered, including an amendment sponsored by Congressmen Danielson and Railsback to alter the court and administrative systems. Congressman Edwards approached the Speaker of the House concerning floor time and was verbally assured by the Speaker that efforts would be made to arrange a mid-week consideration. H.R. 8200 was called up for debate, however, late the afternoon of Thursday, October 27, 1977, with the crucial amendments not to be decided until Friday, October 28, 1977.

The House debate revealed no surprises and the stage for the amendment process was set. After a noncontroversial amendment was adopted, Congressman Danielson offered an amendment commonly known as the "Danielson-Railsback Amendment." The amendment was designed to eliminate the article III status of bankruptcy courts and to reinstitute their original position as adjuncts to the United States District Courts. The amendment also proposed to restrict the jurisdiction of bankruptcy courts and to place the United States trustee system under the aegis of the judiciary rather than the Department of Justice. The Danielson-Railsback Amendment was debated and passed on a roll call vote by a margin of 183-158. Congressman Don Edwards then successfully employed a parliamentary device whereby H.R. 8200 was temporarily withdrawn from further floor consideration.

With proceedings in the House at impasse, the focus shifted to the Senate. During the spring and summer of 1977, no formal action was taken by the Senate. Senator Dennis DeConcini, newly-appointed Chairman of the Subcommittee on Improvements in Judicial Machinery of the Senate Judiciary Committee, however, instructed his subcommittee staff to prepare an alternative to the House version of the legislation. This Senate version would be considered if and when the House of Representatives passed their bill.

Events in the House resulted in a change in this strategy. On October 31, 1977, Senator DeConcini introduced S. 2266, cosponsored by Senator

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73. Hon. Thomas P. (Tip) O'Neill, Jr.
76. Id. at 11,761. The amendment was proposed by Representative Foley and involved an unrelated technical revision.
77. Id. at 11,763.
78. See id. at 11,767-68 (remarks of Rep. Danielson).
79. Id. at H11,782-83.
80. The technical motion was "that the Committee [of the Whole House on the State of the Union] do now rise." Id. at H11,793.
Malcolm Wallop, ranking minority member of the subcommittee. S. 2266 was essentially the analogue of H.R. 8200, although there were substantial differences between the two bills. In late November and early December, 1977, Senator DeConcini presided over three days of hearings on S. 2266 by the Subcommittee on Improvements in Judicial Machinery. The subcommittee heard testimony from at least sixty witnesses, including Attorney General Griffin B. Bell, and received several hundred written statements and comments on the bill. No further Senate action on the bankruptcy legislation was taken during 1977.

Meanwhile in the House, Congressman Don Edwards conducted an investigation of alternative court and administrative systems. He presided over hearings on that aspect of H.R. 8200 held by the Subcommittee on Civil and Constitutional Rights on December 12, 13, and 14, 1977. Twenty-two witnesses testified on this controversial issue, including Attorney General Griffin B. Bell and representatives of the powerful Judicial Conference of the United States. After the hearings concluded, the subcommittee published a report reflecting its unanimous and continued belief that article III bankruptcy courts were constitutionally required.

Buoyed by the tenacity of the Subcommittee on Civil and Constitutional Rights on the issue of article III courts, several groups who had testified in opposition to the Danielson-Railsback Amendment commenced a spontaneous educational effort with various congressmen. As a result, Congressman Edwards decided to employ a parliamentary device that would entitle him to request another vote on the Danielson-Railsback Amendment when H.R. 8200 was again considered by the House.

On Wednesday, February 1, 1978, the House of Representatives resumed consideration of H.R. 8200. As reported by the Committee on the Judiciary, H.R. 8200 contained a controversial provision repealing exceptions to dis...

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82. See Hearings on S. 2266 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary, 95th Cong., 1st Sess. (1977) [hereinafter cited as Senate Hearings 2266].


85. Id. Members of the House Judiciary Committee who had supported the Danielson-Railsback Amendment were invited to attend the hearings but declined to do so.

86. SUBCOMMITTEE ON CIVIL AND CONSTITUTIONAL RIGHTS OF THE HOUSE COMMITTEE ON THE JUDICIARY, 95TH CONG., 2D SESS., REPORT ON HEARINGS ON THE COURT ADMINISTRATIVE STRUCTURE FOR BANKRUPTCY CASES (Comm. Print No. 13, 1978). See also SUBCOMMITTEE ON CIVIL AND CONSTITUTIONAL RIGHTS FOR THE COMMITTEE ON THE JUDICIARY, 95TH CONG., 1ST SESS., A REPORT (Comm. Print No. 3, 1977). This report refers to Palmore v. United States, 411 U.S. 389 (1973), in which the Supreme Court states: "[T]he requirements of Article III, ... are applicable where laws of national applicability and affairs of national concern are at stake..." Id. at 407-08.
charge for certain educational loans. 87 Congressman Allen E. Ertel, a member of the committee whose amendment was defeated at the committee level, offered an amendment to H.R. 8200 to insert an educational loan exception to discharge into the Bankruptcy Code; 88 this time the amendment prevailed on division by a vote of 54-26. 89 Two additional amendments were adopted by voice vote before the recount of the Danielson-Railsback Amendment. 90 Immediately before the vote on final passage of the bill, Congressman Don Edwards asked for a separate vote on the Danielson-Railsback Amendment. In a dramatic reversal of the vote of October 23, 1977, the House defeated the amendment by a record vote of 146 for and 262 against. 91 The House then passed H.R. 8200, as amended, by voice vote, 92 and the bill was engrossed and sent to the Senate on February 8, 1978. 93

Passage of H.R. 8200 by the House of Representatives spurred action in the Senate. The Subcommittee on Improvements in Judicial Machinery synthesized both the results of the hearings it held on S. 2266 in November and December of 1977 94 and comments made after those hearings into an amendment in the nature of a substitute to S. 2266. 95 On May 17, 1978, the subcommittee reported out the amendment to S. 2266 by a vote of 3-0 with one member not voting. 96 The full Senate Judiciary Committee met and considered S. 2266, as amended, on July 12, 1978. After adopting and incorporating three of its own amendments, 97 the Senate Judiciary Commit-

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91. Id. at H477-78.
92. Id. at H478.
93. 124 Cong. Rec. S1,582 (daily ed. Feb. 8, 1979). The engrossed copy of a bill is a clean copy representing the final action of the first house of Congress to take action on a bill.
94. See note 82 supra.
95. Senate Report, supra note 83, at 4.
96. Id.
tee voted unanimously in favor of the amendment in the nature of a substitute to S. 2266. Senator DeConcini promptly filed his report to accompany S. 2266 on July 14, 1978. 99

Supporters of the bankruptcy legislation waited nervously as S. 2266 was sent to the Senate Finance Committee on a thirty-day sequential referral to review certain specified provisions. 99 There was legitimate doubt whether the bill could be passed by the Senate, and resolved in a conference with the House before adjournment of the 95th Congress. 100 If new bankruptcy legislation was not enacted during the 95th Congress, the entire process would have to start afresh in the 96th Congress in 1979.

Congressman Don Edwards recognized that if the Senate did act on the bankruptcy legislation in August or September of 1978, there would be very little time to resolve the differences between the two houses of Congress. Accordingly, as soon as S. 2266 passed the Senate Judiciary Committee, he instructed his subcommittee staff to prepare a memorandum comparing H.R. 8200 as passed by the House, and S. 2266 as reported by the Senate Judiciary Committee. On August 1, 1978, members of the House Subcommittee on Civil and Constitutional Rights received a memorandum outlining fifty-two potential issues which might surface at a conference between the two houses and an additional memorandum anticipating amendments to S. 2266 that might be adopted by the Senate Finance Committee. On August 2, 1978, members of the House subcommittee were briefed by its staff on those issues together with numerous ancillary points.

Meanwhile, the Senate Finance Committee collaborated with the staff of the Joint Committee on Taxation and with representatives of the Internal Revenue Service, and the Departments of Treasury and Justice. The full Senate Finance Committee considered S. 2266 on August 8, 1978, and adopted several committee amendments to S. 2266. The Senate Finance Committee then reported S. 2266 as amended, and Senator Russel B. Long, Chairman of the Finance Committee, filed his committee's report on August 10, 1978. 101

The Senate proceeded to consider S. 2266 on September 7, 1978. An amendment offered by Senator Dewey Bartlett permitting reaffirmation of discharged debts was passed on a roll call vote of 51 to 20, and three other less controversial amendments were agreed to by voice vote. 102 Then, according to normal Senate procedure, the Senate tabled S. 2266, took up

98. Senate Report, supra note 83.
99. Only sections 346, 507, 509, 523, 728, 1146, and 1331 of proposed title 11 were sequentially referred to the Senate Finance Committee.
100. Conference on a major piece of legislation can often take months, e.g., as with the energy legislation in the 95th Congress.
H.R. 8200, struck out all of the text appearing after the enacting clause, and instead inserted the text of S. 2266, as amended. H.R. 8200, as revised by the Senate amendment in the nature of a substitute, was then passed by voice vote. The Senate immediately insisted on its amendment and requested a conference with the House, but no Senate conferees were appointed.

The Senate amendment in the nature of a substitute to H.R. 8200 differed substantially from the House version. The principal difference involved the court and administrative systems. Under the House bill, independent article III bankruptcy courts were established, while supervision of the administration of cases was entrusted to United States trustees monitored by the Department of Justice. Under the Senate amendment to H.R. 8200, bankruptcy courts would remain adjuncts to the United States District Courts eliminating United States trustees. There were significant differences in the substantive law as well, including issues such as exemptions, reaffirmation, and the treatment of public companies in reorganization cases.

For the moment, all of these differences were dwarfed by a seemingly insignificant amendment to the Internal Revenue Code which was originally adopted by the Senate Finance Committee and passed by the Senate. The House parliamentarian advised members of the House Judiciary Committee that there was a problem. This amendment originated in the Senate and reduced revenues, and, since the bankruptcy bill was not a revenue-raising bill, the amendment violated the constitution. Therefore, the engrossed copy of the Senate amendment would not be accepted by the Speaker of the House. Accordingly, arrangements were made to vitiate the passage of H.R. 8200 as amended by the Senate and to delete the controversial tax amendment. On September 22, 1978, passage of H.R. 8200 was vitiated by unanimous consent of the Senate, and, after an appropriate amendment in the nature of a substitute was adopted, the bill was passed again by unanimous consent.

On September 26, 1978, the Senate insisted on its version of H.R. 8200, requested a conference with the House, and appointed conferees. On that same day, Congressmen Edwards, Butler, Drinan, Volkmer, and

103. Id. at S14,745.
104. Id.
105. Section 318(a) of the amendment in the nature of a substitute to H.R. 8200 passed by the Senate on September 7, 1978, would have amended section 47 of the Internal Revenue Code with respect to certain transfers to Conrail.
106. U.S. CONST. art. I, § 7, cl. 1 provides that "[a]ll Bills for raising Revenue shall originate in the House of Representatives. . . ." Bills reducing revenue may be within the purview of this provision.
108. Id.
109. 124 CONG. REC. S16,210 (daily ed. Sept. 22, 1978) (remarks of Sens. Robert Byrd and Clark). Senators James Eastland, Chairman of the Senate Judiciary Committee, DeConcini, Joseph Biden, Strom Thurmond, and Wallop were named as conferees. Id. The appointment of conferees by the Senate was a precondition to sending the papers back to the House for action.
McClory met with Senators DeConcini and Wallop at a public meeting to discuss the procedure for resolving the differences between the House and Senate versions of H.R. 8200.\footnote{See 124 CONG. REC. H11,069 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards).} It was readily apparent that a House-Senate conference would not be fruitful because the crucial compromises to be reached would not be within the scope of the differences between the House and Senate versions of the bill.\footnote{Clause 3 of Rule XXVIII of the Rules of the House of Representatives, 95th Cong., 1st Sess. (1977), makes a conference report subject to a point of order if it contains matters not within the scope of the differences. W. BROWN, CONSTITUTION JEFFERSON’S MANUAL AND RULES OF THE HOUSE OF REPRESENTATIVES OF THE UNITED STATES, H.R. DOC. NO. 416, 93d Cong., 2d Sess. 616-17 (1975).} Accordingly, the managers of the legislation in the House and Senate agreed to resolve the differences between the two versions of the bill without a formal conference.\footnote{124 CONG. REC. H11,089 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards).} This agreement was offered by Congressman Don Edwards in the House of Representatives on September 28, 1978, in the form of a House amendment to the final adopted Senate amendment in the nature of a substitute to H.R. 8200.\footnote{Id. at H11,047.} An amended version of H.R. 8200 was then passed by unanimous consent,\footnote{Id. at H11,117.} even though an initial unanimous consent request was unsuccessful.\footnote{Id. at H11,037.} Immediately thereafter, the new House amendment was engrossed and sent to the Senate, where it would have been considered and probably passed on the evening of September 28, 1978.

At that point, however, the Chief Justice of the United States\footnote{Hon. Warren E. Burger.} personally intervened in an attempt to thwart passage of the bankruptcy legislation.\footnote{See, e.g., Los Angeles Daily Journal, Oct. 4, 1978, at 1, col. 7.} As a compromise between the House bill and the Senate amendment, the new House amendment provided for non-tenured bankruptcy judges to serve on independent bankruptcy courts as adjuncts to the United States Courts of Appeals, with a pilot program of United States trustees in eighteen judicial districts.\footnote{See §§ 201 & 224 of H.R. 8200 as passed by the House of Representatives, September 28, 1978. 124 CONG. REC. H11,107 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards).} The Chief Justice objected to the proposed elevation in status of bankruptcy judges. He first voiced his objection to Senator DeConcini during a telephone conversation.\footnote{See, e.g., Los Angeles Times, Oct. 7, 1978, § 1, at 10.} The Chief Justice then telephoned Senators Wallop and Thurmond, at which time Senator Thurmond immediately placed a “hold” on the legislation, effectively preventing its consideration by the Senate.\footnote{See 124 CONG. REC. S17,434 (daily ed. Oct. 6, 1978) (remarks of Sen. Thurmond). Senator Thurmond’s “hold” on the House amendment to the Senate amendment in the nature
The next week witnessed intense confrontations at several levels. The most important of which was a meeting of the Attorney General with the House and Senate managers of the bankruptcy legislation, called in order to forge a compromise. Efforts by the Chief Justice to meet with congressional principals were rebuffed. With varying success, special interest groups lobbied senators to place additional "holds" on the legislation unless Senator DeConcini would accept their amendments. Prospects for final passage diminished as negotiations continued. As soon as one problem was solved, a different special interest group would make additional demands. With every passing day adjournment of the 95th Congress, set for October 14, 1978, drew closer.

Thus, it was no small matter that on October 5, 1978, Senator DeConcini arranged a time agreement with Senator Thurmond which facilitated consideration of the bankruptcy legislation. The Senate Majority Leader asked the Chair to lay before the Senate the House of Representatives' amendment to H.R. 8200. Shortly thereafter, Senator DeConcini moved to concur in the House amendment with a series of unprinted Senate amendments offered en bloc. The motion was agreed to by voice vote, and the Senate amendment was returned to the House.

On the morning of Friday, October 6, 1978, Congressman Don Edwards had to make an immediate decision regarding the bankruptcy legislation. Senator DeConcini had telephoned to say that the Senate would not act on the legislation again during the 95th Congress and that the bill was in a "take it or leave it" posture. Congressman Edwards urged acceptance of certain controversial provisions included by the Senate "because of the lateness of the session and our concern with insuring passage of this much-needed legislation."

Passage of H.R. 8200 by the House, however, was far from insured. Because of the lateness of the session, Congressman Edwards could not obtain a rule from the House Rules Committee to gain access to the House floor for consideration of H.R. 8200. Since the bill did not go through the procedure of a substitute to H.R. 8200 did not present a technical parliamentary obstacle to consideration of the bill. Rather, Senator DeConcini refused to process the legislation as a matter of senatorial courtesy. In rare circumstances the Senate leadership may call up legislation notwithstanding a "hold" although there is always a risk that the Senator placing the "hold" will then filibuster the legislation.

121. Hon. Griffin B. Bell.
122. Lobbyists from the commodities industry and the railroads were very successful while the efforts of the Securities Exchange Commission staff and the consumer finance industry were less fruitful.
126. Id. at S17,404-05.
127. Id. at S17,434. The Senate amendment amended the House amendment to the previous Senate amendment, which had been in the nature of a substitute to H.R. 8200.
128. Id. at H11,666 (remarks of Rep. Don Edwards).
of a conference, consideration was not privileged under the rules of the House and an alternative approach was needed. Therefore, on the afternoon of October 6, 1978, Congressman Edwards asked the House of Representatives to unanimously consent to take H.R. 8200, as amended, from the desk, and to unanimously concur in the latest Senate amendment. Congressman John Ashbrook objected and the request was denied.

Unanimous consent is seldom obtained during the final days of a session when the power of dissenting congressmen becomes enormous. Congressman Edwards and others talked with Congressman Ashbrook during the afternoon of October 6, 1978, and before Congressman Edwards left the Capitol to fly to California he was confident an agreement had been reached. Late on the afternoon of October 6, 1978, Congressman Herbert E. Harris II renewed the request for unanimous consent to concur in the Senate amendment. Congressman Robert Bauman, the Republican "official objector," stated that he had no objection, and the motion to concur in the latest Senate amendment carried without objection.

Normally when a bill passes both houses of Congress, enrollment is swift and transmission to the White House for presidential action is rapid. Nothing was normal, however, in the history of H.R. 8200. Days passed as the House enrolling clerk complained of the crush of processing final legislation and delay in receiving enrolled bills from the Government Printing Office. Whatever the reason for or source of the delay, the enrolled bill was not transmitted to the White House until October 25, 1978.

Once the enrolled copy of H.R. 8200 arrived at the White House, it was officially circulated through the Executive Branch. It was rumored that although most recommendations were positive, the Securities and Exchange Commission and the Chief Justice urged the President to veto the bill. Disregarding speculation about who advised the President or when

129. See note 71 supra.
131. Id.
132. Id. at H11,864.
133. Id. at H11,868.
134. Enrollment of a bill involves passage by both houses of Congress, signatures by the proper officials of each house, approval by the president and filing by the secretary of state. See BLACK's LAW DICTIONARY 624 (4th ed. 1968). Before a bill may be transmitted from Congress to the President, the enrolling clerk must "enroll" the bill.
136. See note 116 supra. Evidently the Chief Justice communicated the veto message as Chairman of the Judicial Conference of the United States. On October 17, 1978, the conference, in closed session reportedly voted unanimously to urge the President to veto the bill. See Aldisert, The Judicial Conference and the New Bankruptcy Act, 65 A.B.A.J. 229 (February 1979). Title 28 U.S.C. § 331 (1976) authorizes the Chief Justice to transmit to Congress recommendations of the conference for legislation; however, there is no express authorization for the conference to transmit recommendations for legislation to the President.
137. A grossly inflated cost estimate of the bill totalling more than half a billion dollars over the first ten years was prepared by the Administrative Office of the United States Courts and
a final decision was made, it is public record that the President signed H.R. 8200 into law at Camp David, Maryland, late on the night of November 6, 1978, the last day on which the bill could have been signed into law. Thus, the legislative history of the fifth bankruptcy law of the United States was concluded successfully.

Using Legislative History to Interpret the Law

Recounting the legislative history of the new bankruptcy law is of practical importance to practicing lawyers as well as to legal scholars. To some extent, the legislative history is useful in interpreting the statute whether the purpose is to gain academic insight or to advocate a legal proposition. Unfortunately, proper evaluation of the legislative history of a statute is often confusing even when Congress follows simple legislative procedures. As the history of Pub. L. No. 95-598 indicates, the new bankruptcy law was not enacted by a simple legislative procedure.

Suppose that a particular section of Title 11 of the United States Code must be analyzed and researched. The best method of using the legislative history to aid in interpretation is to begin with the most recent statement of authority and delve backward through the legislative process. Thus the following authorities should be consulted in this order:

1. floor statement of Congressman Don Edwards, October 6, 1978, on final passage of H.R. 8200;
2. floor statement of Senator DeConcini, October 5, 1978, on passage of the final Senate amendment in the nature of a substitute to H.R. 8200;
3. floor statement of Congressman Don Edwards, September 28, 1978, on passage of the House amendment to the Senate amendment in the nature of a substitute to H.R. 8200;

submitted to the Office of Management and Budget. Id. The Congressional Budget Office submitted a cost estimate that was much more reserved and realistic, projecting an average cost less than $20 million per year.

138. Under U.S. Const. art. I, § 7, cl. 2, if Congress had adjourned sine die so that a bill cannot be returned, then the President must sign a bill into law within ten days (excluding Sundays) after it is received by him. If no action is taken by the President under those circumstances, the bill is pocket vetoed.

140. Id.
141. The extent to which legislative history should be consulted is unclear. There are canons of statutory construction that the legislative history is never consulted when the statute is clear and unambiguous. On the other hand, some cases hold that it is always appropriate to consult legislative history to interpret a statute however clear the words of the statute may appear. Train v. Colorado Pub. Interest Research Group, Inc., 426 U.S. 1, 10 (1976).

4. floor statement of Senator DeConcini, September 7, 1978,\textsuperscript{147} on initial passage of the Senate amendment in the nature of a substitute to H.R. 8200; 
5. Senate Report of the Finance Committee\textsuperscript{148} to accompany S. 2266 filed by Senator Long on August 10, 1978; 
6. Senate Report of the Judiciary Committee\textsuperscript{149} to accompany S. 2266 filed by Senator DeConcini on July 14, 1978; 
7. floor statement of Congressman Don Edwards, February 1, 1978,\textsuperscript{150} on passage of H.R. 8200, as amended; 
8. floor statement of Congressman Don Edwards, October 27, 1977,\textsuperscript{151} on consideration of H.R. 8200; 

If further research is necessary, other sources may be consulted, such as hearings\textsuperscript{153} or transcripts of markup sessions.\textsuperscript{154} In any event, it is important to remember that only the statements listed in items one and two above refer to the new bankruptcy law\textsuperscript{155} as enacted. Every other source, items three through nine, interprets an earlier version of the final legislative product. Accordingly, each source must be correlated with the appropriate piece of legislation. For example, the Senate report\textsuperscript{156} must be read with the amendment in the nature of a substitute to S. 2266 as reported by the Senate Judiciary Committee on July 14, 1978, instead of with S. 2266 as introduced\textsuperscript{157} on October 31, 1977.

Consider, for example, the question of whether a person is considered an affiliate of a debtor if that person has all of his or her property operated by the debtor under a lease. To answer this question, the definition of “affiliate” is examined in the code.\textsuperscript{158} The definition covers a person who has all of his or her property operated under an operating agreement with the debtor,\textsuperscript{159} but the term “lease” is not used. To determine if the omission of the word “lease” was intentional, the procedure outlined above should be implemented.

\textsuperscript{148} Senate Report 95-1106, supra note 101.
\textsuperscript{149} Senate Report, supra note 83.
\textsuperscript{152} House Report, supra note 34.
\textsuperscript{153} House Hearings 10792, supra note 25; House Hearings 31 & 32, supra note 31; House Hearings 8200, supra note 84; Senate Hearings, supra note 33; Senate Hearings 2266, supra note 82.
\textsuperscript{154} See notes 45 & 61 supra.
\textsuperscript{155} Pub. L. No. 95-596, supra note 3.
\textsuperscript{156} Senate Report, supra note 83.
\textsuperscript{157} S. 2266, supra note 81.
\textsuperscript{159} Id. at § 101(2)(c).
Under step one, reference is made to Congressman Edwards' final floor statement, but no mention of the definition of “affiliate” is made. Under step two, reference is made to Senator DeConcini's final floor statement and an explanation can be found that the deletion of “lease” was intentional. It is comforting to note that if the third step is pursued, the statement of Congressman Don Edwards explaining the House amendment yields the same result. It must be noted, however, that reference to the House Report in step nine would provide contrary legislative history: the definition of “affiliate” in H.R. 8200 as reported by the House Committee on the Judiciary included property operated under a lease. Thus, when step one or two of the legislative history contains an explanation, it is a mistake to rely unquestioningly on legislative history from step eight or nine because the language of the statute may have been amended. Stated in a different way, the more recent legislative history is usually more accurate than the older history in describing the code.

Often there will be no legislative history derived from step one, two, or three. Then it is necessary to dig deeper. There may be a question on whether costs and an attorney's fee may be awarded against petitioning creditors and in favor of the debtor on the dismissal of an involuntary petition. The code permits the court to award “costs; a reasonable attorney's fee; or any damages.” Examining the Rules of Construction reveals that the word “or” is not exclusive. In order to find out what “not exclusive” means, the nine-step procedure is employed. The first five steps produce no enlightenment; it is not until the Senate Report is examined in step six that the answer is found: “if a party 'may do (a) or (b), then the party may do either or both.'” Examination of step nine, the House report, supports the conclusion that the court may award costs, an attorney's fee, or both costs and an attorney's fee.

Sometimes the legislative history found in one step will expressly incorporate the legislative history from another step. In that event, the legislative history from intervening steps should be ignored in preference to the history that is specifically incorporated by reference. For example, an individual

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161. Id. at 517, 404-31 (remarks of Sen. DeConcini).
162. Id. at S17,406.
164. Id. at H11,090.
165. House Report, supra note 34.
166. Id. at 308.
170. Senate Report, supra note 83.
171. Id. at 28.
172. House Report, supra note 34.
173. Id. at 315.
debtor in a liquidation case may desire to redeem an automobile worth $2,000 from a $1,200 lien under 11 U.S.C. § 722. The issue arises whether the entire lien may be redeemed or only that portion that is technically exemptible. The answer under the code is unclear.\textsuperscript{174} Using the nine-step procedure, one finds that step one produces no results but step two reveals that “[s]ection 722 of the House amendment adopts the position taken in H.R. 8200 as passed by the House and rejects the alternative contained in section 722 of the Senate amendment.”\textsuperscript{175} Therefore, inquiry is focused on the House report\textsuperscript{176} in step nine which reveals that the car may be redeemed from the entire lien.\textsuperscript{177} The fact that the crucial language in the House report is omitted in the more recent Senate report\textsuperscript{178} is of no concern; once step two directs the search to step nine, step six is ignored.

The foregoing method should assist legal scholars, advocates, and judges in accurately evaluating “congressional intent” in relation to Pub. L. No. 95-598. While the method may seem cumbersome or opaque the first few times it is used, eventually it will become as routine as “shepardizing” cases.

\begin{footnotes}
\footnote{174. 11 U.S.C. app. § 722 (Supp. II 1978).}
\footnote{175. 124 CONG. REC. S17,414 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).}
\footnote{176. House Report, supra note 34.}
\footnote{177. id. at 381.}
\footnote{178. Senate Report, supra note 83, at 95.}
\end{footnotes}
In *RadLAX Gateway Hotel, LLC v Amalgamated Bank*, the Supreme Court returned once again to interpreting the absolute priority rule, the foundational principle of the law of corporate reorganizations. The opinion itself, however, gives no hint that the Court was revisiting an issue that it has confronted many times over the last century. Rather than unpacking the contours of absolute priority, the Court focused on what has emerged as a central theme of the Court's recent bankruptcy jurisprudence: the proper domain of the bankruptcy judge.

One might expect the Court to approach that question of domain as it has for administrative agencies. After all, both bankruptcy courts and administrative agencies are non-Article III tribunals.

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3. Indeed, it has been noted that bankruptcy courts could just as well have been organized as administrative agencies had history played out differently. See Douglas G. Baird, *Blue Collar Constitutional Law*, 86 Am Bankr. L.J. 15 (2012). Others have gone further and suggested that bankruptcy administration should be transformed today into an executive-agency model where lawmaking is done by the agencies charged with administering the bankruptcy law. See, for example, Rafael Pardo and Kathryn Watts, *The Structural Exceptionalism of Bankruptcy Administration*, 60 UCLA L Rev 384 (2012).

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But the Court sees them in an altogether different light. Administrative agencies are entrusted in the first instance with carrying out federal policies. They are parts of the executive, and a politically accountable legislature can delegate matters to them. And the scope of that delegation is often viewed quite broadly. They enjoy considerable leeway. In contrast, the Court has confined the space within which the bankruptcy judge may operate.

Some of the explanation for this contrast lies in the different relationship that agencies and bankruptcy courts have with Article III courts. Bankruptcy courts are entirely within the Judiciary. Article III judges themselves appoint bankruptcy judges. Article III judges can withdraw cases from bankruptcy courts, or refuse to refer them to bankruptcy courts in the first instance. Moreover, every bankruptcy judge’s interpretations of law are reviewed de novo on appeal in the same fashion as those of any other inferior court. But in addition to and quite apart from the different structural relationship, the Court’s own understanding of bankruptcy law itself shapes its view about the powers entrusted to the bankruptcy judge.

There are three principal strands to the Court’s bankruptcy jurisprudence. The first, embodied in *Butner v United States* and its progeny, centers on the idea that the bankruptcy forum must vindicate nonbankruptcy rights. In contrast to administrative agencies that give shape to federal policies, bankruptcy judges should not unsettle nonbankruptcy rights—rights that are largely creatures of state rather than federal law. In the absence of a clear directive from Congress, those nonbankruptcy rights trump a judge’s impulse to advance federal policy. The second strand, beginning with *Northern Pipeline Construction Co. v Marathon Pipeline Co.* and continuing last Term in *Stern v Marshall*, focuses on the limits of bankruptcy in a different way. Unlike the public rights at the center of the administrative state, the traditional state rights at stake in bankruptcy lie at the heart of the judicial power and cannot be entrusted to non-Article III courts. Bankruptcy judges must therefore limit themselves to deciding issues central to the administration of the bankruptcy process. They cannot issue a final judgment with respect to those controversies in bankruptcy that are “the stuff of the tradi-

5 485 US 50 (1982).
6 131 S CT 2594 (2011).
Rational actions at common law tried by the courts at Westminster.'

RadLAX is the latest manifestation of a third strand, one driven in large measure by the frequent inability of Article III courts to review the decisions of bankruptcy judges before it is too late to give the losing party an effective remedy. Even with respect to matters properly entrusted to bankruptcy judges, RadLAX makes it plain that the Court reads ambiguous provisions of the Bankruptcy Code in a fashion that narrows the range of decisions over which the bankruptcy judge may exercise her discretion—at least when the exercise of that discretion might impact nonbankruptcy rights. Where the statute is ambiguous and nonbankruptcy rights might be compromised, the preferred reading in those cases is the one that is more rule-like. As the Court put it, “The Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law, and it is our obligation to interpret the Code clearly and predictably using well established principles of statutory construction.” The Bankruptcy Code should be read narrowly to ensure that bankruptcy judges stay on a clearly demarcated path.

That view is in stark contrast to the Court’s approach in administrative law. There the Court observed long ago that Congress has established non-Article III tribunals “to furnish a prompt, continuous, expert and inexpensive method for dealing with a class of questions of fact which are peculiarly suited to examination and determination by [those] specially assigned to that task.” But in bankruptcy the Court sees flexibility in the Bankruptcy Code as a potential source of mischief. The need to accommodate practical difficulties works as a thumb on the scale in assessing the operation of administrative tribunals, yet such pragmatism is not part of how the Court approaches bankruptcy courts. 10 Bankruptcy courts, it seems, need a disciplining hand that ordinary agencies do not. This article attempts to make sense of this state of affairs and proceeds in three parts.

RadLAX is, in the first instance, a straightforward question of statutory interpretation, and Part I sets out the statutory provision that RadLAX confronts and identifies the interpretative challenge

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1 Id at 2609.
2 RadLAX, 132 S Ct at 2073.
3 Crowell v Benson, 285 US 22, 46 (1932).
it poses. Part II links *RadLAX* to the foundational question of the
domain of bankruptcy judges, and Part III explores the conse-
quences that follow from having federal bankruptcy policy vindicated in a forum so different from those of the administrative state.
The conclusion returns to the puzzle of why the Court perceives
the need for oversight so differently.

I. The "Fair and Equitable" Benchmark

The law of corporate reorganizations has as its central re-
quirement that plans of reorganization be "fair and equitable."\(^{11}\) The core substantive meaning of that phrase has long been settled. The "fair and equitable" requirement imposes a regime of absolute priority.\(^ {12}\) A plan must provide for full payment to the senior cred-
itors whenever it provides anything to anyone junior.\(^ {13}\) The Bank-
ruptcy Code, however, does not set out clearly the discretion that
the bankruptcy court enjoys in deciding how the senior creditor is
protected.

The *RadLAX* case itself grew out of the financial failure of the
Radisson Hotel at Los Angeles International Airport. The debtor
borrowed to renovate the hotel and build a parking lot next to it. The economic downturn of 2008 unsettled these plans. The debtor
filed a Chapter 11 petition in August 2009, with the parking lot
incomplete and owing its senior lender $120 million. No one be-
lieved the property was worth that much. After extensive marketing,
the debtor found a buyer willing to acquire substantially all of the
assets for a much lower amount. The debtor used this bid as the
basis for its plan of reorganization.\(^ {14}\)

The debtor proposed an open auction. Even though it seemed
unlikely that another buyer would appear, others would have a
chance to make higher bids. The senior lender would receive all
the proceeds. The junior creditors received no immediate payment
under the plan, but the buyer the debtor found was willing to fund
some distributions to unsecured creditors from the future profits

\(^{11}\) 11 USC § 1129(b).

\(^{12}\) See Douglas G. Baird and Thomas H. Jackson, *Bargaining after
the Fall and the Contours of the Absolute Priority Rule*, 55 U Chi L Rev

\(^{13}\) See Walter J. Blum and Stanley A. Kaplan, *The Absolute Priority

\(^{14}\) *RadLAX*, 132 S Ct at 2068–69.
of the hotel. The senior lender could make its own bid, but it would have to bid in cash just like anyone else.

The debtor argued that this plan was "fair and equitable" and fully respected the rights of the senior creditor. The senior creditor was receiving all the proceeds of the sale, and the value of an asset is what it yields in a regularly conducted sale. The "fair and equitable" requirement demanded only that the senior creditor be given the value of its claim. Someone who both receives the proceeds of an open auction and who participates in the auction on the same terms as everyone else is necessarily receiving the entire value of her collateral. A secured creditor does not have the right to dictate the entire course of the reorganization, even when it is owed more than the firm is worth.

The senior creditor argued that this understanding of the "fair and equitable" principle offered it too little protection. It was entitled to the entire hotel unless someone else was willing to put up more than $120 million to buy it. Hence, it should also have the right to "credit bid," the right to participate in the auction without putting up any cash. As the senior creditor, it was entitled to all the cash that the sale produced. Any cash it gave to the auctioneer would necessarily be immediately returned to it. Hence, unlike other bidders, it should be released from having to put up cash.

Forcing the senior creditor to turn over cash that would be immediately returned serves no purpose other than to place an obstacle in its way. Borrowing cash, even for a short time, is not costless. Among other things, the senior lender is often not a single entity, but rather a consortium of investors, some based overseas. Coor-

15 Debtors' Joint Chapter 11 Plan, In re: RadLAX Gateway Hotel, LLC, No 09-B-30047, Docket No 205, § 3.09 (Bankr N D Ill June 4, 2010). This profit-sharing provision may have been problematic independent of the credit bidding dispute. The debtor, however, argued that the buyer's willingness to share some future profits with junior creditors was not of concern to the senior creditor as long as no such obligation was imposed on other bidders. Though not raised on appeal, this backdoor distribution to the junior creditors might violate the "fair and equitable" requirement. While such "gifting" has become common practice in the wake of sales, it has been questioned regularly by appellate courts. See, for example, In re DBSD North America, Inc., 634 F3d 79 (2d Cir 2011).

16 See, for example, Brief of Petitioner, RadLAX v Amalgamated Bank, No 11-166, *9-10 (S Ct, Jan 28, 2012) ("Petitioner's Brief").


18 See, for example, Brief for Respondent, RadLAX v Amalgamated Bank, No 11-166, *19-20 (S Ct, March 2, 2012) ("Respondent's Brief").
Coordinating actions among them is hard. Regulations may limit the ability of some to contribute new cash, even for a few minutes. The frictions such coordination difficulties present should not keep the senior creditor from taking its collateral when it prefers the collateral to the highest cash offer. So ran the secured creditor’s argument.

To resolve these competing arguments about whether a plan could provide for a sale without giving the secured creditor a right to credit bid, the Court in *RadLAX* turned to the part of the Bankruptcy Code that spells out what it means for a plan to be “fair and equitable” with respect to secured creditors. This provision requires that the plan must provide the secured creditor with (1) a lien on its collateral and a note equal to the value of its secured claim; (2) a sale subject to credit bidding; or (3) “for the realization by such holders of the indubitable equivalent of such claims.”

This language contains an ambiguity. On the one hand, the provision is written in the disjunctive. As long as a sale without credit bidding provides the secured creditor with the “indubitable equivalent” of its claim, a plan is fair and equitable. Each of the avenues is an alternative to the other. The provision that explicitly provides

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19 See, for example, *In re Metallyn Corp.*, 09-13412 (Bankr S D NY 2009) (approving credit bid at the motion of 97 percent of the creditors in the consortium to overcome objections of 3 percent hold-out group).

20 Respondent’s Brief at 20–21.

21 Section 1129(b)(2)(A) provides:

(i) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

Section 363(k) gives secured creditors a right to credit bid in the absence of cause in those cases in which assets are sold outside of a reorganization plan.

22 *In re Phila Newspapers, LLC*, 599 F3d 298 (3d Cir 2010). The Third Circuit invoked the familiar cannon of textual interpretation that focuses on the meaning of disjunctive
that a sale with credit bidding is fair and equitable is not dispositive. It does not exclude the possibility that giving the secured creditor the proceeds of a sale without credit bidding might also provide the indubitable equivalent of the secured claim and therefore also be fair and equitable.

Of course, one can take a different view. While each section stands as an alternative to the others, each sheds light on the other. Because the provision explicitly provides that a sale with credit bidding is “fair and equitable,” one can infer that a sale without credit bidding is not “fair and equitable.” It cannot provide the secured creditor with the “indubitable equivalent” of its claim. Inferring exclusions of some things because of the inclusion of others is a well-recognized part of how ordinary people understand language. Called “scalar implicatures,” linguists have studied them closely for the last fifty years.

Consider the following two statements.

An apartment building limits the pets tenants may have. It permits “cats, small dogs, or pets that are apartment friendly.”

Your nephew has asked you for a video game that has “big scary monsters, robots, or cool stuff.”

Both these examples have the same structure as the provision of the Bankruptcy Code the Court confronted in RadLAX. There is a mandate and three avenues to satisfying it. In the first case, the rule identifies the sorts of pet that a tenant may have; the second example identifies the types of video game that your nephew will like; the Bankruptcy Code identifies the plans that are “fair and equitable.” In all three cases, there are specifically blessed types (“cats” and “small dogs”; “big scary monsters” and “robots”; notes secured by liens on the collateral and sales subject to credit bidding). There is also a general category (“apartment friendly” pets; “cool stuff”; plans that provide the “indubitable equivalent”). Each list puts forward two discrete options, and leaves a large category that
lacks a hard definition. What exactly is an apartment friendly pet? What exactly is cool stuff? What provides the indubitable equivalent?

The linguistic question we face in each case is the extent to which the meaning of the larger and more general category is informed by the inclusion of the other more specific ones. Does the reference to small dogs implicitly exclude large ones and tell us, by implication, that large dogs are not apartment friendly? Does the reference to big scary monsters exclude small ones, and, by implication, exclude the possibility that small scary monsters might be cool? Does the reference to sales subject to credit bidding exclude sales that are not, and, again by implication, exclude the possibility that sales without credit bidding can provide the indubitable equivalent?

Items on such a list can serve different roles. A specific item on a list might be understood as a specific illustration or a safe harbor, and not as serving to exclude others of the same type. The owner of a cat or a small dog is spared the effort of arguing that a particular cat or a particular small dog is apartment friendly. Specific items can provide context that enables the rule provider to understand the more general mandate. The nephew might list a specific type of video game that is acceptable without any intent that you exclude other games or draw inferences about what is not cool. Instead, he may have pointed to big scary monsters to make vivid what sorts of games are cool.26

It is axiomatic among modern linguists that one cannot determine how an ordinary speaker understands any of these statements merely by resorting to abstract principle. Instead, one must engage in empirical inquiry. As it happens, most ordinary native speakers of English think that the apartment building does not permit large dogs.27

26 In the case of the nephew, another force may be at work. The ability to infer the exclusion of one thing from the inclusion of another is underdeveloped in young children. See Ira Noveck, When Children Are More Logical Than Adults: Experimental Investigations of Scalar Implicature, 78 Cognition 165 (2001); Anna Papafragoua and Julien Musolino, Scalar Implicatures: Experiments at the Semantics-Pragmatics Interface, 86 Cognition 253, 267 (2003). A speaker of English may infer a young age for the nephew from the way the preferences are spelled out and take this into account in trying to understand what is being said.

27 We surveyed 2,000 individuals using Mechanical Turk, and 74 percent of the native English speakers opted for this interpretation. We ran an alternative survey of 2,000 different individuals using the word “and” in place of “or.” The results were not meaningfully different: 77 percent of the native English speakers opted for the interpretation excluding large dogs. Web-based surveys, of course, rely on samples that, while diverse, are not randomly drawn. There are other potential sources of bias as well. Alternative
By listing small dogs as among the pets that are permitted, the speaker is understood to exclude large dogs. The speaker is telling us both that she judges small dogs to be apartment friendly, and that she has reached the opposite conclusion for large dogs. The purpose of an open-ended category is to allow for certain apartment-friendly pets that are neither cats nor dogs. It is still open whether canaries are apartment friendly, but the issue is resolved as far as dogs are concerned. Small ones are; large ones are not. In this example, the use of the adjective "small" is functioning as a scalar implicature for the typical native speaker.

Implicatures can be expected to be used in accordance with certain linguistic maxims. For example, the two Gricean maxims of quantity suggest that a speaker will make his statement (1) as informative as necessary, but (2) no more so. A speaker who includes the word "small" would, under the first maxim, be expected to include the word "large" if both small and large dogs were allowed. The word's absence violates the first maxim of quantity if large dogs were allowed. The statement thus implies the exclusion of large dogs. As with other linguistic maxims, this one was anticipated by one of the standard Latin maxims of statutory interpretation. In this case, it is *expressio unius est exclusio alterius.*

The same analysis could apply to the nephew's request. Ordinary native speakers of English believe that the nephew is perfectly open to the possibility that small scary monsters, like robots and big scary monsters, might be cool. The nephew refers to large scary monsters to illustrate what might constitute cool stuff, not to create an excluded category of scary monster. This is consistent

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29 Id at 26.

30 Of course, just "dogs" would have sufficed as well.

31 The close connection between maxims of statutory interpretation and Gricean maxims has, of course, been long recognized. See, for example, Geoffrey P. Miller, *Pragmatics and the Maxims of Interpretation,* 1990 Wis L Rev 1179 (1990).

32 Again we surveyed 2,000 individuals using Mechanical Turk, and 76 percent of the native English speakers opted for this interpretation. An alternative survey of 2,000 different individuals using the phrase "or any other cool stuff" in place of "or cool stuff" did not produce meaningfully different results (74 percent).
with an application of Grice's second maxim of quantity. The parallel maxim of statutory interpretation at work here is *eiusdem generis*. The specific examples (big scary monsters and robots) illuminate the large category ("cool stuff"). "Cool stuff" has to be like big scary monsters or robots in some way, but it does not have to be big scary monsters or robots.

Linguistic theory alone is still too primitive to explain when ordinary speakers will draw different inferences from statements that have the same grammatical structure. Much ink continues to be spilled over words such as "some" and "or." Linguists are not yet able to explain the difference between using the word "big" in asking for a video game with "big scary monsters" and using the word "small" in permitting tenants to have "small dogs" as pets. The best one can do is to observe that ordinary listeners understand these statements differently.

The understanding of ordinary speakers can change with only small changes in context. Even when we limit ourselves to an apartment's pet policy, different items on the same list can serve different functions. If goldfish are added to the list of permitted pets, ordinary speakers are not inclined to think that all other types of fish are excluded. They might think that goldfish are on the list not to exclude other types of fish, but rather to provide an example with which others might be compared. There is more room to argue that tropical fish are permitted than there is room to argue that large dogs are apartment friendly.

This is simply to say that linguistic maxims, like their counterparts in statutory interpretation, can be helpful in identifying the dynamics at work, but they are less useful in pinning down the meaning of a specific statement. In understanding whether a particular adjective (small, gold, or big) implicitly excludes the others (large, tropical, or small) that are within the larger category (of dogs, fish, or scary monsters), context matters. Ordinary speakers may be familiar with apartments that have weight limits on dogs. They may also have listened enough to young children to know that they are not as attuned to the way that the use of adjectives may implicitly exclude what is not described. They may also think that young children make their illustrations vivid ("big scary monster") to convey what constitutes "cool stuff."

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11 In our surveys, a majority of the native English speakers opted for this interpretation (60 percent in one survey and 69 percent in the other).
All that being said, even context leaves matters unclear. The in-
ference that the majority of native speakers of English draw will
not be universal. One in four native English speakers thinks that
the apartment permits large dogs if apartment friendly. For this
minority, if someone wants to prohibit large dogs, their rules should
not have open-ended categories. Exclusions should be explicit. Sim-
ilarly, one in four speakers of English understands the nephew to
exclude small scary monsters. He wants a video game with big scary
monsters because these are the only sorts of monsters that are cool.

Even if linguistics were more advanced, one can progress only
so far in interpreting a statute by relying on the understanding of
native speakers. Legislation is not understood in the same fashion
as ordinary language. The way statutes are drafted is so radically
different from the way language is typically used that one has to
be careful about focusing on the common understanding. The bal-
ance between clarity and redundancy is likely to be struck differ-
ently. Less may be left to implication, and ambiguity may arise for
altogether different reasons.

Statutes are written in a special language and often with special
care. Sometimes this makes the task of statutory interpretation eas-
ier. The drafters of the Bankruptcy Code, for example, created a
concordance and ensured that when the same words and phrases
were used in different places in the text, they had the same meaning.
But precisely because they are trying to be clear, drafters may leave
less to implication. Inferences that might be reasonable with respect
to regular speech might not make sense with respect to legislation.14

At the same time, statutes contain language that is ambiguous in
ways that ordinary speech is not. Drafting of legislation reflects the
product of competing interests. Accommodating these may itself
result in ambiguities that arise not by virtue of carelessness, but
because each competing interest finds itself better off living with
the ambiguity (and with its belief about how such ambiguity will
be resolved) than continuing to struggle over text.15

As it happens, the difficulties we face in interpreting the section

14 Grice's maxims, for example, emphasize concision. An ordinary speaker avoids re-
dundancy. As a result, listeners draw inferences in order to give each word meaning. Grice,
Studies in the Way of Words (cited in note 24). The drafter of a statute does not value and
does not expect her listeners to value concision, at least not in the same way. Hence,
inferences one would ordinarily draw make less sense.

15 On the sources of legislative ambiguity, see Saul Levmore, Ambiguous Statutes, 77 U
of the Bankruptcy Code at the center of RadLAX arise for just this reason. The provision itself reflects a compromise between those who favored credit bidding in all cases and those who did not. The provision was drafted in the mid-1970s in the shadow of a recent real estate bankruptcy case. A group of investors put up a modest amount of capital, formed a limited partnership, and had it borrow $1.45 million from an insurance company to build Pine Gate, an apartment complex outside of Atlanta. The lender agreed to look only to this real property in the event of default.\(^{36}\)

After a short time the investors filed a bankruptcy petition.\(^{37}\) The bankruptcy judge estimated the value of the property and confirmed a plan of reorganization in which the insurance company was given a note that the bankruptcy judge found was worth the value of the property.

The plan, in his view, provided the “indubitable equivalent.” The empirical evidence suggests that bankruptcy judges provide unbiased valuations of assets, but these valuations are subject to wide variance and this variance alone may give the debtor an ability to capture value.\(^{38}\) The debtor does not have to go forward with any particular plan before it learns the judge’s valuation. If the judge provides a value that is too high, the debtor could walk away from the property. By contrast, if the judge announces a value that is too low, the investors could put in place a plan of reorganization and then flip the property, paying the senior creditor the artificially low amount set by the bankruptcy judge and pocketing the difference.

Guarding against this sort of strategic behavior on the part of the debtor is one of the things that a bankruptcy judge must do in trying to craft rules that vindicate the “fair and equitable” requirement. Bankruptcy lawyers and judges are aware of the *Pine Gate*


\(^{37}\) *Pine Gate* turned out to be too far from Atlanta to attract the tenants willing to pay the rent the investors expected. Indeed, it attracted few renters of any kind. The property was not going to do well until there was more development in the area, and it became clear this would not happen for a long time. The property was no longer worth what the insurance company was owed. Moreover, if the insurance company foreclosed, the investors would be saddled with enormous tax liabilities. They took advantage of accelerated depreciation rules so that their basis in the property was much lower than its foreclosure value. Baird, 38 John Marshall L Rev at 7 (cited in note 36).

problem and indeed know it by that name. One can argue that such cases provide a reason to entrust these issues to the bankruptcy court in the first place. Like much else in bankruptcy practice, the Pine Gate problem is not especially visible to outsiders. The case itself cannot be found in any of the standard reporters, nor is it in Westlaw; but bankruptcy judges and lawyers know it, worry about it, and talk about it.

The drafters of the Bankruptcy Code trusted the ability of bankruptcy judges to implement the fair and equitable rule through case-by-case development. The drafters, however, had to contend with representatives of real estate lenders who had the ear of some of the legislators and who took a different lesson from Pine Gate. For them, Pine Gate showed a downside to giving bankruptcy judges discretion over too broad a domain. In the course of vindicating other goals, bankruptcy judges will slight the fair and equitable requirement, even while giving lip service to it. These representatives wanted to corral the scope of bankruptcy judges' discretion and limit their ability to develop the "fair and equitable" rule.19

The compromise that emerged is the Bankruptcy Code's elaboration of fair and equitable with its two specific provisions—notes supported by liens and sales subject to credit bidding—and one general one—providing the indubitable equivalent. The drafters consciously left tension between them unresolved.40 In other words, the legislative compromise itself introduced the ambiguity. We face a difficulty that does not arise when one person attempts to convey meaning to another.

The kind of ambiguity that emerges in these environments depends on what background rule of interpretation the contending interests think the courts will ultimately adopt. To put the point somewhat more formally, a compromise such as the one here is a Bayesian equilibrium in which neither party to the negotiations thinks it can improve its position given the position of the other and given its beliefs about how a court will interpret the ambiguity.


40 Complex statutes passed many decades ago are usually the work of many forgotten hands. Hence, most discussions of what the drafters believed they were doing are abstract and somewhat artificial. Whether an ambiguity was deliberate is a matter for speculation. Not so with bankruptcy. Its world is small, and everyone in it knows the two individuals who drafted the Bankruptcy Code. It is easy enough to ask one of them about such things, and we have. This is not to say, of course, that the drafters' awareness of the ambiguity should itself have any effect on how the language is interpreted.
The method that resolves the ambiguity, or at least beliefs about this method, is part of the background against which the statute is drafted in the first place.41

That the drafters themselves understood they were leaving matters ambiguous should caution against thinking that the text itself provides a clear answer.42 Instead of adopting an interpretative rule that tries to resolve the meaning of the text, it may make more sense to adopt an interpretative rule that vindicates other objectives and assume that, over time, those who bargain over legislative language will negotiate with this rule in mind. RadLAX and the sequence of cases leading up to it may be understood as an effort to articulate such a background rule. We explore the rule that seems to be emerging and trace its origins in the next part.

II. Bankruptcy’s Domain

In confronting the ambiguity in RadLAX, the Court could have leaned toward expanding the scope of the bankruptcy judge’s discretion. One can argue that, in the absence of an unambiguous statute, much is sensibly left to case-by-case adjudication. Reviewing courts have little expertise with respect to reorganizing large corporations. Congress may have intended for bankruptcy judges to enjoy considerable discretion when it provided a general directive that plans be “fair and equitable” and allowed them to confirm plans of reorganization without staying them pending review by an Article III court.

41 Others, of course, have made this point. See, for example, McNollgast, Positive Canons: The Role of Legislative Bargains in Statutory Interpretation, 80 Georgetown L J 713 (1992). The compromises that force courts to confront statutory ambiguity arise in many environments. See, for example, United States v Taylor, 487 US 326 (1988) (Speedy Trial Act); Board of Education v Mergens, 496 US 226 (1990) (interpreting provisions of Equal Access Act, statute forbidding discrimination against religion-based student groups). For a general discussion of the problem, see Courtney Simmons, Unmasking the Rhetoric of Purpose: The Supreme Court and Legislative Compromise, 44 Emory L J 117 (1995).

42 See Levmore, 77 U Chi L Rev at 1083 (cited in note 33). The question of intentional ambiguity provides interpretative challenges in other contexts as well. Contract cases are full of examples where the parties have intentionally left it to a later court to determine the precise meaning of a provision. The interpretative role of courts in those cases is quite different from interpreting intentional ambiguity in a statute. See, for example, Omri Ben-Shahar, Agreeing to Disagree: Filling Gaps in Deliberately Incomplete Contracts, 2004 Wis L Rev 389 (2004) (discussing how courts deal with intentional ambiguity); see also UCC §2-204(4) (providing that contracts with open terms are valid if there is a basis for an appropriate remedy); United Rentals Inc. v RAM Holdings Inc., 937 A2d 810 (Del Ch 2007) (adopts a “forthright negotiator” rule where only one party intended the provision to be ambiguous).
Credit bidding is, from this perspective, one of the many issues facing bankruptcy judges who supervise corporate reorganizations. It is their job to assess the value of credit bidding and weigh it against the competing objectives of the Bankruptcy Code. Although there may not be many situations in which restrictions on credit bidding make sense, it is possible to imagine a narrow set of cases where obstacles to a secured creditor’s bid are valuable because that creditor’s participation in an auction might scare away other less informed bidders—even those who might place a higher value on the property. Judges sensibly developing jurisprudence around the idea of “fair and equitable” should be attuned to such issues. The Supreme Court, however, hardly looked at the merits of credit bidding at all. To understand the course it took, it is necessary to step back from the narrow question of statutory interpretation and connect it to the Court’s other bankruptcy opinions.

Indeed, Vince Buccola and Ashley Keller and Adam Mortara argued in an amicus brief in *RadLAX* that these situations were indeed so rare that a plan that prohibits credit bidding cannot be “fair and equitable.” In making this argument, however, they focused on how credit bidding vindicated the absolute priority rule, not on general principles of statutory interpretation. Amicus Brief, *RadLAX Gateway Hotel, LLC v Amalgamated Bank*, No 11-166 (S Ct, March 8, 2012).

The presence of the senior creditor and its ability to credit bid might chill the bidding and junior creditors would suffer part of the cost. This effect matters only when the asset’s true value hovers close above the face value of the senior lien. The ability of the senior creditor to credit bid costlessly may aggravate the problem of the “winner’s curse,” the idea that a bidder who wins an auction has overpaid for the asset because she was willing to pay more than the market for the asset. This effect is magnified when one of the bidders has asymmetric information—all the worse to pay more than the amount that the party who knows the true value is willing to pay. The equilibrium is often that the other bidders anticipate this and therefore make no bid. This in turn pushes down the price the informed bidder pays. Paul Klemperer, *The Wallet Game and Its Applications*, 42 Eur Econ Rev 757 (1998) (noting that a very small information advantage can greatly increase a bidder’s chance of winning and “greatly reduce the price he pays”); Paul Klemperer, *What Really Matters in Auction Design*, 16 J Econ Persp 169, 173 (describing how asymmetric information can depress auction bids as bidders attempt to avoid the “winner’s curse”).

As our interest is in locating where the decision making about credit bidding resides, we are not focused on the merits of this argument. We do not want to overstate the argument for limitations on credit bidding. Among other things, limiting credit bidding is a particularly ineffective and crude way of eliminating the potential winner’s curse (assuming the problem is real to begin with). Auction theorists have suggested more direct ways of designing nonascending auctions to deal with this situation. But very little work has been done to apply those design theories to bankruptcy. One notable exception is Paul Povel and Rajdeep Singh, *Sale-Backs in Bankruptcy*, 23 J L Econ & Org 710 (2007) (discussing ways to bias auctions against informationally advantaged bidders to increase the expected final bid). Povel and Singh note that while it may be optimal to exclude the informationally advantaged bidders in ascending auctions, it is “optimal to always let [them] participate” when the sale procedures can be freely designed. Id at 712. Nothing in the Bankruptcy Code requires ascending auctions or prohibits free auction design. See, for example, *In re Texas Rangers Baseball Partners*, 431 BR 707, 710 (Bankr N D Tx 2010) (noting the court’s clear power to “authorize and adopt bidding procedures”).
RadLAX is part of a family of cases in which the Court has limited the domain over which the bankruptcy judge may exercise her discretion. The most prominent of these is the sequence of cases beginning with *Northern Pipeline Construction Co. v Marathon Pipeline Co.* and *Granfinanciera SA v Nordberg* that continued with *Stern v Marshall* in 2011. Those cases dealt directly with the fact that bankruptcy judges are not Article III judges and do not possess judicial power. As a result, they can issue final judgments only with respect to matters that are central to the administration of the bankruptcy process. *RadLAX*—and other cases not usually included in the Marathon-to-Stern list—embrace an analogous principle.

*RadLAX* provides a gloss on how the Court understands Congress to have exercised its bankruptcy power. Principles like "indubitable equivalent" allow for "unruly" exercises of discretion. Hence, Congress intended that the boundaries within which such discretion is available should be narrow—particularly when the results of that discretion are unreviewable as a practical matter. The confirmation of a plan puts in place a sequence of events that is hard to reverse. Assets have been sold and new securities have been issued. The senior creditor no longer has a right to protest because the dispute is "equitably moot." The amount of free rein the bankruptcy judge enjoys must be seen in this light. Between two interpretations of the Bankruptcy Code that are otherwise plausible, the one to be preferred, at least when nonbankruptcy rights are in issue, is the one that limits the power of the bankruptcy judge to depart from objective benchmarks such as those that the market provides. This idea has long been an undercurrent in the Court's bankruptcy jurisprudence. Indeed, it is fundamental to the evolution of the "fair and equitable" doctrine itself.

The Supreme Court's first clean take on the meaning of "fair and equitable" came in *Case v Los Angeles Lumber Products.* The Court treated these words as terms of art that meant absolute priority. The relevant precedent did not compel this understanding of the language. The Court could have picked instead an interpretation

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131 S Ct 2594 (2011).
*RadLAX*, 132 S Ct at 2073 ("The Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law.").
that gave bankruptcy judges greater freedom to decide whether a particular plan of reorganization could be confirmed. By choosing the absolute-priority meaning, the Court significantly limited the scope of discretion available to the lower courts in reorganization cases.

The Court’s answers to other questions about the meaning of “fair and equitable” follow in the same spirit. In spelling out the “fair and equitable” test as it applies to unsecured creditors, the Bankruptcy Code prohibits junior interest holders from receiving any property on account of their existing claim or interest when those senior to them are not paid in full. On its face, this provision adds little. If the firm owes the senior lender $200, and the firm is worth $100, there is no way to give anything to the junior stakeholders and comply with the absolute priority rule. When they are not being paid in full, the seniors are entitled to everything.

The old junior stakeholders, however, sometimes offer to make a new contribution to the firm. They insist that they are not receiving anything on account of their old interest. They are receiving a share of the reorganized firm on account of the new value they are putting in. In principle, acquiring an interest in the firm in return for such contributions does not violate absolute priority. The question, however, is whether the bankruptcy judge can even entertain such an argument. In *Los Angeles Lumber*, the Court suggested in dictum that, when senior stakeholders were not paid in full, participation by the junior stakeholders required new value from them in “money or money’s worth.” Sweat equity was not good enough—regardless of the value a bankruptcy court might place on it.

When the Court confronted this question again in *203 N La-Salle*, it found that giving the old stakeholders any kind of exclusive right to a share of the reorganized business, even in return for cash, was suspect. It was not permissible for the bankruptcy judge to rely on experts to determine that the old stakeholders were paying enough. The junior stakeholders could participate, but only if their contribution was market tested. It was not enough that the bankruptcy judge found it sufficient. The key issue was not the sub-

**Notes:**


308 US at 122.

stantive right of the junior stakeholders, but whether the bankruptcy judge had been delegated the power to decide whether the junior stakeholders were entitled to exercise it and what it is worth. 54

RadLAX follows in the same spirit. The substantive right of the senior creditors was not open to doubt. Because the assets were worth less than they were owed, they were entitled to whatever value the assets had. No one argued otherwise. The question rather was whether the bankruptcy judges had been delegated the power to choose the form in which senior creditors were given that value. Like her determination that a junior stakeholder is providing new value, the bankruptcy judge’s determination that the senior creditor is receiving the “indubitable equivalent” is essentially unreviewable. The Court limited the impact of this unreviewable discretion to confirm a plan of reorganization by holding that it did not include plans that provided for sales without credit bidding. In the face of an ambiguous statute, the court opted for the reading that narrowed the options of the bankruptcy judge to reshape nonbankruptcy rights.

Limiting the domain of the bankruptcy judge’s decision protects nonbankruptcy rights from dilution. We can see this at work in In re River East, 55 a case decided while RadLAX was before the Court. The issue in that case can be put simply. Debtor owes Bank $100 and owns Blackacre, which the bankruptcy court finds is worth $50. Bank demands it be given a lien on Blackacre for $100 and a note that has a discounted present value of $50. Debtor proposes a plan that it claims provides Bank with the “indubitable equivalent” of its claim. It offers to give Bank a stream of payments backed by a treasury bill that is worth $50. There is no doubt that the stream of payments that Bank is being offered is in fact worth the value of its secured claim as measured by the bankruptcy judge. Unlike the note secured by the building, the note secured by the treasury bills has a readily ascertainable market value and this value is $50.

54 Id at 457-58. There was nothing novel about the idea that discretionary valuation can interfere with substantive rights or about using the market as a solution. Peter Leeson notes that even eighteenth-century pirates recognized this problem and applied a similar solution. Peter Leeson, An-arrrgh-chy: The Law and Economics of Pirate Organization, 115 J Pol 1049, 1073 (2007). (Noting that the elected quartermaster would auction off items with uncertain value to prevent conflict and “constrain[ ] the discretion of the quartermaster, who might otherwise be in a position to circumvent the terms of compensation”).

55 In re River East, 669 F3d 826 (7th Cir 2012).
Hence, the debtor argues, the secured creditor is getting the indubitable equivalent of a $50 claim.\textsuperscript{16}

Confirming such a plan, however, runs contrary to the spirit of \textit{RadLAX} and the cases leading up to it. A plan that gives Bank a lien on Blackacre for the amount of its claim gives it a chance to capture upside in the event that the property proves to be worth more than the bankruptcy judge decides it is worth. The ability to enjoy liens provides a cushion against undervaluation—as does the ability to credit bid. We cannot be confident that a bankruptcy judge will guard against the problem of valuation variance in assessing “indubitable equivalence.” Hence, we want to limit the range of circumstances in which the debtor can satisfy the “fair and equitable” requirement using this test.

Nothing in the provision setting out what it means for a plan to be “fair and equitable” explicitly bars the debtor from proposing a plan in which the secured lender receives only equity in the reorganized business, but those who do not trust the judge’s discretion will resist readings of the Bankruptcy Code that allow such license.\textsuperscript{17}

When the secured creditor is provided with senior secured debt under a plan, it is more likely to be paid the true value of what it is owed even when the bankruptcy judge misvalues the underlying assets.

Together these cases start to form a pattern. On certain questions, the market and Congress are the only competent arbiters. To the extent Congress is unclear in addressing those questions, the Court will view it as providing as narrow a rule as is reasonably consistent with the Code’s language.

This presumption arises not from ordinary understanding or some general interpretative canon, but rather from an interpretative principle indigenous to bankruptcy. From this view, bankruptcy policy is best vindicated when, even with respect to the business properly entrusted to them, bankruptcy judges are limited in their freedom to make factual decisions that may impact nonbankruptcy entitlements. It is for this reason, and not the understanding of the ordinary speaker, that a sale subject to credit bidding is more like a small dog than a big scary monster.

\textsuperscript{16} 668 F3d at 832–33.

\textsuperscript{17} See 203 N LaSalle, 26 US at 457 (“It was, after all, one of the Code’s innovations to narrow the occasions for courts to make valuation judgments.”).
III. Bankruptcy through a Chevron Lens

In bankruptcy, the threshold question is similar but covers a different type of power than the one at issue in administrative law. In the case of an administrative agency, there is a threshold inquiry about the extent to which Congress has effectively delegated lawmaking power to the agency in the first place. That is to say, the "step-zero" question of administrative law is about which legal decisions fall under the agency power. The answer determines when courts will defer to an agency. In the case of bankruptcy, on the other hand, the threshold question concerns not the delegation of law making but the delegation of discretion to the bankruptcy judge to apply legal principles to the facts before her. Here the Court has consistently found that, when the underlying statutory language is unclear, there should be a presumption in favor of interpretations that limit the extent to which the bankruptcy judge can exercise her discretion where it may impact nonbankruptcy rights.

The different issues at stake caution against pressing the analogy between bankruptcy and administrative law too far. Nevertheless, many of the factors that incline the Court to think an agency should be entrusted with an interpretation of a statute seem to suggest a


59 One should not confuse the decision at step zero with a decision about the level of deference being granted to the agencies once an issue is delegated. At step zero the decision is about the scope of delegation. See Frank H. Easterbrook, Judicial Discretion in Statutory Interpretation, 57 Okla L Rev 1, 4-5 (2004) (lamenting the tendency of the Court and scholars to conflate the scope of delegation with the level of deference). The same is true in the bankruptcy context. There, the level of deference is set in large part by the unreviewable nature of the decisions. But the question of the scope of delegation is the one that was before the court in RadLAX, and the question of interest to us.

60 The answer is a source of deep division among the Justices. Sunstein, 92 Va L Rev at 199 (cited in note 58). Justice Breyer has advocated a case-by-case inquiry looking at what "a sensible legislator would have expected given the statutory circumstances." Id. Justice Scalia has advocated an across-the-board presumption of delegation. Under this view, Congress is presumed to have delegated authority any time it creates ambiguities. Put another way, for Justice Scalia all the action occurs at step one. The Court has accepted neither view outright and has vacillated from points between them. Sunstein suggests that Breyer's view gained considerable (though not absolute) traction in the trilogy of step-zero cases of Christensen, Mead, and Barnhart. Id. In these cases the standard for step zero has blurred a little (at least rhetorically) into the inquiry for subsequent steps. See Christensen v Harris County, 529 US 576 (2000) (considering the procedural exercise of discretion as a factor relevant to the inquiry of whether the discretion was delegated in the first place).

61 As we have suggested, there is no deference to the bankruptcy court in its interpretation of the ambiguous statute itself. Such interpretations are reviewed de novo.
posture toward interpreting the Bankruptcy Code that is different. Instead, bankruptcy judges, when the statute is ambiguous, should be able to apply a general standard to a given set of facts. A bankruptcy court makes its decision by formal adjudications with the force of law. Moreover, the arguments about flexibility, expertise, and institutional competence that have been put forward to support the delegation of authority to administrative agencies apply similarly to bankruptcy courts. The bankruptcy court possesses an expertise in administering the Bankruptcy Code, and that administration—especially when it turns on the facts of a particular case—is highly complex and not particularly amenable to inflexible rules. Case-by-case adjudication allows for the natural evolution of sound practices, practices that may not be particularly amenable to top-down directives.

It is in part the accountability of agencies—because they are appointed by an elected branch—that justifies giving them room to maneuver, and bankruptcy courts are among the least politically accountable entities. They are neither elected, nor appointed by an

\[\text{61 Christensen, 529 US at 587 (distinguishing “a formal adjudication or notice-and-comment rulemaking” from opinion letters in holding that the latter did not have the markings of legislative delegation of the former), United States v Mead, 533 US 218, 230 (2001) (noting the “overwhelming number” of cases applying Chevron deference dealt with “the fruits of notice-and-comment rulemaking or formal adjudication”).}

\[\text{62 Mead, 533 US at 226-27 (“We hold that administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.”). Of course, some rulings of the bankruptcy court no longer have the force of law after Stern and Marathon. But matters not excluded by those cases are still understood to be decided with the force of law.}

\[\text{63 But see Stern, 131 S Ct at 2615 (“This is not a situation in which Congress devised an “expert and inexpensive method for dealing with a class of questions of fact which are particularly suited to examination and determination by an administrative agency specially assigned to that task.” Crowell, 285 U.S. at 46; see Schor, supra, at 855-856.”). Of course others have argued that any reference to the expertise of administrative agencies is a fiction itself. See Easterbrook, 57 Okla L Rev at 3 n 6 (cited in note 59).}

\[\text{64 Barnhart v Walton, 535 US 212, 222 (2002) (“[T]he interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of that administration, and the careful consideration the Agency has given the question over a long period of time all indicate that Chevron provides the appropriate legal lens through which to view the legality of the Agency interpretation here at issue.”). For an interesting game theoretic analysis of the delegation choice in a context that involves only agencies and Article III courts, see Dennis W. Carlton and Randal C. Picker, Antitrust and Regulation (forthcoming 2013) online at http://www.nber.org/chapters/c12565.pdf.}

\[\text{65 The degree to which accountability actually exists for administrative agencies is open to debate.}
elected branch. But accountability is a much less weighty factor when the discretion is being exercised over factual findings than over legal interpretations. Legal interpretations are a form of law making. That is traditionally a function of elected government. Factual determinations are not.

The explanation for the Court's reluctance to find that Congress entrusted bankruptcy courts to apply broad standards to the facts before her may lie in the way that RadLAX is connected to other parts of the Court's bankruptcy jurisprudence. Butner stands for the idea that nonbankruptcy rights create a baseline. The law of corporate reorganizations is designed to help investors solve the collective-action problem they face when their firm encounters financial distress. Bankruptcy provides a forum in which they can sort out conflicting claims when the assets are insufficient to pay everyone off in full. Nothing in this policy requires altering the priority that one creditor enjoys over another outside of bankruptcy.

Once one accepts this principle, it is only a short step to assume that Congress is similarly reluctant to expand the discretion that bankruptcy courts enjoy. Discretion with respect to questions such as the value of a nonbankruptcy entitlement can result in this entitlement being slighted. As 203 N LaSalle suggests, when markets are available to assess the value of nonbankruptcy entitlements, there is no need for a bankruptcy judge to do so.

The need to guard the nonbankruptcy rights closely might seem to lead to limiting the power of bankruptcy judges to reshape them. But it is not a necessary response. Adherence to Butner might not require limiting the power of bankruptcy judges. Taking Butner seriously only means that whoever is entrusted with the power to affect the nonbankruptcy rights of parties should be well aware of and respect that principle. Indeed, there is no reason to think bankruptcy judges will systematically slight nonbankruptcy rights or that rules are needed to rein them in. Not only are bankruptcy courts likely to be aware of the importance of the Butner principle, they are likely to have a comparative advantage (over Congress and Article III courts) in identifying which factual issues and decisions are prone to raise Butner concerns and go astray of nonbankruptcy rights. For what it's worth, the bankruptcy courts in RadLAX and

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67 See Margaret Lemos, The Other Delegate: Judicially Administered Statutes and the Nondelegation Doctrine, 81 S Cal L Rev 405 (2008).

Philadelphia Newspapers found that plans that denied senior creditors the ability to credit bid were not fair and equitable. It was the circuit judges who were divided. 69 Similarly, the bankruptcy judge in River East limited the breadth of plans allowed as indubitably equivalent to protect the value of nonbankruptcy rights. 70 Moreover, limiting the power of the bankruptcy court in these cases will not protect the nonbankruptcy rights in all cases. In particular factual scenarios, the bankruptcy court’s discretion might be exercised precisely to protect the nonbankruptcy rights where the narrow rule-like reading is sometimes underprotective. 71

Of perhaps even greater importance is the posture that the Court has taken to the constitutional problems inherent in delegating so much power to non-Article III judges. While one can trace some of the limits on judicial discretion in bankruptcy to an era in which judges in reorganization cases were Article III judges, today a large part of the rationale derives from the fact that bankruptcy judges are not Article III judges and that their decisions are hard to review. Indeed, in Stern the majority squarely rejected the dissent’s argument that the implicit control that the judiciary has over bankruptcy courts by means of appointment, oversight, and appellate review somehow alleviates balance-of-power structural concerns.

Congress has the power to create substantive bankruptcy provisions that may alter state law rights, but any grant of discretion that allows the bankruptcy court to apply a general directive to achieve that same outcome begins to look like a traditional adjudication of private rights at common law. And those adjudications are the special province of Article III judges. Precisely because bankruptcy law is, by its nature, both vindicating and altering nonbankruptcy (often state law) rights, the Court worries more about those nonbankruptcy rights. The more Congress entrusts discretion of any kind to bankruptcy judges or anyone else who lacks the

69 In re River Rd Hotel Partners LLC, 2010 Bankr Lexis 5933, *1 (Bankr N D Ill 2010) (denying motion to approve bidding procedures); In re Phila Newspapers, LLC, 418 BR 548, 552 (E D Pa 2009) (reversing bankruptcy court’s rejection of bidding procedures).

70 See In re River East, 669 F3d at 829 (“The bankruptcy judge rejected the plan, lifted the automatic stay, and dismissed the bankruptcy proceeding.”).

71 For an example of a case in which a rule-like interpretation slights nonbankruptcy rights, see United Savings Ass’n of Texas v Timbers of Inwood Forest Ass’n, 434 US 365 (1988) (rejecting the bankruptcy court’s power to include the value of postpetition use of collateral in a secured creditor’s adequate protection, even where it arguably was entitled to as much outside of bankruptcy).
attributes that Article III requires, the more constitutionally question-able the system becomes.

Put simply, Congress can alter nonbankruptcy rights but the bankruptcy judge cannot. The less rule-like the bankruptcy law, the greater the danger that the bankruptcy judge will be shaping bankruptcy policy rather than applying the one Congress has created. Moreover, the more one relies on the discretion of the bankruptcy judge, the more likely the bankruptcy judge will be adjudicating nonbankruptcy rights, a function exclusive to Article III judges. RadLAX puts in place an avoidance presumption that reads ambiguities in the Bankruptcy Code in a way that limits the ability of the bankruptcy judge either to alter nonbankruptcy rights or adjudicate them.

Unlike most areas of federal law, bankruptcy law has as its guiding principle the vindication of rights that exist independent of itself. It is one thing to allow a non-Article III tribunal to alter state law rights to achieve a uniform federal environmental policy, but quite another to allow it to alter those rights in the name of a statute that has the vindication of those very rights as one of its foundational principles. If Congress intends to change that nonbankruptcy law, it does so explicitly; if it intends to point to that law as a guide for application, interpretation, or gap filling, an Article III court may be required to adjudicate the matter.

This understanding of bankruptcy law embedded in Butner and Marathon naturally leads to RadLAX. If Congress wants a bankruptcy judge to vindicate some bankruptcy policy (and thus risk undermining Butner or running afoul of Marathon), it should speak clearly. If Congress wants debtors to be able to pay creditors in exotic coin that is hard to value, it must say so. If it wants to allow sales without credit bidding, it must be clear. Congress must be explicit if it wants to give bankruptcy judges the power to make subjective judgments (valuations, approval of sale procedures, approval of the form of payment) about what is "fair and equitable."

RadLAX is unlikely to have much direct impact on the way that bankruptcy judges apply the absolute priority rule. There are few cases where limits on credit bidding make sense. In the vast majority of cases, the effect of limits on credit bidding is to deny the secured creditor some of the value of its claim. Hence, a plan with-
out credit bidding will rarely offer secured creditors the indubitable equivalent of their claim, and today's bankruptcy judges would be most unlikely to approve such plans. To limit the bankruptcy judge's discretion in these cases is to mandate the result they almost always reach anyway. But *RadLAX* matters because the presumption it brings to interpreting the Bankruptcy Code whenever deferring to the bankruptcy court's discretion might compromise the principles at work in *Burner* and *Marathon*.

In this way, the arc from *Los Angeles Lumber* to 203 N LaSalle to *RadLAX* and its relationship to *Burner* and *Stern* give some meaning and direction to the Supreme Court's repeated admonition to adhere strictly to the text of the Bankruptcy Code. The opinion should not be understood as a general mandate to apply strong maxims of statutory interpretation to the Bankruptcy Code. Nor should it be read as an instruction to be narrow across all ambiguities, but rather only where those ambiguities intersect with the application of non-bankruptcy rights.

The importance of understanding that *RadLAX* is not a general mandate for mechanical application of the canons of interpretation can be seen in two examples. Courts have struggled with the appropriate treatment of executory contracts for intellectual property rights in bankruptcy. A provision of the Bankruptcy Code provides for special protections for holders of copyrights and patents, but not for trademarks. Contested is whether the treatment of trademarks is different when the more general provisions of the Code are applied.

If *RadLAX* were read simply as giving a thumb on the scale in favor of the interpretative canon of *expressio unius*, then it would suggest that, by giving special protection to patent and copyright, Congress has determined that patent and copyright deserved this sort of protection and trademarks did not. If Congress had wanted this protection for trademarks, they could have easily provided it. Hence, one should incline away from an interpretation of general principles to reach the same result. This approach seems wrong across several dimensions. The question about the consequences that flow from the rejection of an executory contract in bankruptcy has nothing to do with the domain of the bankruptcy judge's discretion over nonbankruptcy rights. Indeed, inferring that the debtor enjoys a greater power to reject trademark licenses than patent
licenses expands the domain of bankruptcy and runs counter to the 
Butner principle.

Another example can be found in a question that has divided a 
number of courts. In drafting a series of amendments to the Bank-
ruptcy Code in 2005, Congress enacted a number of provisions that 
had the effect of ensuring that individuals received comparable 
treatment regardless of which chapter of the Bankruptcy Code they 
filed under. Under the most literal reading, however, the various 
sections in combination appear to abolish the absolute priority rule 
in individual Chapter 11 cases. Apart from unmoored literalism, 
however, this reading of the Bankruptcy Code has little to rec-
ommend it. Nothing about RadLAX, however, pushes in favor of 
such a reading. The amount of discretion delegated to bankruptcy 
judges is not implicated. None of the concerns about bringing order 
to the unruly world of bankruptcy push toward excluding ordinary 
prepetition assets from the bankruptcy estate.

More importantly, the substantive presumption of RadLAX is not 
a blanket presumption of narrowness. When viewed in connection 
with Butner and Marathon, the RadLAX presumption is about lim-
iting discretion where its exercise may alter nonbankruptcy rights. 
If the ambiguity in the statute does not involve altering nonbank-
ruptcy rights or exercising anything akin to the judicial power with 
respect to nonbankruptcy rights, there is no reason to gravitate 
toward the narrow interpretation. Neither Butner nor Marathon is 
implicated.

As noted above, much of the Bankruptcy Code does involve the 
adjudication of nonbankruptcy rights, but that is not uniformly true. 
Some provisions are pure bankruptcy law. When Congress has left 
ambiguity over these provisions and where the bankruptcy court's 
discretion impacts only the federal rights created 
by the Bankruptcy 
Code, courts must look elsewhere for interpretative guidance. For 
example, when courts are interpreting the boundaries of voidable 
preferences and good-faith filing requirements, they should recall 
that each is a statutory matter that exists only as a function of 

\footnote{Judge Easterbrook looks beyond mechanical rules of statutory interpretation to reach 
this result in Sunbeam Products, Inc. v Chicago American Mfg. LLC, 686 F3d 322 (7th Cir 
2012).}

\footnote{Compare In re Shat, 424 Bankr 854 (Bankr D Nev 2010 (Markell, J)), with In re 
Stephens, 2013 WL 151193 (10th Cir 2013) (in face of ambiguity, court will not read the 
Bankruptcy Code to erode absolute priority rule "absent a clear indication that Congress 
intended such a departure").}
bankruptcy law and independently of nonbankruptcy rights. Voidable preferences exist only in bankruptcy and protect the integrity of the collective proceeding. 75 Similarly, the application of discretionary principles such as good faith filing can only be answered by resort to bankruptcy law principles. 76

Ambiguities in these provisions do not implicate the RadLAX presumption. A question of how broadly a court can define a voidable preference should be viewed with the policy of bankruptcy in mind rather than some imported state law directive. 77 The same is true for ambiguities that may exist as to the breadth of anti-ipso-facto-clause provisions of the Bankruptcy Code. These are not provisions intended to vindicate nonbankruptcy rights but rather to further specific bankruptcy principles and bring coherence to the Code. 78 In none of these cases is there a question of the interpretation, adjudication, or discretionary application of nonbankruptcy rights. 79

III. Conclusion

While Stern makes it clear that bankruptcy courts are not Article III courts, RadLAX adds the message that they are also not administrative agencies or anything like them. 80 The former narrows
the range of legal issues that they may decide; the latter limits the
domain of factual discretion they may exercise in deciding those
issues.

RadLAX crystallizes a substantive interpretive principle that has
been in the background of the Court's bankruptcy jurisprudence
for decades: in interpreting the Bankruptcy Code, courts should
start with the presumption that the range of discretion a bankruptcy
judge enjoys over issues that affect the application of substantive
nonbankruptcy rights is narrow. Between two interpretations of the
Bankruptcy Code that are otherwise plausible, the Court will incline
toward the one that limits the power of the bankruptcy judge to
unsettle those rights.

From the perspective of those deeply immersed in bankruptcy,
the Court's opinion in RadLAX is unsettling. It embraces an
approach to bankruptcy that, quite apart from its logical coherence,
is divorced from reality. Someone reading the Court's bankruptcy
opinions over the last three decades would have no idea of the extent
to which the world it is trying to regulate has changed.

The bankruptcy world the Court confronted in Marathon was
dysfunctional. The judges were former bankruptcy referees, some-
times corrupt and often of limited competence. Debtors ran rough-
shod over the rights of creditors, and firms often entered Chapter
11 only to bleed to death slowly. The bankruptcy world today is
altogether different. Its judges are among the best in the federal
judiciary. Bankruptcy judges as a general matter quickly dispose of
cases that do not belong in Chapter 11. In large business cases, the
judges are typically the equal of any Delaware Chancellor. They
oversee the restructuring of multi-billion-dollar corporations with
consummate skill. As a matter of sound judicial administration, it
would make sense to give them more discretion rather than less.

Those who work on the ground view the bankruptcy court as
creating an umbrella that protects a space within which interested
parties can plot a future course for a distressed business. The process
is necessarily a fluid one and works best with a decent measure of
flexibility and pragmatism. There is no recognition of this state of
affairs in RadLAX or indeed in any of the Court's bankruptcy opin-
ions. The pragmatic imperatives at work when the court assesses
example, Pardo and Watts, 60 UCLA L Rev 384 (cited in note 3). The centrality of
nonbankruptcy rights discussed above may make this more complicated than has been
recognized—or at least may require a great deal more china to be broken. In any event,
RadLAX is a significant move in the opposite direction.
tribunals for everything from workers' compensation to securities trading are altogether absent when it comes to bankruptcy. One can, of course, take the view that, when it comes to interpreting the Constitution or a bankruptcy law passed in 1978, today's realities are irrelevant. Nevertheless, the failure to recognize these realities is in the end the most striking difference when viewing bankruptcy through an administrative law lens.
ABLJ Symposium –
Equitable Powers of
The Bankruptcy Court
40 Years After The Enactment of
The Bankruptcy Code
ABLJ Symposium: Equitable Powers of the Bankruptcy Court 40 Years After the Enactment of the Bankruptcy Code

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THE EQUITABLE POWERS OF THE BANKRUPTCY COURT

Hon. Michelle M. Harner*
Emily A. Bryant-Álvarez**

“But Your Honor, this is a bankruptcy court—a court of equity—surely, you can grant the requested relief under your equitable powers.”

Words to this effect are often spoken in bankruptcy courts across the country. They are grounded in traditional notions of equitable relief and the historical characterization of bankruptcy courts as “courts of equity.” But do they still ring true today? This question arises because of what some commentators suggest is a continuing contraction of the bankruptcy courts’ equitable powers.1 These commentators point to recent U.S. Supreme Court decisions, such as Law v. Siegel, 571 U.S. 415 (2014), to support their thesis. In Siegel, the Supreme Court explained, in the context of discussing a bankruptcy court’s authority to impose sanctions under section 105 or its inherent powers, that “whatever … sanctions a bankruptcy court may impose on a dishonest debtor, it may not contravene express provisions of the Bankruptcy Code ….” Id. at 427–28.

1 See, e.g., Adam James Wiensch, The Supreme Court, Textualism, and the Treatment of Pre-Bankruptcy Code Law, 79 GEO. L.J. 1831, 1860–61 (1991) (“The equitable powers of the bankruptcy courts were codified in section 105 of the Bankruptcy Code. The [Supreme] Court has taken a very narrow view of these powers. In addition to adopting a textualist approach to interpret the Bankruptcy Code, the Court has expressly limited the equitable powers of the bankruptcy courts on several occasions.”) (citations omitted). See also Lawrence Ponoroff, Whither Recharacterization, 68 Rutgers U.L. Rev. 1217, 1222 (2016) (“[T]he bankruptcy courts’ general equitable authority under § 105(a) has taken something of a drubbing in recent years.”); Daniel J. Sheffner, Situating Reimposition of the Automatic Stay Within the Federal Common Law of Bankruptcy, 47 U. Tol. L. Rev. 447, 449 (2016) (“Unfortunately, § 105’s history, salient scholarly commentary, and the Supreme Court’s recent decision in Law v. Siegel indicate that it is improper to base reimposition [of the stay] on § 105”); Melanie L. Cyganowski & Lloyd M. Green, The Demise of Equitable Disallowance of Claims, 24 J. Bankr. L. & Prac. 6, art. 1 (Dec. 2015) (“By reason of the Supreme Court’s 2014 decision in Law v. Siegel, in which the Court limited the scope of the bankruptcy court’s equitable powers and the reach of section 105(a), the future of equitable disallowance is in doubt.”).
The appropriate scope of the bankruptcy courts’ equitable powers is not a new question. Rather, it dates back to the inception of the Union and how the U.S. Constitution allocates jurisdiction to federal courts and power to Congress “[t]o establish … uniform Laws on the subject of Bankruptcies throughout the United States ….” U.S. Const. art. I, § 8, cl. 4. It generally flows from the powers vested in the English Court of Chancery, the notion that the law does not always provide an adequate or sufficiently determinant remedy, and the policies underlying federal bankruptcy law. Nonetheless, the precise parameters of the bankruptcy courts’ equitable powers have evolved over time.

The scope of the bankruptcy courts’ equitable powers also is not a settled question. Commentators have long debated the existence and extent of the bankruptcy courts’ equitable powers. They also debate what it means for a court to do “equity” and how those notions relate to a court’s inherent and statutory powers. Some even suggest that a bankruptcy court is not a court of equity at all.

2 See infra notes 14–18 and accompanying text.
3 See, e.g., U.S. Const. art. III, § 1 (“The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.”); U.S. Const. art. I, § 8, cl. 9 (“The Congress shall have Power . . . To constitute Tribunals inferior to the supreme Court . . .”).
4 See infra notes 23–27 and accompanying text.
5 See, e.g., Lynne F. Riley & Maria C. Furlong, The Supreme Court Restores Discretion and Enhances Jurisdiction of the Bankruptcy Courts, 2008 NORTON ANN. SURV. BANKR. L. 4 (2008) (“[A] growing body of academia that examines the historical underpinnings of the bankruptcy court as a basis for disputing the court’s status as a court of equity. Proponents of this theory profess strict limitations on the bankruptcy court’s discretion to utilize equitable and inherent powers whenever the Bankruptcy Code is silent, vague, or contradictory.”); Matthew T. Gunlock, An Appeal to Equity: Why Bankruptcy Courts Should Resort to Equitable Powers for Latitude in Their Interpretation of “Interests” Under Section 363(f) of the Bankruptcy Code, 47 WM. & MARY L. REV. 347, 365–66 (2005) (“Widespread criticism, however, does not render the language of § 105(a) meaningless. Rather, the language’s inclusion within the Bankruptcy Code should serve as a reminder that, ultimately, bankruptcy courts are equitable in nature and that all of the Code’s provisions are subject to a balancing of the equities in any case.”); Daniel B. Bogart, Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall, 35 ARIZ. ST. L.J. 793, 794 (2003) (“In this article, the author joins a small but growing chorus of scholarly voices criticizing the over-ambitious use of section 105.”); Marcia S. Krieger, “The Bankruptcy Court Is A Court of Equity”: What Does That Mean?, 50 S.C. L. REV. 275, 275–76 (1999) (noting that “scholars regularly debate the scope of the bankruptcy court’s equitable powers and jurisdiction”).
This preface does not attempt to answer these ever prevalent and important questions. Rather, it provides a brief overview of the origins and evolution of the bankruptcy courts’ equitable powers. This overview likewise does not explore all potential nuances, critiques, or alternative perspectives, as that task falls to the exceptionally talented academics participating in the Symposium. Instead, this preface merely strives to set the table for the Symposium and a more forward-looking conversation.

The academic papers that follow (and that are described at the end of this preface) critically analyze the bankruptcy courts’ equitable powers, namely what they are and what, perhaps, they should be. Regardless of existing critiques and questions concerning “bankruptcy courts as courts of equity,” courts and parties frequently invoke, and rely upon, the bankruptcy courts’ equitable powers. The appropriate scope of the bankruptcy courts’ equitable powers thus remains an important issue that affects not only how bankruptcy judges perform their jobs on a daily basis, but also how debtors’ and creditors’ rights are resolved in bankruptcy cases.

I. The Origins of Courts of Equity

An appropriate starting point for evaluating the equitable powers of the bankruptcy courts is the English Court of Chancery. The development of the English Court of Chancery was in many
ways a response to the perceived rigidness of the common law, which arguably was too inflexible to accommodate the particular facts and circumstances of any given case.\textsuperscript{8} Parties who were unhappy with an application of the common law in England would request relief from the King based on the equities of the matter.\textsuperscript{9} As this practice became more commonplace, the role of the King’s chanceries expanded, and eventually England established a formal Court of Chancery.\textsuperscript{10}

Chancellors in the English system initially wielded wide discretion, basically providing a remedy whenever a Chancellor personally found an injustice. They addressed a variety of matters, from trusts and uses and agency law to fraud and other claims, defenses, and remedies not available under the common law.\textsuperscript{11} Over time, the English Court of Chancery evolved, and certain parameters emerged. For example, its jurisdiction was limited to those instances in which no adequate remedy existed under the common law; Chancellors increasingly published their decisions to establish precedent; and Chancery practice generally became more standardized.\textsuperscript{12} Even with these refinements, however, not everyone supported the Court of Chancery,\textsuperscript{13} skeptical of the broad discretion and jurisdiction purportedly vested in Chancellors.
Such was the state of affairs at the time of the adoption of the Articles of Confederation and the early formation of the judicial branch in the United States. The colonies were divided in their approaches to courts of equity and equitable powers more generally.\textsuperscript{14} The Articles of Confederation did not mention “equity,” and it was only added to the U.S. Constitution late in the drafting process.\textsuperscript{15} That revision resulted in the final language of Section 2 of Article III of the Constitution, which provides, “The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority….” U.S. Const. art. III, § 2. “The \textit{Federalist Papers} defended Article III’s jurisdictional grant over cases in equity by explaining that federal courts need the power to fairly adjudicate cases otherwise within their jurisdiction that involve ‘ingredients of fraud, accident, trust, or hardship.’” Michael T. Morley, \textit{The Federal Equity Power}, 59 B.C. L. Rev. 217, 231 (2018) (emphasis in original).

The scope of federal courts’ equity jurisdiction, though grounded in the Constitution, was initially unsettled given the interplay of federal and state law, particularly in diversity cases. The Supreme Court consistently described the equitable powers of the federal courts as akin to those vested in the English Court of Chancery and upheld a wide array of lower court decisions based in equity.\textsuperscript{16} That approach did not change entirely, but it was refined in the context of federal diversity

\textsuperscript{14} See Oleck, \textit{supra} note 8, at 40–41; Morley, \textit{supra} note 9, at 230; Gordon, \textit{supra} note 8, at 185–87, 198–98; DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 1-02, at 1-3 (2018) (“Delaware’s creation of a separate court of equity in 1792 ran decidedly against the trend of the late eighteenth century, a time when most other American jurisdictions either were moving away from separate courts of law and equity or, as was the case in Delaware prior to 1792, had never established a separate equity court in the first instance.”). For a general discussion of courts of equity in the United States in the early 1900s, see Henry H. Ingersoll, \textit{Confusion of Law and Equity}, 21 Yale L.J. 58 (1911).

\textsuperscript{15} Morley, \textit{supra} note 9, at 231; Gordon, \textit{supra} note 8, at 198–98.

\textsuperscript{16} See, e.g., Sheffield Furnace Co. v. Witherow, 149 U.S. 574, 578, 579 (1893) (holding that a federal court could entertain a bill in equity to enforce a mechanic’s lien, even though a state statute “provide[d] for an action at law” to enforce mechanic’s liens, because “foreclosure of a mechanic’s lien is essentially an equitable proceeding” and that states, “by prescribing an action at law to enforce even statutory rights, cannot oust [] Federal court[s], sitting in equity, of its jurisdiction to enforce such rights, provided they are of an equitable nature”). \textit{See also Hipp for Use of Cuesta
cases following the Supreme Court’s decision in *Erie R. Co. v. Tompkins*.17 304 U.S. 64 (1938) (disapproving of its prior decision in *Swift v. Tyson* and holding that federal courts sitting in diversity must apply applicable substantive, state law).18 The decision did not, however, otherwise limit the general equitable powers of the federal courts.

II. The Origins of Bankruptcy Courts as Courts of Equity

The genesis of bankruptcy courts’ equitable powers is arguably more nuanced than that of Article III courts. The structure of bankruptcy courts as Article I courts that operate as a unit of Article III district courts creates a hybrid platform from which to analyze bankruptcy courts’ equitable powers.19 Some commentators argue that the structure of the bankruptcy court limits its equitable powers, though that same structure may support both the general equitable powers vested in federal courts and those granted by the Bankruptcy Code.

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17 **See, e.g., Guar. Tr. Co. of N.Y. v. York**, 326 U.S. 99, 112 (1945) (“Dicta may be cited characterizing equity as an independent body of law. To the extent that we have indicated, it is. But insofar as these general observations go beyond that, they merely reflect notions that have been replaced by a sharper analysis of what federal courts do when they enforce rights that have no federal origin.”).

18 **See, e.g., Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co.,** 559 U.S. 393, 406 (2010) (“Erie involved the constitutional power of federal courts to supplant state law with judge-made rules. In that context, it made no difference whether the rule was technically one of substance or procedure; the touchstone was whether it ‘significantly affect[s] the result of a litigation.’”) (quoting *Guaranty Trust Co.*, 326 U.S. at 109).

19 28 U.S.C. § 151 (2019) (“In each judicial district, the bankruptcy judges in regular active service shall constitute a unit of the district court to be known as the bankruptcy court for that district. Each bankruptcy judge, as a judicial officer of the district court, may exercise the authority conferred under this chapter with respect to any action, suit, or proceeding and may preside alone and hold a regular or special session of the court, except as otherwise provided by law or by rule or order of the district court.”).
Any analysis of a bankruptcy court’s equitable powers should consider the policies and language of Articles I and III of the Constitution, the concept of equity in federal courts, and the Bankruptcy Code. Moreover, Congress did not craft the Bankruptcy Code on a clean slate, but against the backdrop of the Bankruptcy Act of 1898 and the exercise of equitable power in insolvency cases prior to that time.

Before considering the language of the Bankruptcy Code, it is helpful to reflect on the traditional jurisdiction of courts of equity. As noted, courts of equity generally focus on situations in which the remedy at law is inadequate or indeterminate. As Justice Story concisely explained, “[p]erhaps the most general if not the most precise description of a Court of Equity, in the English and American sense, is that it has jurisdiction in cases of rights, recognized and protected by the

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20 Congress is empowered to create uniform bankruptcy laws, and it has reserved certain equitable powers to the bankruptcy courts in that legislation. U.S. Const. art. I, § 8, cl. 9; 11 U.S.C. § 105. See also 2 COLLIER ON BANKRUPTCY ¶ 105.02 (16th ed. 2019) (discussing the bankruptcy court’s inherent and statutory powers under section 105 and providing examples of how courts exercise such powers).

21 The Supreme Court noted this general concept in the context of civil contempt and section 105, explaining: Our conclusion rests on a longstanding interpretive principle: When a statutory term is “obviously transplanted from another legal source,” it “brings the old soil with it.” Hall v. Hall, 584 U.S. ––––, ––––, 138 S.Ct. 1118, 1128, 200 L.Ed.2d 399 (2018) (quoting Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947)); see Field v. Mans, 516 U.S. 59, 69–70, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) (applying that principle to the Bankruptcy Code). Here, the statutes specifying that a discharge order “operates as an injunction,” § 524(a)(2), and that a court may issue any “order” or “judgment” that is “necessary or appropriate” to “carry out” other bankruptcy provisions, § 105(a), bring with them the “old soil” that has long governed how courts enforce injunctions.


22 See, e.g., Gordon, supra note 8, at 185–87 (“Chancery recognized forms of equitable property (trusts, mortgages, and priorities of estates and interests), enforced torts by injunction, enforced contracts by specific performance and injunction, afforded relief against the rigidity of the common law (fraud, undue influence, accident, and mistake), and provided procedural convenience (account, interrogatories, and discovery).”); Kristin A. Collins, “A Considerable Surgical Operation”: Article III, Equity, and Judge-Made Law in the Federal Courts, 60 DUKE L.J. 249, 266 (2010) (“Both historically and today, the term “equity” refers to a set of rights, remedies, and procedures available ostensibly to ameliorate defects of the common law (such as in the cases of fraud, mistake, and forgery) and to enforce equitable instruments that require the ongoing supervision of a court (such as trusts and guardianships).”); Thomas O. Main, Traditional Equity and Contemporary Procedure, 78 WASH. L. REV. 429, 442 (2003); Chateau Apartments Co. v. City of Wilmington, 391 A.2d 205, 207 (Del. 1978) (“In order for the Court of Chancery to assume jurisdiction over a proceeding, of course, there must be an absence of an adequate remedy at law.”).
municipal jurisprudence, where a plain, adequate, and complete remedy cannot be had in the Courts of Common Law.”

Courts in the United States historically have viewed situations in which a debtor’s assets are insufficient to satisfy her obligations to creditors as instances in which equity may assist. If a debtor cannot pay an obligation and an award of damages would prove futile, equitable principles may fill the void. Indeed, the premise of enjoining creditors’ actions to promote a fair and equitable distribution of the debtor’s assets is aligned with remedies commonly granted by courts of equity. Congress was aware of the various uses of equity in the context of resolving debtor-creditor relationships when it enacted early bankruptcy legislation, including the Bankruptcy Act of 1898.

23 Story, supra note 7, §33, at 29.
24 Ralph A. Newman, The Effect of Insolvency on Equitable Relief, 13 St. John’s L. Rev. 44, 44–45 (1938). See also Matter of Terry Ltd. P’ship, 169 B.R. 182, 185 (Bankr. N.D. Ind.), aff’d sub nom. Invex Holdings, N.V. v. Equitable Life Ins., 179 B.R. 111 (N.D. Ind. 1993), aff’d sub nom. Matter of Terry Ltd. P’ship, 27 F.3d 241 (7th Cir. 1994); In re Landau Boat Co., 8 B.R. 436, 437–439 (Bankr. W.D. Mo. 1981). In a related context, the English Court of Chancery routinely exercised jurisdiction over actions of account, which could include incidental matters such as “the administration of personal assets; consequently of debts, legacies, the distribution of the residue, and the conduct of executors and administrators.” 2 Joseph Story, Commentaries on Equity Jurisprudence §593, at 10 (Boston, Charles C. Little & James Brown 14th ed. 1918) (explaining the development of the English Court of Chancery). See also In re Judiciary Tower Assoc., 170 B.R. 8, 9–10 (Bankr. D.D.C. 1994) (“In Cook, a joint bankruptcy commission was taken against two partners, and the partners’ assets were assigned for the benefit of their joint creditors. Thereafter, the partners’ individual creditors took out a separate commission on the partner’s individual assets. The English court required an action at equity to account for the assets as between the assignee for the benefit of the joint creditors and the assignees for the benefit of the individual creditors.”).
25 The English Court of Chancery used injunctive relief in various scenarios. See, e.g., Oleck, supra note 8, at 38 (describing English Court of Chancery granting “injunctive restraint for nuisances”); Hagner v. Heyberger, 1844 WL 4922, at *1 (Pa. 1844) (“The English chancery can by injunction restrain the commission of acts contrary to equity.”). See also Story, supra note 24, §§1181–1191, at 549–558. Likewise, U.S. district courts overseeing equity receiverships relied on their equitable powers to prevent dissipation of the debtor’s assets prior to a resolution of the receivership. See Harry W. Kroeger, The Jurisdiction of Courts of Equity to Administer Insolvents’ Estates, Considered in Relation to Historical Antecedents, 9 St. Louis L. Rev. 179 (1924). The district courts continue to invoke similar powers in the context of federal receiverships, which are largely based on equitable principles. See, e.g., S.E.C. v. Credit Bancorp, Ltd., 290 F.3d 80, 90 (2d Cir. 2002) (“We agree with the District Court that receiverships are ‘insolvency proceedings,’ and that the law of federal equity receiverships applies.”); S.E.C. v. Elliott, 953 F.2d 1560, 1566 (11th Cir. 1992) (“The district court has broad powers and wide discretion to determine relief in an equity receivership” … “This discretion derives from the inherent powers of an equity court to fashion relief.”) (citations omitted).
26 The relation to existing concepts of equity is evident even in the language of the statute itself. For example, “Section 77(a) of the Bankruptcy Act, 11 U.S.C. s 205(a), provides that the reorganization court shall ‘have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it...
Under the Bankruptcy Act of 1898, Congress recognized the role of equity in bankruptcy cases. Specifically, section 2(a)(15) of the Act permitted courts to:

Make such orders, issue such process, and enter such judgments, in addition to these specifically provided for, as may be necessary for the enforcement of the provisions of this Act: Provided, however, That an injunction to restrain a court may be issued by the judge only.

11 U.S.C. § 11(a)(15) (1938). Although limited in scope, section 2(a)(15) drew upon traditional notions of equity. As explained by the Supreme Court:

By section 2 of the Bankruptcy Act (U.S.C. title 11, s 11, 11 USCA s 11), courts of bankruptcy are invested ‘with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings.’ They are essentially courts of equity, and their proceedings inherently proceedings in equity, the words ‘at law’ probably having been inserted only with regard to clause (4) of section 2, 11 USCA s 11(4), which confers authority to arraign, try, and punish bankrupts and others for violations of the act. Local Loan Co. v. Hunt, 292 U.S. 234, 240, 54 S.Ct. 695, 78 L.Ed. 1230, 93 A.L.R. 195. Their adjudications and orders constitute in all essential particulars decrees in equity. Id., page 241 of 292 U.S., 54 S.Ct. 695. The power to issue an injunction when necessary to prevent the defeat or impairment of its jurisdiction is, therefore, inherent in a court of bankruptcy, as it is in a duly established court of equity.


The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105. As discussed below, courts continue to recognize the broad grant of equitable powers to the bankruptcy courts under the Bankruptcy Code, but often urge caution in the exercise of those powers.31

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30 See, e.g., In re Padilla, 389 B.R. 409, 431 (Bankr. E.D. Pa. 2008) (“Section 2a(15) is quite similar to and is considered § 105(a)’s direct antecedent.”); In re James, 20 B.R. 145, 149 (Bankr. E.D. Mich. 1982) (“The legislative history to this Code provision states that s 105 is derived from s 2(a)(15) of the Act.”); In re Mason, 18 B.R. 817, 823 (Bankr. W.D. Tenn. 1982) (“11 U.S.C. Section 105(a) is based on, and does not substantially differ from Section 2(a)(15) of the former Bankruptcy Act, 11 U.S.C. Section 11(a) (15).”).

31 James, 20 B.R. at 150 (“Section 105 of the Bankruptcy Code, 11 U.S.C. s 105, retained this broad grant of equitable powers, but at the same time caution is urged. “The basic intention of the section is to enable the bankruptcy court to do whatever is necessary to aid its jurisdiction, i.e., anything arising in or relating to a bankruptcy case.” 2 Collier on Bankruptcy at 105-4 (15th ed. 2003).”
III. Courts’ Use and Interpretation of Section 105(a) of the Bankruptcy Code

Courts and parties in bankruptcy cases consistently refer to bankruptcy courts as courts of equity.32 Perhaps just as frequently, courts acknowledge limitations on the bankruptcy courts’ equitable powers. Those powers are qualified and may not necessarily encompass all authority vested in traditional courts of equity. Indeed, courts tend to confine the bankruptcy courts’ equitable powers to those “necessary or appropriate” to implement the policies and provisions of the Bankruptcy Code.

The Supreme Court concisely articulated this proposition in *Norwest Bank Worthington v. Ahlers*, explaining that “whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”33 485 U.S. 197, 206 (1988). Although the principle is simply stated, courts tend to struggle with its implementation. See, e.g., *In re Aquatic Dev. Grp., Inc.*, 352 F.3d 671, 673, 680–81 (2d Cir. 2003) (vacating a nunc pro tonc order that retroactively closed a bankruptcy estate and noting that “the general grant of equitable power contained in section 105(a) cannot trump specific provisions of the Bankruptcy Code, but must instead be exercised within the parameters of the Code itself”); *In re Combustion Eng’g, Inc.*,...

32 See, e.g., *Young v. United States*, 535 U.S. 43, 50 (2002) (“That is doubly true when it is enacting limitations periods to be applied by bankruptcy courts, which are courts of equity and “appl[y] the principles and rules of equity jurisprudence.” Pepper v. Litton, 308 U.S. 295, 304, 60 S.Ct. 238, 84 L.Ed. 281 (1939). See also *United States v. Energy Resources Co.*, 495 U.S. 545, 549, 110 S.Ct. 2139, 109 L.Ed.2d 580 (1990); *Ketchen v. Landy*, 382 U.S. 323, 326–27 (1966) (“The bankruptcy courts are expressly invested by statute with original jurisdiction to conduct proceedings under the Bankruptcy Act. These courts are essentially courts of equity, ...., and they characteristically proceed in summary fashion to deal with the assets of the bankrupt they are administering.”) (citations omitted); *Young v. Higbee Co.*, 324 U.S. 204, 214 (1945) (“Courts of bankruptcy are courts of equity and exercise all equitable powers unless prohibited by the Bankruptcy Act.”) (citations omitted).

33 This general proposition also was articulated by the Supreme Court in one of its last cases decided under the Bankruptcy Act. See *Butner v. United States*, 440 U.S. 48, 55–56 (1979) (“The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems. But undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt.”).
391 F.3d 190, 236 (3d Cir. 2004), as amended (Feb. 23, 2005) (vacating and remanding a decision of the bankruptcy court that expanded the scope of a channeling injunction and stating that “the Bankruptcy Court relied upon § 105(a) to achieve a result inconsistent with § 524(g)(4)(A)”; In re Saxman, 325 F.3d 1168, 1170, 1174 (9th Cir. 2003) (holding that “bankruptcy courts may partially discharge student debt pursuant to their equitable authority under 11 U.S.C. § 105(a)” as “§ 523(a)(8) is silent with respect to whether the bankruptcy court may partially discharge the loan”).

In 2014, the Supreme Court further addressed the equitable powers of bankruptcy courts when faced with a specific statutory provision. In Law v. Siegel, the Court made clear that, although bankruptcy courts possess statutory and inherent powers, they “may not contravene specific statutory provisions” in exercising them. 571 U.S. 415, 420–21. It held that the bankruptcy court could not surcharge a debtor’s statutorily exempt property on equitable grounds, though it recognized that the bankruptcy court could impose sanctions against the debtor under Federal Rule of Bankruptcy Procedure 9011(c)(2).34 The Court concluded that the Bankruptcy Code does not confer on bankruptcy courts “a general, equitable power … to deny exemptions based on a debtor’s bad-faith conduct.”35

Subsequent case law has confirmed Siegel’s edict, while observing that such a ruling does not strip bankruptcy courts of their powers under section 105(a) of the Bankruptcy Code. See, e.g., In re Arthur B. Adler & Assocs., Ltd., 588 B.R. 864, 874 (Bankr. N.D. Ill. 2018) (“[T]he Supreme Court in Siegel explicitly stated that a bankruptcy court may not exercise its inherent powers in

34 Siegel, 571 U.S. at 427. The Supreme Court further observed that bankruptcy courts “may also possess further sanctioning authority under either § 105(a) or its inherent powers.” Id. See also 2 Collier on Bankruptcy ¶ 105.01 (16th ed. 2019) (discussing Siegal opinion).
35 Siegel, 571 U.S. at 425.
contravention of the statutory provisions of the Bankruptcy Code. … In that case, the Supreme Court determined that a bankruptcy court allowing the surcharge of a debtor’s exemption had exceeded its statutory and inherent authority. … However, that decision did not strip bankruptcy courts of their authority pursuant to 11 U.S.C. § 105(a). Rather, it merely requires a bankruptcy court to be mindful of the remedies it crafts to avoid contravening the Bankruptcy Code.”)

(citations omitted); In re Brown, 851 F.3d 619, 625 (6th Cir.), cert. denied sub nom. Brown v. Ellmann, 138 S. Ct. 328, 199 L. Ed. 2d 212 (2017) (emphasis in the original) (“Law [v. Siegel] does not strip bankruptcy courts of their ability to interpret the Bankruptcy Code; it merely reinforces the common-sense notion that bankruptcy courts may not use their discretionary powers to reach results that are inconsistent with the clear meaning of the Bankruptcy Code.”).

The language of the Bankruptcy Code and Supreme Court precedent unquestionably continue the tradition of bankruptcy courts as courts of equity. That general proposition does not, however, end the inquiry. Questions remain concerning the appropriate scope of the bankruptcy courts’ equitable powers. Some commentators continue to debate whether the bankruptcy courts should even have equitable powers, while others suggest that changes are needed to vest the bankruptcy courts with more flexibility in the exercise of such powers. The papers that follow thoughtfully explore many of these issues.

IV. Potential Future Issues and Developments

The American Bankruptcy Law Journal Symposium brings together four distinguished academics to consider the issue of the equitable powers of the bankruptcy courts forty years after the enactment of the Bankruptcy Code. Professors Coordes, Dick, Markell, and Westbrook each analyze a different, yet complementary, aspect of the bankruptcy courts’ equitable powers. Their
research and perspectives make meaningful contributions to the literature and help move the conversation forward.

For example, Professor Coordes approaches the issue through the lens of statutory interpretation. She argues that “bankruptcy judges should have particular equity powers because exercising these powers is part and parcel of the function of any entity tasked with statutory interpretation.”36 To support her thesis, Professor Coordes examines “other entities that regularly engage in statutory interpretation, including Article I courts such as the Tax Court ….37

Professor Dick offers data from a qualitative survey of bankruptcy judges concerning “their beliefs regarding, and approaches to, the equitable and other discretionary powers of the bankruptcy court.”38 She uses the survey to try to gain a better understanding of “how bankruptcy judges perceive bankruptcy courts’ equitable powers, and whether and to what extent they view them as separate and distinct from courts’ broader discretion and decision-making authority.”39 Her survey results should inform the conversation with a more in-depth understanding of issues facing bankruptcy judges in the exercise of their equitable powers.

Professor Markell addresses this issue from a structural perspective, considering “what it means to call a body or panel a ‘court,’ and what is added (or changed) by adding the modifier ‘of equity.’”40 His paper explores the concept of a statutory court and whether it has powers beyond those specifically granted in that court’s authorizing text. He concludes that, as a court, a bankruptcy court has the inherent powers of any court, subject of course to limits the Bankruptcy

36 Laura N. Coordes, Code-Based Courts and Equity Powers, abstract (attached to this preface).
37 Id.
38 Diane Lourdes Dick, Equitable Powers and Judicial Discretion: A Survey of U.S. Bankruptcy Judges, abstract (attached to this preface).
39 Id.
40 Bruce A. Markell, Courting Equity in Bankruptcy, abstract (attached to this preface). A draft of Professor Markell’s Symposium paper follows the four abstracts for the four papers in the symposium.
Code and the Constitution impose. With respect to equity, Professor Markell expands his examination to identify and justify actions and practices taken by bankruptcy courts in the name of equity, from allowing and disallowing claims based on equitable principles to improvising practices and remedies consistent with the Bankruptcy Code, but not precisely specified therein. He concludes, however, that his investigations “lead to a different take on the powers of a bankruptcy court to address situations in which there are no clear answers, but also reaffirms the primacy of the text of the legislation creating the courts when practical solutions are prohibited by the Code’s text.”

Professor Westbrook assesses the particular need for the bankruptcy courts’ equitable powers in the context of chapter 11 cases. He explains that “[a]dapting Chapter 11 to our rapidly changing social and financial world requires addition of statutory authority for bankruptcy judges to exercise discretion (or ‘equity’) in favor of those Congressional goals proclaimed but not yet codified.” He considers current trends in statutory interpretation and how a “plain meaning” approach might constrain the necessary evolution of the Bankruptcy Code. Consequently, he suggests a “need to codify discretion to consider and balance specified public interests.”

Each of these academic papers offers a thoughtful analysis of an issue that impacts bankruptcy courts, debtors, and creditors on an almost daily basis. Bankruptcy courts must continue to assess the use of their equitable powers on a case-by-case basis in accordance with the Bankruptcy Code and existing case law. As commentators, legislators, and courts consider the appropriate scope of bankruptcy courts’ equitable powers, these papers add new and important perspectives to that conversation.

41 Id.
42 Jay L. Westbrook, abstract (attached to this preface).
43 Id.
Code-Based Courts and Equity Powers

Outside of bankruptcy, courts and administrative agencies use equitable principles to fashion relief in accordance with the dictates of circumstances and policy. Although this ability to “do equity” is sometimes expressly delegated to these bodies, there are plenty of circumstances where the “delegation” of equity powers is implicit and indirect.

Within the bankruptcy context, there is ongoing disagreement over the extent, scope, and even existence of a bankruptcy court’s equity powers. Some scholars have argued that equity powers have no basis in the Bankruptcy Code and that therefore, a court’s ability to exercise equitable powers should be significantly cabined, if not eliminated entirely. Yet, others have argued that equitable powers should be embraced and even expanded in the bankruptcy context. Justifications for robust equitable powers often take one of two forms: first, the Bankruptcy Code, as a statute, necessarily cannot comprehensively address every conceivable situation that arises in bankruptcy court; and second, there is no administrative agency (or equivalent) in bankruptcy designed to address situations the statutory framework does not contemplate.

This Article seeks to reframe the debate about the bankruptcy court’s equity powers as part of a larger question about the role of courts in interpreting and applying statutes. The Article will posit that bankruptcy judges should have certain equity powers, in part because exercising these powers is part and parcel of the function of any entity tasked with interpreting statutes. To support this argument, the Article will examine other entities that engage in statutory interpretation, including other Article I courts such as the Tax Court, and administrative agencies, to see when and how these entities apply equitable powers, as well as the authority they are given to exercise those powers. The Article will then consider why bankruptcy courts in particular have faced increasing scrutiny of their use of equitable powers.

Of course, no court can have unfettered discretion to simply “do equity,” and this Article will highlight some limits on the bankruptcy courts’ equitable powers. Nevertheless, as scholars and policymakers consider whether and how to update the Bankruptcy Code on the heels of its 40th anniversary, the Article will argue that we must be cognizant of ways to meld form with function and clarify that bankruptcy courts have the ability to exercise equitable powers when doing so is necessary and appropriate to their role as interpreters of the Bankruptcy Code.
Equitable Powers and Judicial Discretion: A Survey of U.S. Bankruptcy Judges

By
Diane Lourdes Dick

ABSTRACT

U.S. bankruptcy courts have been traditionally described as having “broad” and “inherent” equitable powers, with section 105(a) of the Bankruptcy Code typically cited as the current codification of such powers. Over the years, bankruptcy courts have fashioned a variety of equitable remedies in full or partial reliance on section 105(a), with some of these remedies becoming entrenched in modern bankruptcy law and practice. And, although recent judicial decisions appear to limit bankruptcy courts’ equitable powers by narrowly construing section 105(a), bankruptcy judges continue to exercise considerable equitable discretion. This is because, although courts are expected to apply the Code rather than vague principles of equity, the Code itself calls upon judges to exercise substantial discretion, with some provisions directing the court to specifically consider principles of equity. Moreover, the very nature of a bankruptcy case—with multiple parties and other stakeholders competing over scarce and dwindling resources—naturally invites courts to scrutinize claims and actions with fairness and equity in mind. All of this means that it is not always clear where the so-called inherent equitable powers end and the court’s broader judicial discretion begins.

In an effort to help clarify some of the confusion, this Article reports the results of a survey of sitting U.S. bankruptcy judges concerning their beliefs regarding, and approaches to, the equitable and other discretionary powers of the bankruptcy court. A primary goal of the survey is to understand how bankruptcy judges perceive bankruptcy courts’ equitable powers, and whether and to what extent they view them as separate and distinct from courts’ broader discretion and decision-making authority. Survey questions are designed to help understand, among other things, what judges perceive to be the sources of bankruptcy courts’ equitable powers, how they interpret and apply section 105(a), what they believe it means for a court to act in the name of equity, whether they would like more guidance from Congress or the Supreme Court regarding the scope of the court’s equitable powers, their approaches to exercising judicial discretion, and whether they have perceived a change in the level of judicial discretion that bankruptcy judges possess.

In addition to presenting and analyzing the results of the survey, the Article also highlights significant trends and important questions that emerge from survey responses. The Article concludes with a lively discussion that uses the empirical data presented in this Article to help inform the broader conceptual debates concerning the nature and extent of the bankruptcy courts’ equitable and discretionary powers.
Courting Equity in Bankruptcy
By Bruce A. Markell

Abstract

Bankruptcy courts are often referred to as courts of equity. In this paper, I want to examine this reference in detail. Specifically, I want to examine what it means to call a body or panel a “court,” and what is added (or changed) by adding the modifier “of equity.”

My investigations reveal that bestowing a body or panel with the moniker “court” assumes or requires a sophisticated apparatus and infrastructure related to binding decisionmaking. Not only do courts decide cases – that is, they decide contested allegations and apply or interpret legal rules to the allegations as decided – but they also do so in a manner which gives their decisions both legitimacy and enforceability. In United States bankruptcy, much of this work is done by borrowing concepts and structures from existing court systems. But basic competencies, such as who can appear before the bankruptcy court, how and when those may individuals appear, and how to manage and control the manner of discourse with those individuals, remains compressed in the concept of a “court” and the inherent powers possessed by any “court.”

Specifying that a court should also be a court “of equity” imbues, I maintain, a court with various powers. It first allows the court to apply the doctrines and practices developed by courts of equity in nonbankruptcy contexts, especially in the context of resolving claims against the estate. It also permits courts to create remedies and rights as directed by Congress, as with the doctrine of equitable subordination. Finally, it allows courts to make exceptions to general rules when such exceptions do not change results mandated or implied by a governing statute such as the Bankruptcy Code. One simple application of this is the traditional power of equity courts to correct their own mistakes. A more complicated application lies in the practices and customs which have evolved regarding approval and payment of attorneys.

These investigations lead to a different take on the powers of a bankruptcy court to address situations in which there are no clear answers, but also reaffirms the primacy of the text of the legislation creating the courts when practical solutions are prohibited by the Code’s text.

These investigations lead to a new take on the powers of a bankruptcy court to address situations in which there are no clear answers, but also reaffirms the primacy of the text of the legislation creating the courts when practical solutions are prohibited by the Code’s text.
Abstract

Adapting Chapter 11 to our rapidly changing social and financial world requires addition of statutory authority for bankruptcy judges to exercise discretion (or “equity”) in favor of those Congressional goals proclaimed but not yet codified. The essential evolution of the Bankruptcy Code is in tension with the rise of the “plain meaning” device for statutory interpretation, which is often used to ignore any goal that is not expressly stated in the text of the statute. Yet both traditional and emerging Congressional goals may not yield specific provisions because they require balancing public interests that conflict inter se, as well as sometimes conflicting with legitimate and important private interests. Thus the need to codify discretion to consider and balance specified public interests.

The necessary authority should cover traditional goals, such as due consideration of the rights of employees and public investors. Other public interests that may require codification include court discretion in determining the relationship between arbitration and bankruptcy and in protecting tort victims, consumers, and other underrepresented stakeholders. Specific authorization of these goals will avoid grant of a too-broad discretion that might damage commercial expectations while nevertheless empowering experienced commercial judges to include these important goals in their interpretation and application of Chapter 11.
INTRODUCTION

Are bankruptcy courts properly called courts of equity? Various justices of the Supreme Court seem to assume so, but other judges and academics have asked this question in many different ways, with many different answers. The point of this article is to question whether the question is well formed. That is, can it be answered without first knowing or agreeing on what a “court” is or what “equity” means? I think not. This article thus attempts to explore these protean concepts to achieve a better understanding of what is asked by the opening question.


2 I do not write on a blank slate. Some of the key articles in this discourse are Randolph J. Haines, The Conservative Assault on Federal Equity, 88 Am. Bankr. L.J. 451 (2014); Alan M. Ahart, A Stern Reminder that the Bankruptcy Court is Not a Court of Equity, 86 Am. Bankr. L.J 191 (2012); Michael D. Sousa, Equitable Powers of a Bankruptcy Court: Federal All Writs Act and § 105 of the Code, Am. Bankr. Inst. J. at 28 (July/August 2006); Adam Levitin, Toward A Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime, 80 Am. Bankr. L.J. 1 (2006); Alan M. Ahart, The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity, 79 Am. Bankr. L.J. 1 (2005); Steve H. Nickles & David G. Epstein, Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code, 3 Chap. L. Rev. 7 (2000); Marcia S. Krieger, “The Bankruptcy Court is a Court Of Equity”: What Does That Mean?, 50 S.C. L. Rev. 275 (1999). All but two of these articles were written by judges, or former judges.
Start first with bankruptcy. Congress vested bankruptcy jurisdiction in Article III district courts. As “inferior courts” established by acts of Congress, district courts have the “judicial power” as provided for in the Constitution. This “power” includes equity powers. It thus follows that, unless Congress removes or limits that power when conferring jurisdiction over statutory bankruptcy cases, district courts are courts of equity when it comes to the Code. But that is trivial. District courts are courts of equity with respect to any federal statute that they are called upon to apply.

I will have more to say on what it means to be a court of equity with respect to a statutory area later, but for now, the focus is on whether the congressional permission for Article III courts to delegate bankruptcy matters to non-Article III bankruptcy judges alters this analysis. Put another way, a key question for me is whether it is permissible to delegate authority to designate bankruptcy judges as units of the district court to administer bankruptcy cases, and with that delegation transfer to the bankruptcy judges equitable powers and discretion necessary or appropriate to administer the statute at issue? Or is the fact that a collection of bankruptcy judges as a legitimate court automatically imbues them with certain equitable powers and discretion, bounded by statute and by approved methods of statutory interpretation?

COURTS
To call a body a “court” is to infuse that body with a collection of powers that cohere with the usage of “court” in legal parlance. Among these powers are the power to compel testimony and to render enforceable decrees. Adding “of equity” to “court” is generally taken to imbue a court with different and somewhat more expansive powers than a “court of law” or a “statutory court.” I explore this distinction below.

For purposes of this article, I assume that the term “court of equity” has two discrete components: one describes a “court,” and the second is that the “court,” so described, exercises powers of “equity.” I explore these concepts separately.

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4 “The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.” U.S. Const., Art. III, § 1.
5 “The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States . . . .” U.S. Const., Art. III, § 2.
6 Title 11, United States Code. In this article, I use “Code” to refer to the Bankruptcy Code as found in title 11.
7 I don’t mean to address the thorny issues of what types of cases require determination by a court with the judicial power. Put another way, this focus of this article is not upon the limits Stern v. Marshall, 564 U.S. 462 (2011) places on bankruptcy judges. Rather, I am interested in whether Congress has permissibly created bankruptcy courts, as we know them, in such a way that they are “courts” capable of receiving a grant of equitable powers from Article III courts.
8 In this sense, I am using a bankruptcy “court” as a collective noun to describe a collection of bankruptcy judges, just as a murder of crows describes a collection of crows.
9 As noted by Professor James Pfander, the constitution speaks generally of “courts” and sparingly of “tribunals.” To address many of the problems noted in this article, Professor Pfander would distinguish between Article III courts and Article I tribunals. Professor Pfander argues that adopting such a distinction would
Statutory Powers of Courts
Courts have assumed that the bankruptcy power did not exist at common law, and that bankruptcy remedies were creatures of statute.10 Partial recognition of this status lies in the Constitution’s allocation of the bankruptcy power to the legislature,11 and the power over common law and equity matters to the courts.12
The current system creates statutory bankruptcy rights, and then vests the power to administer such rights in the existing Article III court system.13 This vesting comes with an option: the courts can delegate all bankruptcy duties to a separate system of bankruptcy judges.14 Examining this system can assist in determining whether bankruptcy judges exercise powers of a court of equity.

District Courts and Bankruptcy
Congress created an entire title of the United States Code to deal with bankruptcy. That title, title 11, is mostly freestanding and agnostic as to who or what administers it. It is silent on what body should administer the law. That directive comes from title 28, the title on the judiciary. In that title, Congress gave original and exclusive jurisdiction over bankruptcy cases to “the district courts.”15 The same section grants original but not exclusive jurisdiction over civil proceedings arising in, arising under, or related to cases under title 11 to “the district courts” as well.16 A “district court” is comprised of all of the district court judges appointed to a particular district.17 A “district judge” is someone appointed by the president and confirmed by the Senate for a particular judicial district,18 and who serves for life or during good behavior, whichever

suggestion[] that Congress enjoys a degree of flexibility in creating Article I tribunals. On such a reading, the Inferior Tribunals Clause may empower Congress to create inferior “tribunals” with judges who lack Article III protections. While these tribunals must remain inferior to the Supreme Court and the judicial department, Article I does not require that they employ life-tenured judges and Article III does not formally invest these tribunals with the judicial power of the United States.


10 E.g., In re Elmira Steel Co., 109 F. 456, 476 (N.D.N.Y. 1901) (“The provisions of the bankrupt act, which are in derogation of the common law, under which, by proceedings in invitum, parties are against their consent deprived of rights, must in their interest  be construed strictly, and, as so construed, closely followed.”); Stuart v. Hines, 33 Iowa 60, 70 (1871) (“The act being summary in its nature, and in derogation of the common law, must receive a strict construction, and cannot be enlarged so as to include cases not provided for.”).
11 U.S. Const., Art I, § 8, cl. 4.
12 U.S. Const., Art. III.
13 Congress could (and at least once, in 1800, did) create a bankruptcy system that is primarily administrative, with enforcement of completed administrative decisions left to the courts.
17 28 U.S.C. § 132(b): “Each district court shall consist of the district judge or judges for the district in regular active service.”
ends first. There is no doubt that district courts are “courts.” That means, for my purposes, that they have whatever jurisdiction Congress delegates to them (in the case of bankruptcy, whatever jurisdiction flows from section 1334), plus whatever jurisdiction is inherent in their status as a “court.” Accordingly, Congress created a bankruptcy statute using its powers under the Constitution’s bankruptcy clause, and then vested jurisdiction over that statute in the district courts, courts which have the full “judicial Power [over] all Cases, in Law and Equity.” District courts are possessed of the “judicial Power,” which gives them full equity powers with respect to matters, including bankruptcy, which come before them.

District Courts and Referral of Delegated Jurisdiction

Accordingly, Congress created a bankruptcy statute using its powers under the Constitution’s bankruptcy clause, and then vested jurisdiction over that statute in the district courts, courts which have the full “judicial Power [over] all Cases, in Law and Equity.” District courts are possessed of the “judicial Power,” which gives them full equity powers with respect to matters, including bankruptcy, which come before them.

The same analysis does not apply to bankruptcy judges. The source of jurisdiction for bankruptcy judges is section 157(a) of title 28. It permits, but does not require, district courts to refer “to the bankruptcy judges for the district” — not the bankruptcy court for the district — all bankruptcy cases and “any or all proceedings arising under title 11 or arising in or related to a case under title 11.” According to the statute, the judges receiving this referral “shall constitute a unit of the district court to be known as the bankruptcy court for that district.”

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20 “The judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish.” U.S. Const., Art. III, § 1. See also 28 U.S.C. § 132(c): “the judicial power of a district court with respect to any action, suit or proceeding may be exercised by a single judge, who may preside alone and hold a regular or special session of court at the same time other sessions are held by other judges.”

21 The operative term in the statute is a “bankruptcy judge.” Section 151 of title 28 states that “In each judicial district, the bankruptcy judges in regular active service shall constitute a unit of the district court to be known as the bankruptcy court for that district.” 28 U.S.C. § 151. This statute uses “bankruptcy court” as a collective noun for the collection of all bankruptcy judges in a district; that is, the presumption is that a bankruptcy court describes a collection of judges (with the exception being one judge districts such as Montana, Alaska, or Hawaii) who have their official station in a particular judicial district. As a result, a pedant would say that the statement “I appeared before the bankruptcy court today” to be a grammatical error unless all bankruptcy judges in that district were somehow sitting en banc, or unless that bankruptcy judge had the power to commit and bind all bankruptcy judges in that district.


bankruptcy court thus receives, through the order of referral, all powers to decide bankruptcy cases and proceedings, in accordance with the statute and with local district court rules. Unless the equitable power is reserved in the referral, or withheld or withdrawn by the Constitution, a statute or court rule, the bankruptcy court thus presumptively receives all equitable powers over cases and proceedings referred as had the district court that referred them. As stated in section 152(b), “[b]ankruptcy judges shall serve as judicial officers of the United States district court established under Article III of the Constitution.”

The text of section 157(a) leaves little doubt that Congress permitted the district courts to delegate their entire bankruptcy jurisdiction to bankruptcy judges. There is, however, much doubt about how much of that delegation is permissible under the Constitution. Bankruptcy judges are not appointed under Article III, and thus do not have the full “judicial Power” granted district court judges under section 2 of Article III of the Constitution. Cases from *Northern Pipeline* to *Stern* to *Wellness International* have struggled with exactly what types of cases require decision by a judge holding the “judicial Power,” and what cases can be referred, and decided, by judges who do not wield the “judicial Power.”

That debate has consumed much paper and ink (and electrons). I do not wish to wade into that debate here. No one doubts that Congress could not create a court, give it jurisdiction over traditional equitable cases, and then fail to give the judges of that court all of the protections of Article III. Accordingly, Congress created a bankruptcy statute using its powers under the Constitution’s bankruptcy clause, and then vested jurisdiction over that statute in the district courts, courts which have the full “judicial Power [over] all Cases, in Law and Equity.” District courts are courts with equitable powers with initial bankruptcy jurisdiction. These courts may, but are not compelled, to refer this power to the bankruptcy judges in their districts.

**Bankruptcy Courts as "Courts"**

Under the delegation permitted by section 157(a), bankruptcy judges can, according to title 28, make final decisions on matters of statutory bankruptcy law (at least to the extent that the provision does not usurp or overlap a cognate common law doctrine). That is the essence of section 157(b)’s grant of the power to bankruptcy judges to “hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11.” This power is supplemented by section 151(a):

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27 Although I argue that this is what Congress likely has done in 11 U.S.C. § 502(b)(1). See TAN xxx infra.

Matters arise in a case if the proceeding involves the administration and structuring of the estate (e.g., attorney fee application; order confirming plan; borrowing order) that would have no existence but for the bankruptcy case. *See In re Wood*, 825 F.2d 90, 97 (5th Cir. 1987); *Dall v. Bank One*, Chicago (In re Dally), 202 B.R. 724 (Bankr. N.D. Ill. 1996).
Each bankruptcy judge, as a judicial officer of the district court, may exercise the authority conferred under this chapter with respect to any action, suit, or proceeding and may preside alone and hold a regular or special session of the court, except as otherwise provided by law or by rule or order of the district court.30

So bankruptcy judges can make binding rulings on core matters31 such as motions related to the automatic stay or as to the scope of the discharge, matters alien to the common law but commonplace under the Code. These binding rules are subject to appeal, not de novo review, and thus factual findings, for example, are subject to clearly erroneous standard of review.32 The powers granted to bankruptcy judges do not stop there. Congress realized that bankruptcy judges would have to, in the exercise of their duties, decide matters that were not statutory — the amount owed to a creditor, or the existence of a perfected lien. Bankruptcy judges were given the power to “hear,” but not determine, these matters, under the so-called “related” matter jurisdiction.33 The statutory norm is that these matters are to be the subject of a bankruptcy judge’s report and recommendation to the district court, which the district court would review de novo, even to the extent the report examined and resolved factual matters in reaching its recommendation.34 After Wellness International, however, many (if not most) of these related matters are heard and determined by consent of the parties, so that appeal would be the proper method of review.35

As a result, bankruptcy judges can finally determine some matters, even without the advance consent of the parties bound. Add to that the power to compel testimony,36 and thus a collection of bankruptcy judges in a district has sufficient attributes of a “court.”

“Inherent” Powers of Courts

Not everything a bankruptcy judge does is specified by statute. From ordinary aspects such as hours of operation, to everyday matters such as specifying who can appear, to the extraordinary power of contempt, many aspects of what bankruptcy judges do is not specified by statute. For courts other than bankruptcy court, the powers not specifically granted are often collectively referred to as “inherent” powers. Do bankruptcy judges have those powers?

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31 Congress specified core matters in 28 U.S.C. § 157(b)(2)(A)-(P). The Supreme Court has already determined that this list is over broad to the extent that a compulsory counterclaim to an action brought by the estate is a claim that can be decided only by a court possessing the judicial power of the United States. Stern v. Marshall, 564 U.S. 462 (2011).
32 Under Bankruptcy Rule 7052, as supplemented by Bankruptcy Rule 9014(c), all factual findings in adversary proceedings and contested matters are subject to Fed. R. Civ. P. 52. That rules states that: “Findings of fact, whether based on oral or other evidence, must not be set aside unless clearly erroneous, and the reviewing court must give due regard to the trial court’s opportunity to judge the witnesses’ credibility.” Fed. R. Civ. P. 52(a)(6).
35 This outcome is anticipated by the statute. It provides that “the district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to a bankruptcy judge to hear and determine . . . .” 28 U.S.C. § 157(c)(2)
Inherent Powers of District Courts

The Supreme Court addressed federal courts’ “inherent power” to manage their dockets and enforce their orders in *Chambers v. NASCO, Inc.* 37 There, Chambers was the sole shareholder of a company involved in nasty contract litigation with NASCO. During the litigation, Chambers misbehaved in numerous ways. He tried to deprive the court of jurisdiction by selling the property subject to the contract to a third party, defied a preliminary injunction directing him to allow NASCO to inspect corporate records, and, with the help of his attorney, filed meritless motions and pleadings along with other delaying tactics. 38

After losing an appeal in the initial litigation, Chambers found himself before the district court on remand having to answer for his misdeeds. Although the district court refused to impose sanctions under 28 U.S.C. § 1927 or Federal Rule of Civil Procedure 11, it did impose sanctions under its inherent power for Chambers’ bad faith conduct. 39 And the damages were were significant. The district court awarded NASCO all of its attorneys’ fees and costs, totaling close to $1 million.

The Supreme Court affirmed. In doing so, the Court relied on tradition and necessity to find some power for the court to perform its duties. The Court stated, “[i]t has long been understood that ‘[c]ertain implied powers must necessarily result to our Courts of justice from the nature of their institution, ‘powers’ which cannot be dispensed with in a Court, because they are necessary to the exercise of all others.’” 40 According to the Court, “[t]hese powers are ‘governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases.’” 41

What are these powers? Historically, they have included the power to regulate appearances before the court (including the power to deny, permanently or temporarily, the privilege of attorneys to appear before a court) 42 and the power of contempt. 43

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39 Chambers v. NASCO, 501 U.S. 32, 41-42 (1991). Rule 11 could not be used, since Chambers had not signed any documents. Section 1927 only applies to attorneys, and so it was also unavailable.
42 The power is one which ought to be exercised with great caution, but which is, we think, incidental to all Courts, and is necessary for the preservation of decorum, and for the respectability of the profession.


43 The power to punish for contempts is inherent in all courts; its existence is essential to the preservation of order in judicial proceedings, and to the enforcement of the judgments, orders, and writs of the courts, and consequently to the due administration of justice. The moment the courts of the United States were called into existence and invested with jurisdiction over any subject, they became possessed of this power.

Ex parte Robinson, 86 U.S. 505, 510 (1873) (Field, J.) In United States v. Hudson and Goodwin, 11 U.S. (7 Cranch) 32, 34 (1812), the Court held that inherent powers, under the name of contempt, did not extend to crimes not specified by statute or recognized at common law, but nonetheless said that:
Inherent Powers of Bankruptcy Judges

Do bankruptcy judges enjoy similar inherent powers? Since *Chambers*, the Supreme Court has toyed with the issue. In *Marrama v. Citizens Bank of Massachusetts*, for example, the Court was faced with a chapter 7 debtor’s arguable bad faith attempt to convert his case to one under chapter 7, a conversion that would have reclaimed control of his assets and arguably protected him from claims of repetition fraudulent transfers. The chapter 7 debtor argued that the Code gave him the absolute right to convert. After all, section 706(a) states that “The [chapter 7] debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time . . . .” a right congressional history characterized as “absolute.”

The *Marrama* majority relied primarily on the “abuse of process” language contained in section 105.

the broad authority granted to bankruptcy judges to take any action that is necessary or appropriate “to prevent an abuse of process” described in § 105(a) of the Code, is surely adequate to authorize an immediate denial of a motion to convert filed under § 706 in lieu of a conversion order that merely postpones the allowance of equivalent relief and may provide a debtor with an opportunity to take action prejudicial to creditors.

But the Court hinted at an alternate holding based upon inherent authority. The argument was sparse but complete:

Indeed, . . . even if § 105(a) had not been enacted, the inherent power of every federal court to sanction “abusive litigation practices,” . . . . might well provide an adequate justification for a prompt, rather than a delayed, ruling on an unmeritorious attempt to qualify as a debtor under Chapter 13.

But the brevity of the observation, combined with its less-than-unequivocal “might well provide” qualification left the issue unsettled.

The Court’s reticence to declare inherent powers in bankruptcy judges surfaced again in *Law v. Siegel*, a case in which a fraudulent debtor tried to hornswoggle the court into believing in phantom mortgages to save his house. After much wasteful litigation, Law’s frustrated trustee sought to surcharge Law’s homestead to pay for his excessive and unjustified attempts to

Certain implied powers must necessarily result to our Courts of justice from the nature of their institution. . . . To fine for contempt—imprison for contumacy—inform the observance of order, &c. are powers which cannot be dispensed with in a Court, because they are necessary to the exercise of all others: and so far our Courts no doubt possess powers not immediately derived from statute . . . .

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perpetuate his fraud. The lower courts agreed, but the Court took the case, ruling for Law primarily on the basis that nothing in the Code permitted a trustee to surcharge a state-law provided homestead.

In its analysis, the Court flirted with declaring bankruptcy judges had inherent powers. It twice referred to inherent powers of bankruptcy courts, but each time conditioned the bankruptcy court’s possession of inherent powers with “may” — language indicating that the issue has not yet been decided.50

Despite the Court’s dithering, many lower courts have found that bankruptcy courts have inherent powers similar to those held by district courts.51 But some have not. In particular, some article III courts have questioned as to whether Congress’ designation of the bankruptcy judges in a district as a “court” is accurate. In re Hipp is the most famous. There, the court stated it was unsure even that today’s bankruptcy courts are “courts” in a generic sense not defined strictly by Article III. . . . In short, today’s bankruptcy courts are arguably at least as much like magistrates or even administrative agencies as they are like other non-Article III courts.52

The Seventh Circuit Court of Appeals echoed this sentiment after Stern. In Ortiz v. Aurora Health Care, Inc. (In re Ortiz),53 Aurora, a medical health care provider, had filed over 3,200 proofs of claim against Wisconsin-based debtors. Each of these proofs of claim allegedly violated the medical privacy rights of the debtors under Wisconsin law. The bankruptcy judge found clear violations, and entered summary judgment against Aurora. A direct appeal to the Seventh Circuit was taken.

The Seventh Circuit dismissed for lack of jurisdiction. Key to its dismissal was that the case involved application of Wisconsin law, something that the Seventh Circuit believed Stern required the “judicial Power” to decide. Since bankruptcy judges do not possess the “judicial Power,” the bankruptcy judge’s decision regarding Wisconsin law unconnected to bankruptcy was not supported by the Constitution, and was no more an order that could be appealed from than some jottings on a paper bag.

When the alternate argument was made that the bankruptcy court had the inherent power to regulate its claims docket by sanctioning someone who filed proofs of claim that violated state law, the Seventh Circuit was unimpressed.

Aurora argues that the debtors’ claims are different than Vickie’s counterclaim [in Stern] because the debtors’ claims go to the heart of the

50 Cf. Law v. Siegel, 571 U.S. 415, 421 (2014) (stating that bankruptcy court “may also possess ‘inherent power . . . to sanction “abusive litigation practices.”’” (emphasis supplied)), and id. at 427 (“The court may also possess further sanctioning authority under either § 105(a) or its inherent powers.”) (emphasis supplied).

51 See, e.g., Gowdy v. Mitchell (In re Ocean Warrior, Inc.), 835 F.3d 1310, 1316–17 (11th Cir. 2016) (“Civil contempt power is inherent in bankruptcy courts since all courts have authority to enforce compliance with their lawful orders.”); Mapother & Mapother, P.S.C. v. Cooper (In re Downs), 103 F.3d 472, 477 (6th Cir. 1996) (“Bankruptcy courts, like Article III courts, enjoy inherent power to sanction parties for improper conduct.”).


53 665 F.3d 906 (7th Cir. 2011).
bankruptcy judge’s management of its Chapter 13 cases. Every court, it maintains, has authority to resolve disputes claiming that the way one party acted in the course of the court’s proceedings violated another party’s rights. Yet Aurora assumes that bankruptcy judges are akin to Article III judges by citing cases involving not legislative courts but Article III courts.54

Although the Seventh Circuit did not state so explicitly, its last sentence certainly leaves the impression that inherent powers of regular courts should not be assumed to inhere in “legislative” courts such as those comprised of bankruptcy judges. More recently, the Ninth Circuit Court of Appeals faced the issue of whether a bankruptcy appellate panel was a “court established by Act of Congress.”55 In In re Ozenne, a majority held it was not (and thus found it had no powers under the All Writs act to deal with a mandamus issue). The opinion was later neutered by an en banc opinion finding jurisdiction did not exist even if the bankruptcy appellate panel was a court, and thus the court evaded the issue.56 The initial opinion, however, was not “depublished,” leaving its logic for another day. These cases may well be outliers. As stated in Collier on Bankruptcy: “The majority of cases conclude that all courts, whether created pursuant to Article I or Article III of the Constitution, have inherent civil contempt power to enforce compliance with their lawful judicial orders, and no specific statute is required to invest a court with civil contempt power.”57 But, as shown by Hipp, Ortiz and Ozenne, doubt remains.

Section 105 and Contempt

Of course in bankruptcy, there is also section 105. Subsection (a) of that statute states that:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.58

Section 105’s text would seem to grant to bankruptcy courts the powers generally bundled up and referred to as the inherent powers, including the contempt power.59 Indeed, many courts

54 Ortiz v. Aurora Health Care, Inc. (In re Ortiz), 665 F.3d 906, 913 (7th Cir. 2011).
55 In re Ozenne, 818 F.3d 514 (9th Cir.), reh’g en banc granted, 828 F.3d 1012 (9th Cir. 2016), and on reh’g en banc, 841 F.3d 810 (9th Cir. 2016), cert. denied sub nom. Ozenne v. Chase Manhattan Bank, 137 S. Ct. 1589(2017).
56 In re Ozenne, 841 F.3d 810 (9th Cir. 2016) (en banc), cert. denied sub nom. Ozenne v. Chase Manhattan Bank, 137 S. Ct. 1589 (2017).
57 2 COLLIER ON BANKRUPTCY ¶ 105.02[1][a] (Richard Levin & Henry Summers, eds., 2019). As stated in a recent case from the Eleventh Circuit: “Accordingly, any court—bankruptcy court included—has inherent powers to punish contempt against it, as a means of protecting itself as an institution.” Green Point Credit, LLC v. McLean (In re McLean), 794 F.3d 1313, 1324 (11th Cir. 2015).
59 See, e.g., Alderwoods Grp., Inc. v. Garcia, 682 F.3d 958, 967 n.18 (11th Cir. 2012) (“Civil contempt power is inherent in bankruptcy courts since all courts have authority to enforce compliance with their lawful orders.”) (citation omitted); Joubert v. ABN Mortg. Group, Inc. (In re Joubert), 411 F.3d 452, 455 (3d Cir. 2005) (stating that section 105 provides bankruptcy courts with a contempt remedy); Jones v.
have looked at section 105 and found that it preserves (if you believe in inherent powers)\textsuperscript{60} or grants (if you are a textualist) at least civil contempt power to bankruptcy courts.\textsuperscript{61} And this residual contempt power is used to justify such actions as remedying discharge violations to levying fines on errant lawyers to penalizing creditors for noncompliance with the Bankruptcy Rules.\textsuperscript{62}

Section 105 could, however, be broader. For one thing, it does not specifically grant express contempt powers to bankruptcy judges — something Congress thought necessary or appropriate for non-Article III magistrate judges. Section 636(e) of title 28 states that:

(1) In general.—A United States magistrate judge serving under this chapter shall have within the territorial jurisdiction prescribed by the appointment of such magistrate judge the power to exercise contempt authority as set forth in this subsection.\textsuperscript{63}

\begin{itemize}
\item \textsuperscript{60} The inherent powers of federal courts are those which “are necessary to the exercise of all others.” United States v. Hudson, 7 Cranch 32, 34, 3 L.Ed. 259 (1812). The most prominent of these is the contempt sanction, “which a judge must have and exercise in protecting the due and orderly administration of justice and in maintaining the authority and dignity of the court . . . .”
\item \textsuperscript{61} See, e.g., Alderwoods Grp., Inc. v. Garcia, 682 F.3d 958, 967 n.18 (11th Cir. 2012) (“Civil contempt power is inherent in bankruptcy courts since all courts have authority to enforce compliance with their lawful orders.”) (citation omitted); Price v. Lehtinen (In re Lehtinen), 564 F.3d 1052, 1058 (9th Cir. 2009); Joubert v. ABN Mortg. Group, Inc. (In re Joubert), 411 F.3d 452, 455 (3d Cir. 2005) (stating that section 105 provides bankruptcy courts with a contempt remedy); Jones v. Bank of Santa Fe (In re Courtesy Inns, Ltd., Inc.), 40 F.3d 1084, 1089, 32 C.B.C.2d 498, 506 (10th Cir. 1994) (“We believe, and hold, that [Section] 105 intended to imbue the bankruptcy courts with the inherent power recognized by the Supreme Court in [Chambers v. NASCO, Inc., 501 U.S. 32, 111 S. Ct. 2123, 115 L. Ed. 2d 27 (1991)].”); Mapother & Mapother, P.S.C. v. Cooper (In re Downs), 103 F.3d 472, 477 (6th Cir. 1996) (“Bankruptcy courts, like Article III courts, enjoy inherent power to sanction parties for improper conduct.”).
\item \textsuperscript{62} See 2 COLLIER ON BANKRUPTCY ¶ 105.02[6][b] (Richard Levin & Henry Sommers, eds., 16th ed. 2019).
\item \textsuperscript{63} 28 U.S.C. § 636(e)(1).
\end{itemize}
This power includes “the power to punish summarily by fine or imprisonment, or both, such contempt of the authority of such magistrate judge constituting misbehavior of any person in the magistrate judge’s presence so as to obstruct the administration of justice,”64 as well as the ability to “exercise the civil contempt authority of the district court.”65

Scary Issues

Even if contempt powers were provided for bankruptcy judges by statute, there would remain a problem: to what extent are contempt and other inherent powers essential and nonassignable components of the judicial power of the United States? When viewed in this light, issues seemingly simple become maddeningly complex. Does a bankruptcy judge have the power to impose the broad range of penalties associated with the contempt power? In Chowdhury v Hansmeier,66 for example, the Minnesota Bankruptcy Judge had found parties in contempt for refusing to comply with post-judgment discovery, and, after many hearings, imposed a daily fine for compliance, to be paid to an opposing party. The bankruptcy court also ordered civil incarceration until compliance, but had prepared a report and recommendation for the district court judge. The District Court reversed the daily fine to the extent payable to a party (coercive fines, it noted, are payable only after certain findings are made, and then only into the court’s registry),67 but accepted the incarceration recommendation and issued warrants for the contemnors.68 Evidently, the bankruptcy court drew the line at jailing parties, but without any clear reason why, perhaps deciding that loss of physical freedom is something reserved to those wielding the judicial power of the United States.

This suggests that certain punitive sanctions, short of incarceration, might be permissible if specifically granted.69 For example, does it matter if any penalty imposed is specifically authorized by a text, such as Rule 9011? Does it matter if the penalty is authorized by text and relates to something that could only exist in bankruptcy? If a bankruptcy judge possess inherent powers, do those powers reach a limit if exercise of them results in a penalty authorized only by common law and not by statute?

Finally, and this is the scary, elemental issue, does the judicial power include the power to find facts that are entitled to deference by courts wielding the judicial power? That is, can a bankruptcy judge find malign intent, and have that finding reviewed under a clear error or clearly erroneous standard by a reviewing district judge? Have it respected in another action involving

64 28 U.S.C. § 636(e)(2). Significantly, the criminal contempt power is limited by paragraph (5) which states that “The sentence imposed by a magistrate judge for any criminal contempt provided for in paragraphs (2) and (3) shall not exceed the penalties for a Class C misdemeanor as set forth in sections 3581(b)(8) and 3571(b)(6) of title 18.” 28 U.S.C. § 636(e)(5).
69 See, e.g., Bessette v. Avco Financial Services, 230 F.3d 439, 445 (1st Cir. 2000) (noting that “bankruptcy courts across the country have appropriately used their statutory contempt powers [to award] actual damages, attorney fees, and punitive damages” for violations of § 524); In re Perviz, 302 B.R. 357, 372 (Bankr. N.D. Ohio 2003) (“Bankruptcy courts have the inherent power to punish parties for their contemptuous violation of the discharge injunction through the imposition of punitive damages.”); In re Vazquez, 221 B.R. 222, 231 (Bankr. N.D. Ill. 1998) (awarding punitive damages pursuant to § 105).
common facts? I leave these questions for another time, as the simple designation of a collection of bankruptcy judges as a “bankruptcy court” does not answer these questions. Nor, as will next be seen, does applying the modifier “of equity” to the term “court.”

Summary of the Powers of a Bankruptcy Judge

Bankruptcy judges from a particular district form a tribunal Congress designated as a court. Congress gave these judges the jurisdiction and power to decided matters of bankruptcy, a subject alien to the common law. Bankruptcy involves matters such as the application of the automatic stay to existing and potential litigation, and the vindication of the discharge; these courts can enter final orders in these matters, with their factual findings subject only to clearly erroneous review.

These collection of judges, these courts, have not only the specifically delegated powers in title 28, but also inherent powers to run their tribunals. Much as the Supreme Court has found that Congress, a non-judicial body, has inherent powers to achieve its goals, bankruptcy courts have inherent powers to run their courts. These powers either come from their very existence as a body or tribunal charged with administering the bankruptcy laws, or from referral by district courts — referrals provided for and blessed by Congress.

In addition, Congressionally-delegated bodies have given to bankruptcy courts the power to manage discovery, to compel testimony, and to take evidence, all subject to the same rules applicable to district courts.

EQUITY

As noted above, bankruptcy courts and their predecessors are often been called “courts of equity.” The “courts” part of that locution has been discussed above. The addition of the words “of equity” have lead to much discussion and debate.

One cause of this confusion is that “equity” does not have a unique or standard definition. A good start on the many definitions of equity is Professor Samuel Bray’s definition in *A Student’s Guide to the Meanings of “Equity.”* In this short piece, Professor Bray sets out three variations of the definition of equity:

- **equity, n.**
  1. The recognition of an exception to a general rule.
  3. The doctrines and remedies developed in the English courts of equity, especially the Court of Chancery.

I will take these in reverse order in an effort to discern whether bankruptcy courts are courts “of equity” as this definition describes.

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70 A bankruptcy judge, for example, could find a debt non dischargeable for fraud, but not liquidate the claim. One of the elements of fraud typically is injury. Would a state court in a later action in which the amount was at issue have to give issue preclusive effect to the bankruptcy court’s finding that there was injury? Or a court could find a home’s value fit within a homestead exception – what would be the issue preclusive effect on state taxing agencies of that finding of value?

Equity's Doctrines and Remedies

Professor Bray’s third definition of “equity” is that of “doctrines and remedies developed in the English courts of equity, especially the Court of Chancery.” In this sense, bankruptcy courts are indisputably courts of equity. This is shown by the scope of the definition of property of the estate, the definition of “claim,” and by the claims resolution process.

Upon commencement of a case, an estate is created. So says section 541(a). That estate, in turn, is comprised of “all legal or equitable interests of the debtor in property.” As a result, to the extent that the doctrines developed in equity create property rights, section 541(a)(1) transfers those property rights into the bankruptcy estate. They then within the exclusive jurisdiction of the bankruptcy court.

Bankruptcy courts not only have jurisdiction over the debtor’s equitable interests in property, but also over equitable claims that may be asserted against the debtor and the estate created by section 541(a). Section 101(5)’s definition of “claim” includes all “equitable” claims, and the discharges granted under the various chapters cover all “claims.”

Finally, Congress set up the claims resolution process to allow bankruptcy judges to apply equitable doctrines to defeat or reduce asserted claims, both in the allowance process and otherwise. Section 502(b)(1), for example, states that a bankruptcy judge may disallow a claim if “such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured.” One class of objections under nonbankruptcy law would be those objections a

72 “(a) The commencement of a case . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: [¶] (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.”


73 11 U.S.C. § 541(a)

74 An exception lies in section 541(d), which excludes any equitable interest in property from passing into the estate if the debtor held only legal title, without also possessing any equitable interest in the property to which the debtor held title. 11 U.S.C. § 541(d).

75 28 U.S.C. § 1334(e)(1) (district court has exclusive jurisdiction “of all the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate.”). This of course assumes that the district court has referred (and can refer) its jurisdiction over such property to the bankruptcy court under the referral authorization contained in 28 U.S.C. § 157(a).

76 11 U.S.C. §§ 727(b) (“a discharge under subsection (a) of this section discharges the debtor from all debts that arose before the date of the order for relief under this chapter, and any liability on a claim that is determined under section 502 of this title as if such claim had arisen before the commencement of the case”); 1141(d)(1)(A) (“the confirmation of a plan—[¶] (A) discharges the debtor from any debt that arose before the date of such confirmation,”); 1228(a) (“after completion by the debtor of all payments under the plan, . . . the court shall grant the debtor a discharge of all debts provided for by the plan, allowed under section 503 of this title, or disallowed under section 502 of this title”); 1328(a) (“as soon as practicable after completion by the debtor of all payments under the plan, . . . the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title”).

Section 101(12) states that “The term ‘debt’ means liability on a claim.”

77 11 U.S.C. § 502(b)(2)


nonbankruptcy court, sitting in or apply equity, could employ to reject the claim or reduce its
amount. Put another way, the broad phrasing of section 502(b)(1) gives a bankruptcy judge
access to the same panoply of reasons to disallow a claim as would be available to a state court
judge or a federal district court judge. This broad vesting of powers to decide claims on the
same basis as under nonbankruptcy law thus vests bankruptcy judge with the powers of a court
of equity, including invocation of such traditional equitable defenses as fraud, duress, and
mistake.

**Equity's Moral Readings**

Professor Bray’s second entry for equity is that of “[a] moral reading of the law.” I take this to
mean that a court, acting under this sense of “equity,” has the power to create rights and
remedies responsive to particular situations even though no legislation addresses it, and no
precedent supports it. The right or remedy responds to a need to adjust rights or expectations so
that relations or rights are just and fair. Professor Bray’s example is *Moses v. Macferlan,* in
which an endorser of four notes paid the amount of the notes into court, and then sought to
enforce an oral indemnity to compel return of the funds, as the indemnity was given to induce
him to give the endorsements in the first place. The endorser could not find a right at common
law or a remedy in a statute to address his particular case, but Judge Mansfield, speaking for
Kings’ Bench, nonetheless held that “the gist of this kind of action is, that the defendant, upon
the circumstances of the case, is obliged by the ties of natural justice and equity to refund the
money.” The *Restatement (Third) of Restitution and Unjust Enrichment* describes the
explanation of *Moses* as

> Explaining restitution as the embodiment of natural justice and equity gives
> the subject an undoubted versatility, an adaptability to new situations,
>
80 There is likely an argument here that, in some cases, only a court with the “judicial power of the
United States” could hear or determine such equitable claims. That argument, separate from whether a jury
should hear such claims, raises the issue of the effect of a disallowance on nonbankruptcy proceedings. If
all a bankruptcy judge is doing is determining who shares in property of the estate, that would seem to be
within the bankruptcy power allocated to Congress. If, however, there are affects outside of bankruptcy,
such as issue or claim preclusion against thirds parties, there are significant questions raised. See generally
Crowell v. Benson, 285 U.S. 22, 50-51 (1932) (upholding use of administrative agency fact-finder as
adjunct to district court); United States v. Raddatz, 447 U.S. 667, 682-84 (1980) (upholding use of
magistrates as adjunct to district court); see generally N. Pipeline Const. Co. v. Marathon Pipe Line Co.,
458 U.S. 50, 77 (1982) (plurality) (referring to *Crowell* and *Raddatz* as “cases in which we approved the
use of administrative agencies and magistrates as adjuncts to Art. III courts”). See also Wellness Intern.
Network, Ltd. v. Sharif:

> “If the judges should sit to hear ... controversies [beyond ...their cognizance], they
would not sit as a court; at the most they would be arbitrators only, and their ...
decision could not be binding as a judgment, but only as an award.”

**THOMAS M. COOLEY, A TREATISE ON THE CONSTITUTIONAL LIMITATIONS WHICH REST UPON THE**
**LEGISLATIVE POWER OF THE STATES OF THE AMERICAN UNION** 399 (1868)).

81 See 4 COLLIER ON BANKRUPTCY ¶ 502.03[2][b] (Richard Levin & Henry Sommer, eds., 16th


(in the eyes of many observers) a special moral attractiveness. Restitution in this view is the aspect of our legal system that makes the most direct appeal to standards of equitable and conscientious behavior as a source of enforceable obligations.84

Although this justification is legitimately objectionable given its arbitrary nature,85 there are circumstances in which bankruptcy courts are asked to apply similar standards, and thus can be considered courts of equity in this second sense. These circumstances include direct instructions from Congress for bankruptcy judges to reach equitable results. The most obvious example of this type of grant appears in section 510(c)(1). That section states that “the court may—¶(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . . ”86 This section allows a bankruptcy court to alter distributions based on the “principles of equitable subordination.” The legislative history to this section suggest that it essentially codified existing judge-made law,87 but also permitted courts, presumably courts sitting in bankruptcy, to continue to refine and shape these equitable principles.88 Indeed, the legislative history describes section 510(c) as “recogniz[ing] the inherent equitable power of the court under current law, and the practice followed with respect to contractual provisions.”89 Other provisions also grant equitable discretion to, more or less, “do the right thing” to bankruptcy judges. In particular, Congress included in the Code direction to bankruptcy judges to to make “equitable” divisions of estate and non debtor assets in such diverse cases as grain

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84 RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1, com. b (2011).
85 Id. (“In numerous cases natural justice and equity do not in fact provide an adequate guide to decision, and would not do so even if their essential requirements could be treated as self-evident.”).
88 124 Cong. Rec. 32,398 (1978) (statement of Rep. Edwards); and id. at 33,998 (statement of Sen. De Concini). In lieu of a Conference Report, members of Congress read virtually identical statements into both the House and Senate records on the bill that became current title 11. 124 Cong. Rec. 32,391 (1978) (statement of Rep. Rousselot). As noted at the time, Congress believed that this procedure imbued such remarks with “the effect of being a conference report.” Id. The Supreme Court has agreed with this characterization. See Begier v. IRS, 496 U.S. 53, 64 n.5 (1990) (“Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent.”).
storage\textsuperscript{90}, customer property in stockbroker liquidations,\textsuperscript{91} excess partnership assets,\textsuperscript{92} and community property.\textsuperscript{93}

Congress also conditioned the right to convert a case to chapter 12 on the conversion being “equitable.”\textsuperscript{94} Finally, the legislative history indicates that in fashioning adequate protection, an elemental concept in most bankruptcies, it was “expected that the courts will apply the concept [of adequate protection] in light of facts of each case and general equitable principles.”\textsuperscript{95} These are just a few of the instances of direct grant of equitable powers in this second, moral, sense.\textsuperscript{96}

**Equity's Exceptions to General Rules**

Professor Bray’s first example of “equity” — “[t]he recognition of an exception to a general rule” — is probably the sense of equity that most people think of when thinking about courts of equity. “Equity” in this sense is often heedlessly used to describe or justify deviation from the consequence of the application of an accepted rule or standard when the application would be deemed unjust or unfair. In its best application, however, it is a reflection of the notion that not all consequences of general rules can be anticipated, and when confronted with an unanticipated consequence, individual justice should trump the need to extend a brittle general rule.

\textsuperscript{90} 11 U.S.C. § 557(d)(2)(D).

\textsuperscript{91} 11 U.S.C. §§ 752(a). The Senate Report indicated that “[i]t is anticipated that the court will apportion such administrative claims on an equitable basis between the general estate and the customer property of the debtor.” S. Rep. 989, 95th Cong., 2d Sess. 103 (1978). See also 11 U.S.C. § 767(h), for which the House Report indicated that “Section 767(a) [enacted as section 766(h)] provides for the trustee to distribute customer property pro rata according to customers’ net equity claims. The court will determine an equitable portion of customer property to pay administrative expenses.” H.R. Rep. No. 595, 95th Cong., 1st Sess. 392 (1977).

\textsuperscript{92} 11 U.S.C. § 723(d). The Senate Report stated that “Subsection (d) provides for the case where the total recovery from all of the bankrupt general partners is greater than the deficiency of which the trustee sought recovery. This case would most likely occur for a partnership with a large number of general partners. If the situation arises, the court is required to determine an equitable redistribution of the surplus to the estate of the general partners.” S. Rep. 989, 95th Cong., 2d Sess. 95 (1978).

\textsuperscript{93} 11 U.S.C. § 726(c).

\textsuperscript{94} 11 U.S.C. § 1112(d). Indeed, initially Congress drafted the list of “causes” for a motion to dismiss or convert to be non-exhaustive, and open to equitable additions. “This list is not exhaustive. The court will be able to consider other factors as they arise, and to use its equitable powers to reach an appropriate result in individual cases.” S. Rep. 989, 95th Cong., 2d Sess. 117 (1978). See also H.R. Rep. No. 595, 95th Cong., 1st Sess. 406 (1977).


\textsuperscript{96} Other examples might include 11 U.S.C. § 523(d), in which a court assess attorneys’ fees and costs against a creditor who unsuccessfully seeks to declare a debt nondischargeable unless “special circumstances would make the award unjust.” As originally enacted, the statute read “clearly inequitable” instead of unjust; the legislative history gives no reason for the change.

I do not include section 1129(b)(1)’s requirement that a cramdown plan be “fair and equitable” as to a dissenting class. The history of the statute indicates that Congress first required nonconsensual plans to be “fair” and only added “and equitable” several years later as part of an effort to construct a statute that would mirror judicial decisions of that time. See Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 Emory Bankr. Dev. J. 92 (2016).
This sense of “equity” is ancient. Aristotle observed that “the very nature of the equitable [is] a rectification of law where law falls short by reason of its universality.”\footnote{NICOMACHEAN ETHICS 114 (Martin Ostwald, trans., 1962). The quotation is from Book Five, Chapter 10, 1137b, at lines 26-27. A more recent translation renders the line as: “This is the nature of what is decent, a setting straight of a law, insofar as it leaves something out as a result of being universal.” NICOMACHEAN ETHICS 100 (Joe Sachs, trans., 2002). Yet another translation is “[T]he nature of the equitable is a correction of law where it is defective owing to its universality.” NICOMACHEAN ETHICS 99 (D. Ross, transl., 2009). This latter translation was recently used by Justice Breyer. Petrella v. Metro-Goldwyn-Mayer, Inc., 572 U.S. 663, 688 (2014) (Breyer, J., dissenting).} In law, the “rectification” can manifest in many ways: clarifying an ambiguous statutory term; creating a new remedy for an acknowledged wrong;\footnote{E.g., Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944) (“The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case”).} or even developing a new right where none previously existed.\footnote{In the bankruptcy contest, one might look at first day motion practice in chapter 11, when many orders are entered not anticipated by the Code but deemed necessary to the success of the case, such as orders regarding payment of employees for prepetition periods or for roll-ups of repetition debt to be replaced by postpetition financing.} When a bankruptcy judge engages in any of these activities, the justification for the actions ultimately taken is often that the bankruptcy court is acting as a “court of equity.”

Discretion and Equity

One common thread in these activities is the exercise of discretion;\footnote{Similar to “equity,” there are many shades of meaning contained with “discretion,” including the quality of being discreet. The meaning stated in text is close to the definition 3b in Webster’s Unabridged Dictionary: “power of free decision or choice within certain legal bounds.”} that is, the taking of action or of a position when two or more choices are each reasonable, lawful and possible.\footnote{Coke famously discussed judicial discretion as follows:}

For discretion is a science or understanding to discern between falsity and truth, between wrong and right, between shadows and substance, between equity and colourable glosses and pretences, and not to do according to their wills and private affections; for as one saith, \textit{talis discretio discretionem confundit}.\footnote{Rooke’s Case, 5 Co. Rep. 99b, 77 Eng. Rep. 207 (C.P. 1598). Not all English judges saw discretion in such even terms. Lord Camden is reported to have said:}

The Discretion of the Judge is the Law of Tyrants; it is always unknown; it is different in different Men; it is casual, and depends on the Constitution, Temper, and Passion. In the best, it is oftentimes Caprice, in the worst it is every Vice, Folly and Passion to which Human Nature is liable.

\textbf{LORD CAMDEN’S ARGUMENT IN} \textit{DOE, ON THE DEMISE OF HINDSON & UX, ET. AL. V KERSEY, WHEREIN LORD MANSFIELD’S ARGUMENT IN WYNDHAM V. CHETWYND IS CONSIDERED AND ANSWERED} 53 (1766).

Chief Judge Marshall impliedly rejected Lord Camden’s view. In Osborn v. Bank of the United States, 22 U. S. 738, 866 (1824), he said:

Judicial power, as contradistinguished from the power of the laws, has no existence. Courts are the mere instruments of the law, and can will nothing. When they are said
In bankruptcy the discretion to act is, well, complicated. As noted above, we can start with the proposition that bankruptcy judges have certain powers to act, some of which are delegated by district courts, some of which are inherent.

**Discretion Limited By the Source of Jurisdiction: The Boundaries Set By the Code**

But the power to act does not provide the rules to apply. In bankruptcy, those rules come from acts of Congress, such as title 11 and the jurisdictional provisions of title 28. As noted since Aristotle, however, positive law often is less than complete. If equity exists to fill the gaps necessary to achieve the goals of positive law, then bankruptcy judges should have equity powers to achieve the goals of title 11 and related statutes. Although simply stated, this is a tough proposition to maintain, given the catholic reach of bankruptcy over every aspect of a debtor’s financial life, and given the sometimes discordant provisions and goals of title 11.

But a bankruptcy judge’s equity power in these areas — the power to create exceptions to the general rules of title 11 — rises or falls on the breadth of the corpus of text and rules to be applied. A bankruptcy judge, indeed even a judge invested with the judicial power, does not have the power to enter orders contrary to express provisions of title 11. As stated by the Supreme Court, “[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”\(^\text{102}\) In section 105(a), which is part of the Code, however, Congress permitted courts to enter orders in aid of their bankruptcy jurisdiction. This recursive incorporation of powers and jurisdiction beyond the Code’s operative sections gives rise to questions of how far a court can go to achieve an “equitable” result.

The mediation between these two propositions thus far has been the province of statutory interpretation. How far a court can go to reach a just or fair result in the absence of text prohibiting the desired result is an issue of the scope of the shadow cast by the text itself. The Court recently took this approach in *Law v. Siegal*.\(^\text{103}\) In that case, Law, a debtor, had fabricated a fictitious deed of trust on his house to preclude Siegal, his chapter 7 trustee, from selling the house and distributing to Law’s creditors the excess of sales proceeds over Law’s homestead exemption. Siegal discovered the fabrication and avoided the fraudulent mortgage, but only after much litigation. The trustee, much aggrieved by the debtor fraudulent actions, sought to surcharge Law’s statutory homestead exemption. There was no basis in section 522, the section governing exemptions permitting such a surcharge.

The lower courts approved the surcharge. The Court reversed. It saw no room for equity-influenced exceptions to a detailed statutory scheme. As the Court stated: “The Code’s meticulous—not to say mind-numbingly detailed—enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exceptions.”\(^\text{104}\) In short, the Court was convinced that there were no gaps in coverage, no room to reach a just result since Congress presumably had thought about the total coverage already. On this point, the

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\(^{103}\) 571 U.S. 415 (2014).

Court was clear. Siegal had “suggest[ed] that [some lower court] decisions reflect[ed] a general, equitable power in bankruptcy courts to deny exemptions based on a debtor’s bad-faith conduct. For the reasons we have given, the Bankruptcy Code admits no such power.”

Law relied much on Congress “meticulous” scheme to find no room for equity to create exceptions. But simple schemes also can preclude individual exceptions. In *Popular Auto, Inc v. Reyes-Colon (In re Reyes-Colon)*, creditors had been long pursuing a slippery debtor. The problem was that only two creditors filed the involuntary, and those creditors could not obtain other parties to join. After many years of litigation, the bankruptcy court found that the debtor had more than 11 creditors, but the creditors sought an exception for “special circumstances.” Relying on Law, the First Circuit denied the request. As it stated:

“[T]he Supreme Court held that bankruptcy courts “may not contravene specific statutory provisions” when they exercise their statutory and inherent powers. . . . The Court acknowledged that its holding “may produce inequitable results for trustees and creditors in other cases,” but recognized that Congress, in creating the Bankruptcy Code, “balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions visit on creditors.” . . . [Law] forecloses employing equity to waive this plain statutory requirement.106

**The Range of Permissible Discretion and Equity**

Although the Code is a hard boundary on equitable discretion in bankruptcy, there is still space in which a court can legitimately find exceptions to general rules. Given the nature of equity, and the breadth of bankruptcy, a detailed and definitive outline may not yet be possible, but areas in which exceptions can legitimately be made can be sketched. In particular, equitable discretion can be exercise when necessary to correct errors caused by the court system itself, when courts and counsel work to achieve bankruptcy goals through methods and practices not explicitly provided in the Code, and even when new rights are necessary to achieve specific goals of the Code. I explore instances of each of these below.

**Obvious Uses of Equity to Create Exceptions: Correcting Court-Induced Errors**

The most obvious exception courts can make to general rules is when compliance with the rules is thwarted or precluded by mistakes or errors that the court itself makes. Under these circumstances, almost all courts permit exceptions to rules regarding claim filing deadlines if the late filing is due to a error of the court or the court clerk.107 As stated by the Ninth Circuit, “[t]he equitable power given to courts by 11 U.S.C. § 105(a) would be meaningless if courts were

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105 922 F.3d 13 (1st Cir. 2019).
106 Id. at 21-22. See also Sunbeam Prod., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 375 (7th Cir. 2012) (“What the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be ‘inequitable.’”).
unable to correct their own mistakes.”108 In short, “bankruptcy courts may call upon principles of equity to shield unwitting parties and correct their own errors.”109

**Tolerable Uses of Equity to Create Exceptions: Fashioning Better Remedies for Existing Rights**

Beyond equitable powers to correct mistakes, the analysis becomes less uniform. But courts and counsel have use equity’s exceptions to fashion procedures and practices designed to implement the Code’s policies while not being explicitly stated. In particular, and with no real surprise, many of these exceptions deal with paying lawyers’ fees.

In one sense, the self-interest of lawyers is no surprise. In another, however, good lawyering permits the bankruptcy system to operate more efficiently, and thus it is in the interest of bankruptcy court to ensure that rigid rules do not preclude ethical and efficient lawyers from being paid for their services. Two practices are useful to examine: so called “nunc pro tunc” approvals of employment; and interim fee orders in large chapter 11 cases.

It is generally accepted that no lawyer may be paid from estate funds until his or her employment is approved by the court as consistent with section 327 of the Code. If followed literally, however, courts in cases of any size would be inundated with employment applications on the first day, and lawyers might not work on cases until those applications were approved. As a consequence, courts often retroactively approve employment applications at least to the date of filing, if not to an earlier date when work commenced.110 This exception to the general rule of “no approval/no pay” has much to commend it, and little to nothing to object to, especially if the application is on notice to parties in interest. It is an exception that thus make sense.111

Another practice is similar, although not as uncontroversial. In large chapter 11 cases, firms representing the debtor and committees will often incur time and costs in excess of millions per

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109 Ward v. Yaquinto (In re Ward), 585 B.R. 806, 819 (N.D. Tex. 2018). See also Francis v. Riso (In re Riso), 57 B.R. 789, 793 (D.N.H. 1986) (“[A] bankruptcy court cannot create substantive rights in exercising its equity powers... Allowing [the creditor] to go forward with his objection, however, will not create a substantive right ... but merely allow him to exercise that substantive right.”).

110 See, e.g., In re Jarvis, 53 F.3d 416, 419-420 (1st Cir. 1995) (“In light of the purposefully nonmechanical nature of equity, we think it is appropriate that bankruptcy courts should be permitted to entertain post facto applications for professional services under section 327(a).”). See also

111 Often, this nunc pro tunc standard is modified if the application is made long after the work started. In In re Arkansas Co., Inc., 798 F.2d 645, 650 (3d Cir.1986), the court noted the following factors for approval of such a process: 1) whether the applicant or some other person bore responsibility for applying for approval; 2) whether the applicant was under time pressure to begin service without approval; 3) the amount of delay after the applicant learned that initial approval had not been granted; 4) the extent to which compensation to the applicant will prejudice innocent third parties; and 5) other relevant factors. See also Lazo v. Rose Hill Bank (In re Schupbach Investments, L.L.C.), 808 F.3d 1215, 1220 (10th Cir. 2015); In re Sedgwick, 560 B.R. 786, 795 (C.D. Cal. 2016).

Most courts that have addressed the issue have held that ignorance, negligence, and oversight do not constitute extraordinary circumstances. See 2 Collier on Bankruptcy ¶ 327.03[3] (Richard Levin & Henry J. Sommer eds., 16th ed. 2019).
month. Section 331 of the Code, however, would seem to set up a rule generally that fee applications should be limited to one every three months, although there is an exception if the court approves, and if the fees are approved by appropriate hearings. This, however, often works a hardship on firms engaged in these representations. As a result, many courts will enter so-called “Knudsen” orders, under which firms submit bills on a monthly basis which are paid at 80%-90% of their face amount without court approval, subject to quarterly interim fee applications under which the “retainage” is approved and paid. The case upon which such orders are based, *U.S. Trustee v. Knudsen Corp. (In re Knudsen Corp.)*, placed the following limitations on this practice:

However, in the rare case where the court can make the following findings, a fee retainer procedure like the one here may be authorized:

1. The case is an unusually large one in which an exceptionally large amount of fees accrue each month;
2. The court is convinced that waiting an extended period for payment would place an undue hardship on counsel;
3. The court is satisfied that counsel can respond to any reassessment in one or more of the ways listed above; and
4. The fee retainer procedure is, itself, the subject of a noticed hearing prior to any payment thereunder.

Note that this procedure allows for payment to a professional without court approval. That feature has drawn criticism that the procedure is “illegal.” But similar to the nunc pro tunc

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113 These methods were outlined by the court as follows:

The ability to recover fees may be assured by a variety of methods including, without limitation, the following:

- retainer payments are for only a percentage of the amount billed so that the likelihood or necessity of repayment is minimal;
- counsel can post a bond covering any possible reassessment;
- counsel’s financial position makes it certain that any reassessment can be repaid;
- funds paid prior to allowance are held in a trust account until a final or interim fee allowance is made.

*Id.* at 672.


At least one court has declined to routinely adopt these procedures. In re Haven Eldercare, LLC, 382 B.R. 180 (Bankr. D. Conn. 2008).

orders, the various means of ensuring that their is no discrepancy between what the court ultimately approves and what was paid — generally enforced through holdbacks of 20% to 30% — achieves the Code’s goals of ensuring that all fees and expenses paid for by the estate are, as required by section 330, reasonable and necessary. It assumes that most professionals are honest, and that not every penny need be accounted for before payment; assumptions that are not unreasonable and, most importantly, do not impair achievement of the goal of ensuring that fees and expenses paid are reasonable.

These are, of course, equitable concerns. The “rule,” although not expressly stated, is that nothing gets paid until the court approves everything; that, however, is impractical. If enforced strictly, the system would be less efficient and less able to meet the goal of reorganization though chapter 11. It is an example of not creating new rights, but rather adapting implementation of a rule to meet practical needs after consideration the ultimate interests of all parties. It is designed to ensure that, at the end of the process, the result is the same as if the rule were strictly followed. In short, it is an example of how equity modifies remedies — the fee approval process — in ways unspecified in the Code while at the same time leaving rights — that no professional is paid more than what is reasonable — unimpaired.

**Debatable Uses of Equity to Create Exceptions: New Rights**

There is little support for creating new rights as a consequence of making equitable exceptions. As aptly and famously put by one court, section 105 and equity powers do not “authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.”

It is tautological that rights, once created, are durable; they apply to all instances for which they were created. And they may be fair or just. But rights tend to be universal — by definition, they cover all instances of a specified action or situation — and thus are subject to the same objection and need for exceptions that Aristotle saw long ago. A right created as an exception to a rule may itself require exceptions within that exception to yield fair and just results.

In bankruptcy, this inherent limitation operates within the larger limitation of the Code itself; as indicated above, equity is restrained in bankruptcy by the Code’s text and by the outcomes that text implements. A key example of this limitation has been the use of equitable subordination under section 510(c). As examined above, this is an area in which Congress has given courts the power to define the scope of subordination. This power, however, is not plenary. The Supreme


116 United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); see also Willms v. Sanderson, 723 F.3d 1094, 1103 (9th Cir. 2013) (“More generally, § 105(a) is not a ‘roving commission to do equity.’” quoting Pac. Shores Dev., LLC v. At Home Corp. (In re At Home Corp.), 392 F.3d 1064, 1070 (9th Cir. 2004) and Saxman v. Educ. Credit Mgmt. Corp. (In re Saxman), 325 F.3d 1168, 1175 (9th Cir. 2003)); Jamo v. Katahdin Fed. Credit Union (In re Jamo), 283 F.3d 392, 403 (1st Cir. 2002) (“But section 105(a) does not provide bankruptcy courts with a roving writ, much less a free hand. The authority bestowed thereunder may be invoked only if, and to the extent that, the equitable remedy dispensed by the court is necessary to preserve an identifiable right conferred elsewhere in the Bankruptcy Code.”); 2 COLLIER ON BANKRUPTCY ¶¶ 105.01[2], .05 (Richard Levin & Henry Sommers, eds., 16th ed. 2019). For a possibly contrary, though generally disfavored, view as to the expansiveness of the power under section 105(a), see Sears, Roebuck & Co. v. Spivey, 265 B.R. 357, 371 (E.D.N.Y. 2001) (“Section 105 of the Bankruptcy Code bestows on bankruptcy courts a specific equitable power to act in accordance with principles of justice and fairness. Bankruptcy courts have broad latitude in exercising this power.”).
Court said as much in *United States v. Noland*, 117 a case that indicated a restricted scope for section 510(c). In *Noland*, the lower courts had subordinated payment of an administrative claim — a nonpecuniary tax loss penalty claim — which had arisen upon conversion of the case from a chapter 11 case to one under chapter 7. 118 This was “equitable” in that the amount of the claim did not represent any loss to the governmental taxing authority, and was a penalty designed with nonbankruptcy situations in mind. Further, every dollar paid to the tax collector was a dollar taken away from holders of prepetition claims. As stated by the Sixth Circuit:

> The essence of bankruptcy is equity. . . . We do not see the fairness or the justice in permitting the Commissioner’s claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. . . . To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. 119

The Supreme Court nonetheless reversed. As it stated the issue:

> The answer turns on Congress’s probable intent to preserve the distinction between the relative levels of generality at which trial courts and legislatures respectively function in the normal course. . . . But if the provision also authorized a court to conclude on a general, categorical level that tax penalties should not be treated as administrative expenses to be paid first, it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place. That is, the distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception. We find such a reading improbable in the extreme. 120

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118 The Sixth Circuit held that “[b]ecause of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordinations.” *United States v. Noland (In re First Truck Lines, Inc.),* 48 F.3d 210, 218 (6th Cir. 1995), *rev’d sub nom. United States v. Noland,* 517 U.S. 535 (1996). Given the postpetition nature of the claim, it would thus be entitled to payment in full as an administrative claim before any payment would be made to creditors holding prepetition claims.
In short, a court cannot alter a legislature’s judgment on the relative fairness of a statutory priority scheme.\(^{121}\)

But can a court alter or adjust a right if that action does not alter the scheme? The issue has arisen in so-called “equitable disallowance” or “recharacterization” of claims. This issue arises when insiders denominate funds transferred to a debtor as “debt,” thereby allowing them to argue that the insiders should be able to share pro rata with other creditors upon insolvency. Other creditors, who had no say in the initial characterization, object, raising traditional notions of equity holders’ risks and rewards.

Some courts have found a federal source for the disallowance of such insider claims based on “equity.” Others have denied that any federal right could exist, reasoning that section 502 contains no such grounds for disallowance, and that any alteration of a nonbankruptcy right automatically alters the distribution scheme Congress drafted.

Based on the above, it would seem that no such manner of disallowance would be permitted. But that may be a brittle application. In *Whither Recharacterization*,\(^{122}\) Dean Lawrence Ponoroff dismantles this argument. First, it may very well be that equitable recharacterization is a recognized doctrine under nonbankruptcy law used by nonbankruptcy courts to reduce or eliminate claims to an insolvent’s res.\(^{123}\) That would nestle with Congress grant of equitable powers to courts in section 502(b)(2).\(^{124}\) It also may be that an argument could be made for “no fault” equitable subordination as an anticipated and permitted extension of the law when section 510(c) was enacted in 1978.\(^{125}\) This would also be consistent with congressional efforts to bestow particular types of equitable discretion in discrete cases.\(^{126}\) [see above]

The general conclusion is that no maxim is without exception, which again draws on Aristotle’s ancient observation of equity’s essence. The intricate and labyrinthian construction of the Code — with its outright grants of equitable power in section 502(b)(2), to its incorporation of the power to protect jurisdiction in section 105 — provides legitimate grounds for many practice and procedures not explicitly set down in the Code’s text. These legitimate avenues of authorization ought not to be overlooked.

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\(^{121}\) *Noland*, 517 U.S. at 542-43 (stating that § 510(c) permits a court to make exceptions to a general rule only when justified by particular facts). The Court reaffirmed this position in *United States v. Reorganized CF & I Fabricators of Utah*, 518 U.S. 213 (1996). It held there that even when a claim in question is not entitled to a statutory priority (as was the administrative claim in *Noland*), subordination cannot be wholly based on the nature of the claim itself. *Id.* at 228 (describing *Noland* as having nothing to do with the fact that the claim in that case was entitled to administrative priority, but rather with the reordering of priority on a categorical basis).


\(^{123}\) *Id.* at 1265-1271.

\(^{124}\) See Section 0 supra.

\(^{125}\) Ponoroff, *supra* note 122, at 1282-1288.

\(^{126}\) See Section 0 supra.
CONCLUSION
Is a bankruptcy court a court of equity? There is, in my opinion, no crisp, clear answer.\textsuperscript{127} The bankruptcy judges in any district form a court. As I have argued, it is a court with inherent powers in addition to the statutory powers granted by Congress. These inherent powers cover matters from the mundane to the profound, from setting the hours of operation to jailing parties in civil contempt.

The bankruptcy court is also a court that has various equitable powers: it decides claims against the estate using equitable principles; it is granted the power to decide various matters using equitable principles; and it often creates practices and procedures unanticipated by the text of the Code, but which efficiently implement the Code’s policies. At all times, however, a court’s exercise of equity powers in bankruptcy cases is limited by the text of the Code.

Many of these limitations, however, are not unique to bankruptcy courts. The Code itself exerts limits on district court judges, judges who are possessed of the full judicial power of the United States. And as bankruptcy courts’ jurisdiction and powers under the Code are wholly derivative on the bankruptcy power vested in the district courts, it follows that limitations on district courts are limitation on bankruptcy courts.

Is there something a district court could do in a bankruptcy case under its general equitable powers that a bankruptcy court cannot? The clear answer is yes, and the line of cases from \textit{Stern} to the present focus on the necessity of possessing the judicial power to decide certain types of disputes. Beyond that very significant limitation (and any specific limitation on referral of cases from district courts), however, bankruptcy courts have equitable powers parallel to those held by district courts which enable bankruptcy courts to shape their dockets and the remedies they provide to any other court. In the end, bankruptcy courts are courts with equitable powers.

\textsuperscript{127} This may be why, in the words of one judge, “the bankruptcy court is a court of equity” is the most frequently uttered substantive phrase by attorneys in her courtroom. Marcia Krieger, \textit{“The Bankruptcy Court is a Court of Equity”: What Does that Mean?}, 50 S.C. L. Rev. 275, 297 (1999).
The "P"s of Evidence: Proper Preparation, Presentation, Pitfalls, and Practice Pointers
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1. OBJECTIONS

a. Foundation

Rule 104. Preliminary Questions

(a) In General. The court must decide any preliminary question about whether a witness is qualified, a privilege exists, or evidence is admissible. In so deciding, the court is not bound by evidence rules, except those on privilege.

(b) Relevance That Depends on a Fact. When the relevance of evidence depends on whether a fact exists, proof must be introduced sufficient to support a finding that the fact does exist. The court may admit the proposed evidence on the condition that the proof be introduced later.

1. In short, to be admissible, evidence must be presented that establishes its admissibility.

2. Foundation objections arise in many contexts.

   A. Relevancy. FRE 401.
   B. Competency of law witness. FRE 601
   C. Personal knowledge. FRE 602
   D. Introduction of opinion testimony. FRE 701-705
   E. Qualifications of an expert witness. FRE 702
   F. Exception to hearsay. FRE 803 and 804(b)
   G. Authentication. FRE 901.
   H. Admissibility of non-original writing. FRE 1004
   I. Existence of waiver of privilege.

3. Examples:

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1 Parts 1 through 5 are adopted with minor changes from Practical Evidence Manual by Judge Michael G. Williamson, Chief Bankruptcy Judge, United States Bankruptcy Court, Tampa, Florida. It is used with his permission. The material in Section 6 is adopted from materials presented at the 2018 NACBA presentation by Emily White, Judge LaShonda A. Hunt, Ed Hays and David Cox. It is also used with permission.
A. Objection should be made to exclude debtor’s attempt to introduce expert valuation opinion from an accountant that did not have valuation credentials or experience in marketing and selling debtor’s type of business.

B. Before asking a witness about an event, provide background facts to establish personal knowledge.

C. Corporate e-mails excluded where trustee’s only witness was a party that was neither a party to the e-mail chain nor a custodian of records. *Boyd v. Toyobo America, Inc. (In re Second Chance Body Armor, Inc.),* 434 B.R. 502 (Bankr. W.D. Mich. 2010).

b. Relevance

1. The evidence must have a tendency to make the existence of any fact that is of consequence to the determination of the action more or less probable than it would be without the evidence.
   
   Rule 401: Evidence may be “true,” “reliable” and “accurate” but that does not make it relevant to the subject of the proceeding.

2. Even if the evidence is relevant, the judge has discretion to exclude it where “its probative value is substantially outweighed by the danger of unfair prejudice”
   
   Rule 402: Relevant evidence may nonetheless be excluded.

c. Leading questions

1. The question strongly suggests its own answer but is not necessarily every question that would elicit a yes or no response
   
   EXAMPLES: You listed only $500 in income on your schedules, didn’t you? And your wife wasn’t working at that time, was she?

2. May be appropriate or even effective in certain situations
   
   A. Provide context or the overall big picture for the testimony
B. Tactic to quickly lay foundation to avoid boring the trier of fact
C. Used on redirect to focus the witness on particular areas
3. It is usually better to let the witness tell the story
d. Compound Question
   1. Multiple questions asked at once that can confuse the trier of fact as to
      the answer
      EXAMPLE: Does the property have equity and is it necessary for
      an effective reorganization?
   2. Don’t muddy the record for the trier of fact or the reviewing court
e. Argumentative
   1. Literally, the question makes an argument rather than posing a question
   2. Watch your tone – don’t quarrel with a witness
f. Personal Knowledge - Speculation
   1. Must lay foundation of personal knowledge before evidence can be
      admitted
   2. Rule 602: “A witness may testify to a matter only if evidence is introduced
      sufficient to support a finding that the witness has personal knowledge of
      the matter. Evidence to prove personal knowledge may consist of the
      witness’s own testimony. This rule does not apply to a witness’s expert
      testimony under Rule 703.”
   3. Example: Q: Why was your partner thinking?
   4. Court has wide discretion to determine if sufficient preliminary evidence
      established
   5. Degree or Accuracy of Personal Knowledge
      A. Lack of certainty does not render evidence inadmissible. For
         example, testimony of “I think so,” “to the best of my
         recollection,” and “I believe” go more to weight than admissibility.
Judicial Notice

1. Judicial Notice. Rule 201 of the Federal Rules of Evidence allows courts to take judicial notice of a fact that is not subject to reasonable dispute because it “(1) is generally known within the trial court’s territorial jurisdiction; or (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned.”

2. Adjudicative Facts. The “adjudicative fact” requirement refers to facts “that relate to the parties.” These are the “who did what, where, when, how, and with what motive or intent” facts, which typically go to the jury. FED. R. EVID. 201(b) Advisory Committee’s Notes.

3. Classic Examples. “[T]he kinds of things about which courts ordinarily take judicial notice are (1) scientific facts: for instance, when does the sun rise or set; (2) matters of geography: for instance, what are the boundaries of a state; or (3) matters of political history: for instance, who was president in 1958.” Shahar v. Bowers, 120 F.3d 211, 214 (11th Cir. 1997).

4. Bankruptcy Context Examples. Some facts that courts have judicially noticed include:


D. That bankruptcy schedules were filed, that they were filed on a given date, and that specific items of property were listed. *Fla. Bd. of Trs. of Internal Improvement Trust Fund v. Charley Toppino & Sons, Inc.*, 514 F.2d 700, 704 (5th Cir. 1975) (“It is not error . . . for a court to take judicial notice of related proceedings and records in cases before that court.”).


5. Burden and waiver. The party requesting judicial notice has the burden of persuading the trial judge that taking judicial notice of a particular fact is appropriate.

A. Supply the court with the support needed to determine whether the request is justified.

B. Rule 201(e) provides the opposing party with the opportunity to be heard on the request.

C. A party may waive the right to object to the propriety of the court’s taking judicial notice by failing to timely request a hearing in the bankruptcy court.


(a) Scope. This rule governs judicial notice of an adjudicative fact only, not a legislative fact.

(b) Kinds of Facts That May Be Judicially Noticed. The court may judicially notice a fact that is not subject to reasonable dispute because it:

(1) is generally known within the trial court’s territorial jurisdiction; or
(2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned.

(c) Taking Notice. The court:

(1) may take judicial notice on its own; or

(2) must take judicial notice if a party requests it and the court is supplied with the necessary information.

(d) Timing. The court may take judicial notice at any stage of the proceeding.

(e) Opportunity to Be Heard. On timely request, a party is entitled to be heard on the propriety of taking judicial notice and the nature of the fact to be noticed. If the court takes judicial notice before notifying a party, the party, on request, is still entitled to be heard.

(f) Instructing the Jury. In a civil case, the court must instruct the jury to accept the noticed fact as conclusive. In a criminal case, the court must instruct the jury that it may or may not accept the noticed fact as conclusive.

h. Authentication

1. Rule 901. Authenticating or Identifying Evidence.

(a) In General. To satisfy the requirement of authenticating or identifying an item of evidence, the proponent must produce evidence sufficient to support a finding that the item is what the proponent claims it is.

(b) Examples. The following are examples only—not a complete list—of evidence that satisfies the requirement:

(1) Testimony of a Witness with Knowledge. Testimony that an item is what it is claimed to be.
(2) Nonexpert Opinion About Handwriting. A nonexpert’s opinion that handwriting is genuine, based on familiarity with it that was not acquired for the current litigation.

(3) Comparison by an Expert Witness or the Trier of Fact. A comparison with an authenticated specimen by an expert witness or the trier of fact.

(4) Distinctive Characteristics and the Like. The appearance, contents, substance, internal patterns, or other distinctive characteristics of the item, taken together with all the circumstances.

(5) Opinion About a Voice. An opinion identifying a person’s voice—whether heard firsthand or through mechanical or electronic transmission or recording—based on hearing the voice at any time under circumstances that connect it with the alleged speaker.

(6) Evidence About a Telephone Conversation. For a telephone conversation, evidence that a call was made to the number assigned at the time to:
（A）a particular person, if circumstances, including self-identification, show that the person answering was the one called; or
（B）a particular business, if the call was made to a business and the call related to business reasonably transacted over the telephone.

(7) Evidence About Public Records. Evidence that:
（A）a document was recorded or filed in a public office as authorized by law; or
（B）a purported public record or statement is from the office where items of this nature are kept.

(8) Evidence About Ancient Documents or Data Compilations. For a document or data compilation, evidence that it:
（A）is in a condition that creates no suspicion about its authenticity;
(B) was in a place where, if authentic, it would likely be; and
(C) is at least 20 years old when offered.

(9) Evidence About a Process or System. Evidence describing a process or
system and showing that it produces an accurate result.

(10) Methods Provided by a Statute or Rule. Any method of authentication
or identification allowed by a federal statute or a rule prescribed by the
Supreme Court.

2. Burden of proof. The burden of proof rests on the proponent to establish
that the evidence is what it purports to be.

   A. Example: To get a document admitted into evidence, the proponent
      will need a custodian of records, a party that prepared the
document, a party with knowledge of the chain of custody, or
      expert testimony (i.e. handwriting or fingerprint expert).

3. Standard for review on appeal – abuse of discretion

4. Methods. The ten examples in Rule 901 are not exclusive.

5. Writings

   A. Lay opinion regarding handwriting. See United States v. Calbas,
      821 F.2d 887 (2d Cir. 1987) (lack of expert handwriting analysis
did not bar document’s admission where authenticity was
established by lay opinion of person familiar with subject’s
handwriting).

   B. Expert testimony. Must be qualified under Rules 702 and 703. See
      United States v. Red Feather, 865 F.2d 169, 170 (3d Cir. 1992)
      (per curiam) (handwritten notes were authenticated by expert
testimony that age of paper and ink indicated entries in diary were
made contemporaneously and not all at once).
C. Distinctive characteristics. See *United States v. Jones*, 107 F.3d 1147, 1150 (6th Cir. 1997) (writing may be authenticated by evidence that it deals with obscure matters not commonly known).

6. Certified copies. Public records can be authenticated by establishing legal custodianship which can be done with a certificate of authenticity or a certified copy.

   A. Creditor’s attempt to introduce photocopies of financing statements insufficient to authenticate that the documents were in fact filed with the Secretary of State. The Court noted that the problem could have been easily solved by introducing certified copies of the records. The testimony of a loan officer that the UCC-1 was filed was insufficient. *Commercial Nat’l Bank v. The Furniture Shop, Inc. (In re Furniture Shop, Inc.)*, 28 B.R. 266 (Bankr. N.D. Ohio 1983).

7. Examples:

   A. Trustee’s introduction of documents found in corporate debtor’s records excluded where trustee failed to provide evidence to authenticate documents such as by calling signatory, author of documents, or custodian of records. *Smith v. Litchford & Christopher, P.A. (In re Bay Vista of Virginia, Inc.)*, 428 B.R. 197 (Bankr. E.D. Va. 2010) (trustee’s status as successor to corporate records insufficient by itself).

2. INTRODUCTION OF DOCUMENTS

   a. Hearsay

   1. Evid. R. 801(c) “‘Hearsay’ means a statement that:(1) the declarant does not make while testifying at the current trial or hearing; and (2) a party offers in evidence to prove the truth of the matter asserted in the statement.”
2. Out of court statements are generally inadmissible unless they are “not hearsay” or fall within one of the hearsay exceptions.

3. Evid. R. 803(d) gives two examples of statements that are “not hearsay”:
   
   A. Prior testimonial statements if made under oath in another proceeding and the declarant is available for cross examination. E.g., in a civil trial witness testifies the light was red. This witness may be impeached by testimony under oath from a criminal trial that the light was green.

   B. Party-opponent admission

b. Business Records

   1. Evid. Rule 803(6) “A record of an act, event, condition, opinion, or diagnosis if:
      
      (A) the record was made at or near the time by — or from information transmitted by — someone with knowledge;

      (B) the record was kept in the course of a regularly conducted activity of a business, organization, occupation, or calling, whether or not for profit;

      (C) making the record was a regular practice of that activity;

      (D) all these conditions are shown by the testimony of the custodian or another qualified witness, or by a certification that complies with Rule 902(11) or (12) or with a statute permitting certification; and

      (E) the opponent does not show that the source of information or the method or circumstances of preparation indicate a lack of trustworthiness.”

   2. To present business records, proponent needs a records custodian to lay a proper foundation that each element has been established. Need not have knowledge of the preparation of the particular record, but must be
familiar enough with the record keeping system itself to establish personal knowledge.

c. Privileges

1. Rule 501: “The common law—as interpreted by United States courts in the light of reason and experience—governs a claim of privilege unless any of the following provides otherwise:
   • the United States Constitution;
   • a federal statute; or
   • rules prescribed by the Supreme Court.

But in a civil case, state law governs privilege regarding a claim or defense for which state law supplies the rule of decision.”

2. Flexible standard that permits the evolution of privileges over time.

3. Supreme Court standards that did not become Rules of Evidence

4. Determining whether federal or state law applies

5. Attorney-Client Privilege / Work-Product Protection:

   A. Waiver. Rule 502 governs disclosures or waivers of this otherwise protected information
      a. Intentional waiver
      b. Extends to disclosed and undisclosed communications involving same subject matter
      c. Fairness requires also considering the undisclosed information

   B. Inadvertent Disclosures
      a. No waiver if the disclosure is
         i. Inadvertent
         ii. Holder took reasonable steps to prevent disclosure
iii. Holder promptly took reasonable steps to rectify the error

C. Ethical duty to not read what is obviously an inadvertent disclosure
   a. Must delete
   b. Must notify opposing counsel

D. Example
   a. Counsel hit reply instead of forward and accidentally sent opposing counsel a detailed e-mail intended for his client that included advice and strategy. As soon as it became clear that it was an accident, must delete and notify counsel.
   b. Use of inadvertent disclosure. If document produced that is obviously attorney-client privileged, then don’t attach it to your motion and use it as evidence without first contacting opposing counsel and possibly having the court resolve any dispute. Improper use of an inadvertently produced privileged communication could result in disqualification.

E. Trustee’s Waiver of Corporate Privilege

F. Can a trustee waive an individual’s attorney-client privilege?
   a. The law is currently unsettled. Compare:
      i. *In re Smith*, 24 B.R. 3 (Bankr. S.D. Fla. 1982) (privilege passed to trustee regarding communications between debtor and prepetition counsel to determine if action existed against insurer for failure to settle wrongful death case). *In
re Courtney, 372 B.R. 519 (Bankr. M.D. Fla. 2007) (criticizing and declining to follow Smith’s blanket rule that the privilege always passes to the trustee; allowing trustee to waive the privilege instead based on a comparison of the harm to the debtor and the benefit to the bankruptcy estate);

ii. Foster v. Hill (In re Foster), 188 F.3d 1259 (10th Cir. 1999) (court must balance trustee’s need to waive privilege to administer estate assets and individual debtor’s right to maintain privilege);

iii. In re Eddy, 304 B.R. 591, 599–600 (Bankr. D. Mass. 2004) (after individual Chapter 11 case converted to Chapter 7, trustee could waive privilege for post-petition communications between debtor-in-possession and counsel where post-petition communications concerned or were related to the administration of property of the estate);

iv. In re Silvio De Lindegg Ocean Developments of Am., Inc., 27 B.R. 28 (Bankr. S.D. Fla. 1982) (trustee of jointly administered corporate and individual case where single attorney represented both debtors could not waive privilege regarding communications relating to individual); French v. Miller (In re Miller), 247 B.R. 704 (Bankr. N.D. Ohio 2000) (employing a balancing test to conclude that the trustee could not waive the privilege).

G. Scope of Privilege – Examples
a. Intake forms.

i. Intake form submitted to attorney not privileged in criminal proceeding for bankruptcy fraud. The form did not reflect counsel’s thoughts or impressions and debtor did not provide the information to counsel to elicit legal advice. See United States v. Leonard-Allen, 739 F.3d 948, 953 (7th Cir. 2013), as amended on denial of reh'g and reh'g en banc (Aug. 29, 2013).

ii. Creditor prevailed in motion to compel debtor’s attorney to produce documents and information provided by debtor to prepare schedules and statements. In re Myers, 382 B.R. 304 (Bankr. S.D. Miss. 2008).

iii. “When information is disclosed for the purpose of assembly into a bankruptcy petition and supporting schedules, there is no intent for the information to be held in confidence because the information is to be disclosed on documents publicly filed with the bankruptcy court.” United States v. White, 950 F.2d 426, 430 (7th Cir. 1991).

iv. But, advice by attorney to debtor to list all assets covered by attorney client privilege and admission of such evidence in criminal prosecution for bankruptcy fraud reversed. United States v. Bauer, 132 F.3d 504 (9th Cir. 1997).
b. Practice Pointer. Save questionnaire submitted by debtor to protect yourself from subsequent suit for malpractice after debtor’s discharge denied for false oaths in schedules.

6. Husband-Wife Privileges
   A. Adverse spousal testimony
      a. Held by witness who can refuse to testify against spouse
      b. Extends to any subject including non-confidential matters that occurred prior to marriage
      c. Terminates when marriage ends
   B. Confidential marital communications
      a. Held by the non-testifying spouse. Waiver by testifying spouse in a prior matter like a deposition does not bar non-testifying spouse from later asserting the privilege
      b. Extends to communications made in confidence during marriage
      c. Survives the termination of the marriage
   C. Example
      a. 727 action based on debtor’s alleged communications with non-debtor spouse regarding withdrawing funds from non-debtor’s account

7. Doctor-Patient / Medical Privacy
   A. No privilege recognized by Federal Rules of Evidence
   B. No privilege exists under federal common law
   C. There may be a constitutional right to privacy. *Whalen v. Roe*, 429 U.S. 589 (1977) (indicates there may be a constitutional right of privacy to maintain confidentiality of medical treatment).
D. There are some federal statutes that protect particular types of medical information such as HIPAA

E. State laws may also apply

F. Example
   a. Debtor sought to be excused from attending Rule 2004 examination on grounds of medical issues but refused to disclose the condition so the court could evaluate it. Debtor sought to file the medical records under seal pursuant to Section 107 and FRBP 9018. But, these rules only extend to trade secrets, scandalous, or defamatory matters. Motion denied and debtor had choice to either maintain his privacy and appear or waive his privacy and ask the court to consider accommodations.

8. 5th Amendment - Right against self-incrimination
   D. Waiver. Debtor’s prior testimony operated as a waiver of any subsequent ability to invoke the 5th Amendment. *In re Mudd*, 95 B.R. 426 (Bankr. N.D. Tex. 1989).
   E. Practice Pointer. The moment you believe your client may have committed a crime, you absolutely must warn them in writing
regarding (i) immediately retaining criminal defense counsel; 
(ii) not discussing anything with anyone to avoid a waiver; and 
(iii) consider your ethical obligations regarding remaining in a case 
where debtor is committing bankruptcy fraud.

d. Expert reports including appraisals

1. Do you need to admit into evidence the actual report or is it sufficient to 
have the expert testify as to his opinion?

2. Potential Grounds for Exclusion
   A. Hearsay
   B. Relevance

3. Reasons to allow use as an exhibit during expert’s testimony
   A.Illustrates facts and assumptions relied upon to establish the basis 
      for the opinion – necessary with competing appraisals
   B. Limits the witness to disclosed opinions only

e. Stipulations

1. Generally. Stipulations can facilitate the presentation of evidence 
   without calling witnesses or presenting other proof.
   A. Uncontroverted. A stipulation may involve an uncontroverted 
      matter or an issue upon which the parties mutually see no 
      advantage in presenting witnesses or exhibits.
   B. Judicial economy. Fact stipulations speed up the trial process by 
      eliminating the need for proving essentially uncontested facts, 
      which helps preserve precious judicial resources.

2. Binding nature. After a stipulation is “freely-made,” the stipulation 
   “bind[s] the parties, the trial court, and the appellate court too.”
   
   Evid. Serv. 114 (1st Cir. 2011).
3. Manifest injustice. Courts have, however, allowed for modification in exceptional circumstances, that is, when a failure to modify or set it aside would result in “manifest injustice.” *Waldorf v. Shuta*, 142 F.3d 601, 617–18 (3d Cir. 1998); *Wheeler v. John Deere Co.*, 935 F.2d 1090, 1097–98 (10th Cir. 1991).

4. Factors proving manifest injustice. Four factors that courts have focused on in determining whether a refusal to alter or modify a stipulation would result in manifest injustice.

   A. The effect of the stipulation on the party seeking to withdraw the stipulation;
   B. The effect on the other parties to the litigation;
   C. The occurrence of intervening events since the parties agreed to the stipulation; and
   D. Whether evidence contrary to the stipulation is substantial.

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3. EVIDENTIARY CONSIDERATIONS IN SPECIFIC SITUATIONS

a. Valuation hearings (tax assessment, expert valuation, appraisals, burden of proof)

   1. Valuation is an opinion, derived from other facts.

      A. Lay Opinion Testimony. If a witness is not testifying as an expert, testimony in the form of an opinion is limited to one that is: (a) rationally based on the witness’s perception; (b) helpful to clearly understanding the witness’s testimony or to determining a fact in issue; and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702. See FRE 701.
B. Debtor testimony. Debtor may offer opinion as to value of home.

A debtor may offer an opinion on the value of his home pursuant to FRE 701.

   a. A debtor is not qualified as an expert

   b. Courts will consider the weight to give competing opinions of value

C. Experts. If a witness is not the owner of the property, he or she must qualify as an expert under Rule 702 in order to testify as to an opinion of value.

2. Admissibility of Expert Opinion Testimony: FRE 702

   A. Qualifications. Under FRE 702, an expert must have sufficient “scientific, technical, or other specialized knowledge” to testify competently about the opinion offered. FRE 702(a).


      a. the testimony is based on sufficient facts or data. FRE 702(b);

      b. the testimony is the product of “reliable principles and methods,” FRE 702(c);

      c. and the witness has applied the principles and methods reliably to the facts of the case. FRE 702(d).

   C. Relevance. The expert testimony must “help the trier of fact to understand the evidence or to determine a fact in issue.” FRE 702(a).

3. Appraisals.

   A. Hearsay objection. Consider having the appraiser to overcome a hearsay objection to the admission of an appraisal report.
Appraiser is the custodian for Rule 803(6) “records of regularly conducted activity” requirements.

B. Basis for valuation. You may want to qualify the appraiser as an expert so that he or she may share the basis for any conclusions about valuation.

4. Tax Assessments.


B. Hearsay exclusion. FRE 803(8) excludes from hearsay “[a] record or statement of a public office if: (A) it sets out: (i) the office’s activities; (ii) a matter observed while under a legal duty to report, but not including, in a criminal case, a matter observed by law-enforcement personnel; or (iii) in a civil case or against the government in a criminal case, factual findings from a legally authorized investigation; and (B) the opponent does not show that the source of information or other circumstances indicate a lack of trustworthiness.”

C. Limitations.

   a. Typically, only effective as of January 1 of each year.

   b. Least reliable in times of rapid market changes.


A. Unclear. Neither the Code nor the Federal Rules of Bankruptcy Procedure allocates the burden of proof as to the value of secured claims under § 506(a).

   a. Three approaches. Courts have developed three approaches.
i. Secured creditor. Some courts have concluded that the secured creditor bears the burden of proof. See, e.g., In re Sneijder, 407 B.R. 46, 55 (Bankr. S.D.N.Y. 2009)

ii. Debtor. Other courts have held that the party challenging the value of a claim, usually the debtor, bears the burden of proof. See, e.g., In re Weichey, 405 B.R. 158, 164 (Bankr. W.D. Pa. 2009).

iii. Burden-shifting. A third group of courts has settled on a burden-shifting analysis, pursuant to which “the debtor bears the initial burden of proof to overcome the presumed validity and amount of the creditor’s secured claim,” but “the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim.” In re Robertson, 135 B.R. 350, 352 (Bankr. E.D. Ark. 1992).

b. Dischargeability Actions (burden of proof, admissions, presumptions, witness testimony, state of mind)


   A. Shifting of burden. Once plaintiff proves a prima facie case, the burden shifts to the debtor to establish why discharge should be granted. See Standiferd v. United States Trustee, 641 F.3d 1209, 1212 (10th Cir. 2011) (after creditor establishes debtor’s knowledge of order and refusal to comply, burden shifts to debtor
to explain non-compliance); *Cifelli v. Miles (In re Miles)*, 481 B.R. 838, 845 (Bankr. N.D. Ga. 2012) (once missing assets are shown, burden shifts to debtor to explain loss); *Matter of Juzwiak*, 89 F.3d 424, 427–28 (7th Cir. 1996) (in action regarding alleged lack of adequate records, creditor does not have burden to reconstruct records).

2. Res Judicata (claim preclusion). “Under res judicata, a final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action.” *Allen v. McCurry*, 449 U.S. 90, 94 (1980).

   A. Contract judgment. Does a pre-petition contract judgment bar a 523 action? No. *Brown v. Felsen*, 442 U.S. 127 (1979). In Brown, the parties reached a settlement that provided for entry of judgment for breach of contract. The judgment debtor then filed bankruptcy. The judgment creditor filed an action to except the debt from discharge. The debtor moved for summary judgment arguing that the res judicata effect of the contract judgment precluded the new fraud challenge in bankruptcy. The bankruptcy court, district court, and Tenth Circuit affirmed. The Supreme Court reversed in a unanimous decision concluding that evidence extrinsic to the judgment was admissible to deal with the new defense of bankruptcy being asserted by debtor. In *Brown*, the Court stated in a footnote that its decision did not extend to collateral estoppel.

   B. Dismissals with prejudice. Court have reached similar results when dealing with prepetition settlement agreements that dismiss fraud claims with prejudice. *See Frank v. Daley (In re Daley)*, 776 F.2d 834 (9th Cir. 1985).
C. Releases. Prepetition releases don’t change the result. *See Archer v. Warner*, 538 U.S. 314 (2003) (prepetition releases do not bar the bankruptcy court from looking beyond the record in order to determine if the underlying debt arises from fraud).

3. Collateral Estoppel (issue preclusion). The elements of collateral estoppel are (a) the issue sought to be precluded is the same as an issue in a prior action; (b) the issue must have been actually litigated; (c) the issue has been resolved by a final judgment; and (d) the determination of the issue was essential to the final judgment. *HSSM #7 Ltd. P’ship v. Bilzerian (In re Bilzerian)*, 100 F.3d 886 (11th Cir. 1996).


E. Domestic Support. In Section 523(a)(5) action, state court labels do not control and a debt is only entitled to priority if it was intended to be support and was in fact necessary for support. *Friedkin v. Sternberg* *(In re Sternberg)*, 85 F.3d 1400 (9th Cir. 1996).

   a. But, where intent to injure not litigated, then no collateral estoppel effect. *See B.B. v. Bradley* *(In re Bradley)*, 466 B.R. 582, 588–89 (1st Cir. B.A.P. 2012) (no evidence that state court determined that debtor intended to cause injury
or that his actions were substantially certain to cause injury).

G. False oath. In Section 727(a)(4) litigation, bankruptcy court’s judgment that unscheduled assets were community property of the estate was entitled to collateral estoppel to deny discharge for false oath in failing to disclose. *Searles v. Riley (In re Searles)*, 317 B.R. 368, 376–77 (9th Cir. B.A.P. 2004).

4. Does Federal or State law govern the preclusive effect of a non-bankruptcy judgment? Full faith and credit requires the state court judgment to be given the effect it would carry outside of bankruptcy. *Pemstein v. Pemstein (In re Pemstein)*, 492 B.R. 274, 281 (9th Cir. B.A.P. 2013).

   A. State law varies regarding the effect to be given to default judgments. Some state laws depend on the amount of debtor’s participation prior to entry of default judgment.

5. Presumptions
   c. Motions for Relief
      1. Burden of proof
         A. Grounds for seeking relief
            a. Cause, including the lack of adequate protection of an interest in property of such party in interest, 11 U.S.C. § 362(d)(1)
            b. Property lacks equity and is not necessary for an effective reorganization, 11 U.S.C. § 362(d)(2)
         B. Party requesting relief has the burden of proof on the issue of the debtor’s equity in property – 11 U.S.C. § 362(g)(1)
C. Party opposing relief has the burden of proof on all other issues –
11 U.S.C. § 362(g)(2)

2. Witness considerations

A. Does the witness or affiant have sufficient personal knowledge to
authenticate records as business records?

B. Does the servicer have a history of inaccuracies in records?
   a. Eg. CFPB enforcement action against Ocwen:
   b. Serviced loans using error-riddled information: “Ocwen
uses a proprietary system called REALServicing to process
and apply borrower payments, communicate payment
information to borrowers, and maintain loan balance
information. Ocwen allegedly loaded inaccurate and
incomplete information into its REALServicing system.
And even when data was accurate, REALServicing
generated errors because of system failures and deficient
programming. To manage this risk, Ocwen tried manual
workarounds, but they often failed to correct inaccuracies
and produced still more errors. Ocwen then used this faulty
information to service borrowers’ loans. In 2014, Ocwen’s
head of servicing described its system as “ridiculous” and a

3. Payment histories

A. Does the payment history qualify as a business record? Is the
information contemporaneously and accurately recorded?
B. If servicer is relying on a different company’s data, check for qualifications: E.g. “Notice: Bank Of America Home Loans provides you with detailed reports under the terms of your agreement with it. In contrast, the information provided herein is in a user-friendly summary format and should not be considered as a report. Among other things, the information may not provide sufficient detail for your own reporting or audit purposes, may not be real time data, and therefore it should not be relied upon by you.”

d. Exemptions

1. Exempt property generally is protected from reach of creditors. 11 U.S.C. § 522(c), with the exception of certain specified debts including taxes and marital debts of the kind specified in 11 U.S.C. § 523(a)(5) and (a)(15).

2. Bankruptcy Code allows states to “opt out” of federal exemptions set forth in Section 522(c) and allow debtors to use state law exemptions. 11 U.S.C. § 522(b)(2) and (3). Many states have “opted out.” Thus, in addition to Section 522(b) exemptions, debtors may claim exemptions provided by state law. Sticka v. Applebaum (In re Applebaum), 422 B.R. 684 (9th Cir. B.A.P. 2009).

3. Domicile requirements – Which state’s law will control? Domicile requirement is two years (730 days). 11 U.S.C. § 522(b)(3)(A). If debtor was domiciled in multiple states during the two years prepetition, then the applicable state law will be the state where the debtor was domiciled for the 180 days immediately preceding the 730-day period.

   A. Issues of Proof: Proving location by reference to driver’s license, utility bills, etc.
4. BAPCPA enacted Section 522(b)(3)(C) and (b)(4) which permit debtors the option to exempt certain retirement funds under the Bankruptcy Code. But the amount is capped at $1,283,025 pursuant to Section 522(n). Note: the cap is tied to a cost of living increase and periodically adjust and may also be increased if the interests of justice so require.

   A. Issues of Proof: Proving that funds are in an account “exempt from taxation.”
   B. Can’t affix labels and call anything a retirement plan
   C. Obtain copy of actual retirement plan and get it admitted into evidence
   D. IRS plan qualification letters
   E. What is the interest of justice? Proving special needs for support.
      a. Expert testimony re: income and expenses
      b. Actuarial projections re: needs for support

5. Exemptions are determined based on facts and law in existence as of petition date. *Hyman v. Plotkin (In re Hyman)*, 967 F.2d 1316 (9th Cir. 1992).

   A. What if exemption is needs based and debtor’s needs change post-petition?
   B. Does it matter if Debtor converts the asset from fully exempt property to partially or completely non-exempt property?

6. Timing for objection: If no objection is timely filed, the value of the property claimed as exempt becomes exempt even if there was no colorable claim. *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992).

7. Result of Exemption becoming final: Once an exemption becomes final, the amount claimed exempt is no longer an asset of the bankruptcy estate. *Owen v. Owen*, 500 U.S. 305 (1991); *Mwangi v. Wells Fargo Bank, N.A.*
(In re Mwangi), 764 F.3d 1168 (9th Cir. 2014) (“It is widely accepted that property deemed exempt from a bankruptcy estate revests in the debtor.”) (quoting Smith v. Kennedy (In re Smith), 235 F.3d 472, 478 (9th Cir. 2000)).

8. If the value of the property, however, is higher than the scheduled value, the excess goes to the estate. Schwab v. Reilly, 560 U.S. 770 (2010).

9. Burden of Proof: Rule 4003 provides that the burden of proof is on the party objecting to the claimed exemption

   A. Exception: Several courts have ruled based on Raleigh v. Ill. Dep’t of Revenue, 530 U.S. 15 (2000) that if a state has opted out of the federal exemptions and state law places the burden of proof on the party claiming the exemption, then the debtor has the burden of proof because that is an element of the claimed exemption. See Diaz v. Kosmala (In re Diaz), 547 B.R. 329, 336–37 (9th Cir. B.A.P. 2016).


12. Amended Exemptions. FRBP 1009(a) provides that “A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed.”

   A. Res Judicata barred an amended claim of exemption after entry of an order sustaining an objection to a claimed exemption and turnover. In re Wilson, 446 B.R. 555, 562–63 (Bankr. M.D. Fla. 2011) (claims that were or could have been raised in a prior
proceeding cannot be raised in a subsequent proceeding). See also LaBarge v. Ireland (In re Ireland), 325 B.R. 836, 839 (Bankr. E.D. Mo. 2005) (turnover order barred debtor from claiming an exemption in defense of action to revoke discharge for failing to comply with turnover order).

B. Compare – Res judicata did not bar amended claim of exemption after entry of order disallowing previously claim of exemption.


4. WITNESS EXAMINATION
   a. Direct testimony
      1. Avoid “leading” questions unless you are setting up the background for an issue.
      2. Ask open-ended questions to give the witness an opportunity to tell the full story.
      3. Let the witness testify, not the lawyer.
   b. Cross-examination
      1. Ask “leading” questions to pin the witness down on his testimony and poke holes in his story.
      2. Limit the scope to the topics discussed on direct examination.
      3. Should you ask a question to which you do not already know the answer?
   c. Impeachment
   d. Expert Opinion
      1. Rule 702 provides that
A. If scientific, technical or other specialized knowledge will assist
the trier of fact,

B. A witness qualified as an expert by knowledge, skill, experience,
training, or education

C. May testify if the testimony is –
   a. based upon sufficient facts or data,
   b. the product of reliable principles and methods, and
   c. the witness has applied the principles and methods reliably
to the facts of the case.

2. The trial judge has a great deal of discretion in determining the
reliability of a particular expert’s testimony. In acting as the Daubert
gatekeeper, the question to be answered is whether the expert’s opinions
are sufficiently reliable to be received into evidence.

3. The goal is to exclude expert testimony that is unreliable because:
   A. The methodology is speculative or untested,
   B. The underlying data is faulty,
   C. The “expert” lacks the knowledge or skill to apply a proven
      methodology, or
   D. Any other objective reason.

4. EXAMPLES:
   A. The proposed expert has been asked to opine about the value of a
debtor’s single-family home. He has an associate degree and has
assisted buyers and seller of homes for 20 years. Sufficient?
Probably.
   B. The proffered expert has a novel approach to valuation in that the
most relevant factor is the number of trees on the property and this
method has not failed him in his 20 years of experience. Sufficient? Probably not.

C. What if the same expert who sells residential properties under $500,000 now seeks to opine about luxury properties? Sufficient? The differences between the two markets would need to be established before the judge can rule but if the methodology is the same, probably.

5. The question is whether the expert has the qualifications to opine on the subject to which she is testifying.

e. Proffered testimony
f. Use of depositions at trial

5. THOUGHTS ON PRE-TRIAL AND POST-TRIAL EVIDENTIARY ISSUES

a. Pretrial

1. Disclosures and Rule 26
2. Requests for admissions / Requests to produce documents
3. Rule 2004 Examinations

A. Rule 2004 Examination – the text:

a. Examination on Motion. On motion of any party in interest, the court may order the examination of any entity.

b. Scope of Examination. The examination of an entity under this rule or of the debtor under §343 of the Code may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor’s estate, or to the debtor's right to a discharge. In a family farmer’s debt adjustment case under chapter 12, an individual’s debt adjustment case under chapter 13, or a reorganization case...
under chapter 11 of the Code, other than for the
reorganization of a railroad, the examination may also
relate to the operation of any business and the desirability
of its continuance, the source of any money or property
acquired or to be acquired by the debtor for purposes of
consummating a plan and the consideration given or
offered therefor, and any other matter relevant to the case
or to the formulation of a plan.

c. Compelling Attendance and Production of Documents. The
attendance of an entity for examination and for the
production of documents, whether the examination is to be
carried out within or without the district in which the case is
pending, may be compelled as provided in Rule 9016 for
the attendance of a witness at a hearing or trial. As an
attorney of the court, an attorney may issue and sign a
subpoena on behalf of the court for the district in which the
examination is to be held if the attorney is admitted to
practice in that court or in the court in which the case is
pending.

d. Time and Place of Examination of Debtor. The court may
for cause shown and on terms as it may impose order the
debtor to be examined under this rule at any time or place it
designates, whether within or without the district wherein
the case is pending.

e. Mileage. An entity other than a debtor shall not be required
to attend as a witness unless lawful mileage and witness fee
for one day's attendance shall be first tendered. If the debtor
resides more than 100 miles from the place of examination when required to appear for an examination under this rule, the mileage allowed by law to a witness shall be tendered for any distance more than 100 miles from the debtor’s residence at the date of the filing of the first petition commencing a case under the Code or the residence at the time the debtor is required to appear for the examination, whichever is the lesser.

B. Powerful tool. Rule 2004 provides parties with the ability to conduct pre-litigation discovery in a bankruptcy case.

C. Broad scope—“fishing expedition.” The scope of the examination is broader than that of a deposition and can assist a party in learning about information which would not necessarily be “relevant” under Fed. R. Civ. P. 26.

D. Limitations. “Rule 2004 examinations may not be used to annoy, embarrass or oppress the party being examined.” In re Symington, 209 B.R. 678, 685 (Bankr. D. Md. 1997).

E. Pending Proceeding Rule. Once an adversary proceeding has been commenced, a party is limited to discovery under the FRCP. In re Ramadan, 2012 WL 1230272, at *2, 1012 Bankr. LEXIS 1602 (Bankr. E.D.N.C. Apr. 12, 2012).

4. Supplemental disclosures

5. Prehearing orders

A. Purpose. Prehearing, pretrial or scheduling orders typically streamline the trial process and help the court manage the litigation. However, they can also be a trap for the careless!
B. Final Pretrial Order is binding. Fed. R. Civ. P. 16(e) provides: “The court may modify the order issued after a final pretrial conference only to prevent manifest injustice.” Once the final pretrial order is entered, it controls the course and scope of the proceedings.

C. Objection required. You still must object if the opposing party deviates from the pretrial order.

D. Contents. Rule 16 includes some of the issues that may be addressed in a pretrial order, but your Local Rules and the judge will dictate what must be included. The final pretrial order will typically address deadlines for filing:
   a. Exhibits
   b. Witness lists
   c. Stipulation of Facts and issues to be decided
   d. Certain pretrial motions
   e. Memoranda of Authority, if any

E. May include special requirements, such as, a provision that exhibits not objected to in writing by a date certain will stand as admitted into evidence, if offered.

6. Pretrial stipulations
   A. Get documents admitted or flag the ones subject to objection
   B. Try to identify which facts admitted or disputed
   C. Get stipulation that pretrial stipulation includes all admitted and disputed issues of fact and law. Object to anything offered at trial that is beyond the scope of the pretrial stipulation

b. Post-trial and Appellate Issues
   1. Preserving objections
2. Filing notice of appeal

6. TRIAL ADVOCACY SKILLS
   a. Trial proof outlines (burden of proof / evidence)
      1. What do you need to prove to win? What does the other side need to do prove to win? How can you prove (or exclude) key evidence?
      2. Sample elements chart – Simple debt collection case

<table>
<thead>
<tr>
<th>Plaintiff’s elements</th>
<th>Facts to prove</th>
<th>Evidence to establish facts</th>
<th>How to establish</th>
<th>Defense Evidence Challenge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence of a debt</td>
<td>Valid, enforceable contract</td>
<td>Copy of signed contract</td>
<td>Stipulation Request for admission Authentication of written contract Self-authentication (commercial paper)</td>
<td>Hearsay Not properly authenticated</td>
</tr>
<tr>
<td>Right to enforce the debt</td>
<td>Effective transfer of debt if collector is not original lender</td>
<td>Assignment or negotiation of loan agreement</td>
<td>Stipulation Business records</td>
<td>Hearsay Not properly authenticated</td>
</tr>
<tr>
<td>Default</td>
<td>Payments not made when due, loan accelerated</td>
<td>Payment history</td>
<td>Stipulation Business records</td>
<td>Hearsay Not properly authenticated</td>
</tr>
<tr>
<td>Amount owed</td>
<td></td>
<td>Payment history</td>
<td>Stipulation Business records</td>
<td>Hearsay Not properly authenticated</td>
</tr>
</tbody>
</table>

**Affirmative defenses**

<table>
<thead>
<tr>
<th>No valid debt Contract formation defenses</th>
<th>Documents or testimony</th>
<th>Requests for admission Stipulation</th>
<th>Personal knowledge Hearsay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standing</td>
<td>No valid transfer of debt</td>
<td>Absence of documents demonstrating transfer</td>
<td>Requests for admission Stipulation Self-authenticating records (commercial paper)</td>
</tr>
</tbody>
</table>
b. Opening Statements

1. Outline your case
2. Don’t assume the court knows the case as well as you do
3. Syllogism:
   A. Example. Section 727 provides that discharge shall be denied if a debtor knowingly makes a material false oath. In this case, the evidence will show that debtor knowingly failed to disclose that he is on title to two parcels of real property. This court must determine if debtor’s discharge must be denied.
   B. Example: State homestead law requires a debtor’s residency. In this case, the evidence will show that Debtor was living on the property on the petition date. This Court must determine whether to overrule the Trustee’s objection to exemption.

4. Identify the key points of evidence

c. Closing Statements

1. Identify the elements that must be proven
2. Cite to the evidence that either proves or disproves each element
3. Consider asking the court whether you can submit closings in writing to be able to quote testimony or documents admitted into evidence
d. Witness Preparation

1. Focus on presenting your theme/theory of the case
2. Strategize
   A. WHAT testimony or evidence will be needed?
   B. WHO is qualified to offer that?
   C. HOW will you overcome objections?
   D. WHEN should you present the witnesses?
   E. WHY???
3. Know their strengths and weaknesses as well as your own
   A. Talkative (rambles and speculates)
   B. Combative (likes to argue)
   C. Too Brief (fails to elaborate when needed)
4. Review prior testimony and written statements for inconsistencies and
   be prepared to front it and frame the narrative.
5. Practice your questioning but avoid coming across as too rehearsed

e. Chronology

1. Tell a logical story in a conversational manner
2. Use witnesses and exhibits to build the elements of the case

f. Preserving issues for appeal

1. Introduction
   A. Prepare for appeal from start of case
   B. Consider appellate or trial support counsel early
   C. Ensure a complete record for appeal
   D. Renew objections at different stages of trial to avoid waiver
      arguments
   E. Adopt objections made by co-parties
   F. Remember the record is read
2. General Rule & Requirements - Appellate courts consider only evidence, objections and legal arguments that have been presented to the trial court

A. Exceptions
   a. Apparent or “plain” error
   b. Purely legal question
   c. Questions of public importance
   d. Subject matter jurisdiction
   e. Change to the law

3. Pretrial -- preserving appellate issues
   B. Fed. R. Civ. P. 12. Certain defenses must be raised or are gone forever if not asserted in an omnibus Rule 12(b) motion or responsive pleading. Rule 12(h)
      a. Lack of personal jurisdiction
      b. Improper venue
      c. Insufficient process
      d. Insufficient service of process
   C. Summary Judgment. Rule 56
      b. Denial not final disposition. There are genuine questions of material fact.
c. Motion for Judgment as a Matter of Law. To preserve an argument for judgment, present it under Rule 50(a) and (b)

D. Motion in Limine

a. Party losing Motion in Limine does not need to make a contemporaneous objection during trial

b. Fed. R. Evid. Rule 103, as amended: "Once the court rules definitively on the record—either before or at trial—a party need not renew an objection or offer of proof to preserve a claim of error for appeal."

4. Trial -- preserving appellate issues

A. Requirements

a. On the Record. Present the issue on the record.

b. Timely. For example:

   i. object to examination: when the question is asked

   ii. object to evidence: when the offer is made

   iii. move for mistrial: as soon as the basis is known

c. Specificity. Argument must be raised sufficiently for the trial court to rule on it. Make specific, well-articulated objections. An evidentiary ruling can only be challenged on the grounds argued in support of your position at trial

d. Objection must state the “grounds.” Say enough for the trial court to make an informed ruling

e. Fed. R. Civ. P. 46: A formal exception to a ruling or order is unnecessary. When the ruling or order is requested or made, a party need only state the action that it wants the court to take or objects to, along with the grounds for the request or objection. Failing to object does not prejudice a
party who had no opportunity to do so when the ruling or order was made.

f. Offer of proof. If the court sustains your opponent’s objection to your direct or cross-examination, you must make an offer of proof.

i. Cover each ground of admissibility that may be raised on appeal;

ii. Explain what you expect to prove by the excluded evidence; and


B. Mistrial. A motion for a mistrial must be made immediately after the grounds for that motion appear, thus giving the court an opportunity to cure with a cautionary instruction.

g. A good attorney knows the law, a great attorney knows the judge. Adopting the proper tone, style, etc.

1. Courtroom style and demeanor

   A. Keep a poker face

      a. Avoid rolling eyes, scrunched eyebrows, and other distractions

      b. Conceal glee and disappointment at rulings

      c. No bobbing or nodding in agreement or disapproval of the judge or opposing counsel
d. Educate your clients and witnesses as well; they are a reflection on you

B. Language matters
   a. Stay away from strong language. “Lacks merit” beats “it’s ridiculous!”
   b. Argue without being argumentative
   c. Object without being objectionable

C. Manners matter
   a. Keep it simple: mind your manners
   b. Civility imperative among counsel – but also to witnesses, court personnel, parties, and all involved
   c. Say “thank you!” At the conclusion of a ruling, regardless of the outcome, rise and thank the court for dispensing justice
   d. Be courteous to judicial staff

D. Be understood
   a. Speak clearly and reasonably slow. Maybe the judge is taking notes!
   b. Vary cadence, volume, length of sentences, and tone of your voice
   c. Remember to pause

E. Dress the part
   a. Successful counsel look successful
   b. Professional appearance
   c. Remember your client’s appearance too

2. Tips for argument and trial
   A. Master your facts
B. Know your files and exhibits
C. Be organized
D. Fewer is better and brevity is best when making arguments;
   Shotguns are for those with a poor aim
E. Your arguments must have logical order, if you are to be persuasive
F. Don’t jettison an argument at the first challenging question or raised eyebrow from the bench
G. Know your narrative, be a storyteller, and look for the human element

3. Avoid classic mistakes
   A. Estimating the length of a trial or hearing
   B. Has your Honor read my brief?
   C. Respect the distances, to the witness, the bench
   D. Tardiness
   E. Reading from your own pleadings in court
Blockchain is Coming – Blockchain Basics and How it Might Arrive at a Bankruptcy Near You
Blockchain Is Coming:
Blockchain & Basics and
How It Might Arrive at a Bankruptcy Near You

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History of Blockchain.
When did it start?

• The idea of distributed ledgers has been around since the 1990s.

• Blockchain technology specifically emerged in the wake of the Great Recession.

• Satoshi Nakamoto (alias for one or more persons) developed a protocol in a white paper titled *Bitcoin: A Peer-to-Peer Electronic Cash System*, released on October 31, 2008.

• The interesting thing about bitcoin (and all cryptocurrencies) is that unlike fiat currencies (e.g., USD), they are not controlled or issued by any government.
What is Cryptocurrency?

- What is virtual/crypto currency
  - Electronically created currency recorded on an online ledger called a blockchain
  - Many ways to obtain virtual/crypto currency
    - earning - harvesting - mining - creating - auto-generating - manufacturing - purchasing

- Over 1500 different forms of virtual currency
  - Bitcoin is the leader in size and popularity
  - Ethereum is another well known crypto
What even is “Blockchain”?

WHAT IS THIS?

I DON’T EVEN...
Dictionary Definition.

/ˈblækˌCHān/

noun

a digital ledger in which transactions made in bitcoin or another cryptocurrency are recorded chronologically and publicly.

-Dictionary.com
A Better Definition.

“The blockchain is an incorruptible digital ledger of economic transactions that can be programmed to record not just financial transactions but virtually everything of value.”

-Don & Alex Tapscott, *Blockchain Revolution* (2016)
Let’s unpack that a bit...

- Records Transactions
- Digital Ledger
- Incorruptible
Records Transactions.
What kind of transactions?

• What kind of transactions could be recorded to a blockchain?
  • Not just financial records.
  • Basically, anything of value to the person participating in a blockchain.
    • Stocks and bonds
    • Deeds
    • Intellectual property
    • Art, music, writing
    • Votes
[Somewhat] Helpful Analogy.

- Public blockchains (more on private blockchains later) operate a lot like Wikipedia.
  - Anyone can write onto the blockchain
  - The community controls how the information is amended/updated.
  - Both run on distributed networks.
How is it different from Wikipedia?

- When you go on Wikipedia, you only get the “master copy”—the most updated version.
- There is only one “master copy.”
- Control of the Wikipedia database remains with the Wikipedia admins.
Blockchain = Decentralized Network.

• There is no single “admin” that controls a single “master copy.”
• There are several “nodes” in the network—each of which updates the record independently.
• You don’t just see the final product (i.e., the most updated version)—the entire history of any transaction or record remains on the blockchain.
Visual Aid.

Each “block” represents a bundle of transactions or records that has been accepted by the network.

They are chained together in the order they were created and accepted to form the blockchain.
Who or What maintains the records?

• A “node” is a device on the blockchain network, whose job is to support the network by maintaining a copy of the blockchain (and all the records on it).

• A node can be any active electronic device connected to the Internet:
  • Computer
  • Phone
  • Printer
More on Nodes.

• Whose electronic devices are we talking about?
  • It can be anyone’s.
  • However processing and storing transactions on a blockchain requires a lot of power, so owners of nodes typically collect a transaction fee, currency, or other incentives for providing such services.

• Every node on the network is equal. There is no such thing as the “King Node.”
Digital Ledger.
Distributed Ledgers.

• “Digital ledgers” have been around for a long time (i.e., spreadsheets).

• What is a “distributed ledger”?  
  • Database maintained and updated independently by each participant (or node) in a large network.
  • Data is not communicated in a linear fashion (from one central authority to the nodes), but independently constructed and held by each node.

• This means that everyone on the blockchain can see all the data at the same time.
The Cost of Trust.
The Cost of Trust.

- Traditional transactions require a third party intermediary or a “central authority” to consummate the transaction (like your bank).
- Using a bank costs money and it requires you to trust your bank.
  - Will they have enough funds?
  - Will the bank go under?
  - Will the bank accurately record the transaction?
- A blockchain transaction does not require a third party intermediary to process, record, or store the transaction.
  - It relies on Proof-of-Work: extremely hard math problems (created just for this purpose) that must be solved in order to create a block.
But how do we know that you are who you say you are?

DO YOU KNOW WHO I AM?

I MEAN REALLY DO YOU EVEN KNOW
Authentication.

- Cryptography
  - Blockchain technology relies upon powerful cryptography to form “private keys.”
    - Private keys are assigned to the participant.
    - These keys allow you to authenticate yourself in a way that is far safer than with a signature.
    - VERY hard to “hack” your private key.
    - Your private key = ownership

- A Note on Personally Identifiable Information
  - Not stored on the blockchain
  - Likely stored by cryptocurrency exchange platform
What are the risks of being hacked?

• While the data in the blockchain are very difficult if not impossible to hack or change, there is still some risk
• Cryptocurrency exchanges facilitate transactions on the blockchain
  • Exchanges will store (and be exposed to hacking of):
    • Information associated with the transactions
    • Digital wallets
      • “Hot” storage: linked to network for ready access and transaction facilitation
      • “Cold” storage: stored offline
    • Personally identifiable information
• Examples: Mt. Gox, Binance, Bitfinex, Coincheck (all hacked)
  • Hackers gain access to the information stored in “Hot” storage
    • Can include private keys of customers or the exchange itself
  • With the private keys, transfers can be authorized
    • Once transferred with the key, unable to be recovered
• Some exchanges will reimburse customers from reserve funds (i.e. Binance)
Immutability.
Are data on blockchains really forever?

- Once data has been written onto a blockchain, no one can change it.
- Each block in a blockchain has a “hash.”
  - A fingerprint for the block that is not susceptible to reverse engineering.
  - If the underlying data changes, you get a completely different “hash.”
- Blocks are chained in order.
  - Each block contains the “hash” of the block that comes before it.
  - Because the hash is actually a function of the data themselves, it is not sequential—it’s chronological.
An Example.

• Let’s say Mr. Fraudster wanted to erase a payment he made on Bitcoin’s blockchain (after Bitcoin hit $19,000).

• He downloads a copy of the Bitcoin blockchain (it’s not that big ~55GB) and erases the payment, which is located on Block 200,000.

• What happens?
  • The block hash will no longer match, since the hash changes if even the smallest detail of the underlying data is changed.
  • If the block’s hash is changed, the chain is broken.
  • You would need to change not just the block containing the payment, you would need to change every block thereafter.
Federal and State Regulatory Scheme

- Both Federal and State agencies regulate virtual currency
- The Securities and Exchange Commission has issued guidance related to Initial Coin Offerings
- Numerous enforcement actions have been brought, claiming unregistered sales of securities, also fraud
- The Financial Crimes Enforcement Network
- The Internal Revenue Service—crypto is property
- The Commodities Futures Trading Commission regulations apply to virtual currency
- State regulators, such as New York Department of Financial Services, Illinois, Hawaii, California, Washington State, and Florida have started to pass or consider laws, both as to the sale of digital assets as well as issues such as money transmitter licenses
- MY Bit license is extremely onerous
Government Investigatory Techniques

• Digital currency is only semi-anonymous: the blockchain is public
  • It is possible to trace a public address to a specific IP address
  • The government can issue a subpoena for information underlying a public address.

• The more digital addresses an individual uses, the harder it will be to piece together his or her full financial picture
Securities Enforcement

- SEC and state regulators can and have asserted jurisdiction over virtual currency transactions
- SEC issued guidance about Initial Coin Offerings, utilizing the Howey Test, S.E.C. v. Howey Co, 328 U. S. 293 (1946)
- Howey coin site, https://www.howeycoins.com/index.html, is an effort to alert potential purchasers about fraud
Securities Enforcement (cont’d)

• Traditional considerations as to whether a transaction is a security, regulated by the SEC or state securities regulators
  • Howey test:
    1) investment of money in a
    2) common enterprise and is led to
    3) expect profits
    4) solely from the efforts of the promoter or third party
  • The test is very fact specific
    • Expect continued and increased focus on securities aspects of virtual currency
ICO Regulatory Issues

- Initially, many investors perceived ICOs as unregulated transactions.
- Subsequently, SEC has repeatedly made clear that ICOs generally will be considered securities transactions under SEC v Howey.
- "I believe every ICO I've seen is a security."
  - SEC chair Jay Clayton, Senate Testimony, 2/6/2018
- Securities must either be registered or meet one of the exemptions from registration (Reg D, Reg CF, Reg A+)
  - SEC recently approved Blockstack PBC’s token offering pursuant to Reg A+.
Criminal Enforcement: Money Laundering


• Section 1956
  • Prohibits a financial transaction involving proceeds known to be from “specified unlawful activity,” with one of several possible specific intents: to conceal; to promote; to avoid the Bank Secrecy Act; etc.
  • Other provisions: conspiracy, international and “sting”

• Section 1957
  • The “spending” statute: $10K threshold but no specific intent

• High-profile prosecutions
  • Silk Road and Liberty Reserve
Money Laundering (cont’d)

- BSA requirements can lead to criminal charge of operating unlicensed money transmitter business (18 U.S.C. § 1960)
  - Charlie Shrem and “BTCKing”
  - *United States v. Lord*

- Extraterritorial application of U.S. criminal statutes
  - Issue of sufficient nexus between conduct and U.S.
  - *United States v. Budovsky*
  - *United States v. Vinnik and BTC-e*
Criminal Enforcement: Wire/Mail Fraud

- Wire or mail fraud (18 USC §§ 1341, 1343, ) occurs when person:
  1) intentionally participates in scheme to defraud another of money or property; and
  2) uses mails or wires in furtherance of that scheme.
Wire/Mail Fraud (cont’d)

• The person’s knowledge of the scheme must be proven.
  • "Knowingly" - to act voluntarily and deliberately, rather than mistakenly or inadvertently

• Knowledge can also be established when one remains willfully blind to the criminal conduct
  • The knowledge element of a wire fraud charge can be satisfied with evidence that a defendant "deliberately closed his eyes to what otherwise would have been obvious to him." *United States v. Leahy*, 445 F.3d 634, 652 (3d Cir. 2006)
Blockchain & Bitcoin in Bankruptcy.
Notable Crypto Bankruptcies.

- Mt. Gox was a bitcoin exchange that handled over 70% of all bitcoin transactions. In February 2014, it filed for bankruptcy after being victim of a massive hack and losing ~740,000 bitcoins. (Bankr. N.D. Texas, 14-31229-SGJ)

- Giga Watt was a bitcoin mining firm that filed for chapter 11 in 2018, after it was sued by a group of plaintiffs for conducting an unregistered securities offering in connection with its ICO. (Bankr. E.D. Wash., 18-03197-FPC)

- Quadrigacx, a Canadian crypto exchange, was forced to file for bankruptcy in February 2019 when its CEO died with all the private keys holding $145M worth of crypto. (Sup. Ct. Nova Scotia, Hfx. No. 484742, 2019)

- Crytopia, a New Zealand crypto exchange, filed for chapter 15 relief in the US in May 2019, when one of its suppliers (an AZ company) threatened to terminate its data storage services unless the debtor came up with $2M. (Bankr. S.D.N.Y., 19-11688-SMB)
Practical Aspects of Crypto in Bankruptcy.

- Property of the estate under § 541(a)
  - “all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held.”
  - “cryptoassets” as more inclusive descriptive term for bankruptcy purposes

- Disclosure
  - Debtors required to disclose all assets.
  - Failure to disclose cryptocurrency accounts could support denial of discharge.
    - *See In re Carmack, 2018 WL 5288912 (Bankr. D. Mass. Oct. 22, 2018)* (“under the circumstances [involving other significant omissions], the omission [of a small cryptocurrency account] supports the conclusion that [the debtor] was at least recklessly indifferent to the truth of statements being made in the Original Disclosures and Amended Schedules.”)

- Accessibility
  - If a debtor loses the private key, there is no practical way to access (or administer) the asset.
    - This is because there is no central recourse for recovery of a lost private key
    - But may give rise to a § 727(a)(2)(A) issue if interested party can establish necessary elements


Practical Aspects of Crypto in Bankruptcy (cont.)

• **Valuation**
  
  • Cryptocurrency can have drastic shifts in value over a short time
    
    • ex. One Bitcoin valued as of Sept. 27, 2017 = $3,892.94; as of Nov. 10, 2017 = $7,173.73
    
    • the now infamous “Bitcoin Pizza” was purchased in May 2010 for 10,000 Bitcoin (2 large pizzas)
      
      • June 2019 value of 10,000 Bitcoin = $77.13 Million

• **Classification**
  
  • As an asset, typically considered to be a “general intangible” for purposes of the Uniform Commercial Code
  
  • May be subject to creditor’s security interest or lien if creditor is perfected as to general intangibles pursuant to UCC-1 filing
Practical Aspects of Crypto in Bankruptcy (cont.)

- Chapter 7
  - Liquidation
  - Avoidance of pre-petition transfers under § 550(a)?
    - identifying the transferee can be a problem with anonymous transactions
    - which date applies for valuation? petition date or date of avoidance
    - depends on whether classified as commodity or currency
      - See Kasolas v. Lowe (In re Hashfast Technologies LLC), 2016 WL 8460756 (Bankr. N.D. Cal. June 17, 2016) (raising issue but declining to rule on question at summary judgment stage)

- Chapter 13
  - liquidation test § 1325(a)(4)
    - If applicable, should include in calculation of value of “property to be distributed”
  - modification of plan under § 1329
    - Has the value significantly shifted since plan confirmation so as to justify a modified plan?
Practical Aspects of Crypto in Bankruptcy (cont.)

• Chapter 11
  • May involve insolvent cryptocurrency exchanges with significant holdings
  • Will the liquidation of significant cryptocurrency holdings impact the market price to the detriment of creditors? *(MtGox)*
    • Duty of Trustee to maximize value to estate and creditors
  • International transactions and creditors
    • Tax liabilities and implications may vary

• Chapter 15 - Recognition of a Foreign Proceeding and Relief
  • Given the multilateral nature of cryptocurrency transactions and exchange operations, debtors may proceed in multiple jurisdictions
    • Ex. MtGox proceedings began in Japan, but Bankr. N.D. Texas was later petitioned for recognition under chapter 15.
Practical Aspects of Crypto in Bankruptcy (cont.)

• Other Considerations
  • Historically, parties involved in cryptocurrency exchanges were mainly early adopters. But in the wake of rapid increases in value in 2017, many new entrants made investments or created new currencies and exchanges. As those individuals and companies succeed or fail going forward, likely to see an increasing impact on insolvency practice.
  • While exchanges do not own the assets of their customers, they do acquire significant assets of their own through transaction fees that are often a percentage of the transaction amount.
What About Blockchain in Bankruptcy?

• Blockchain technology is gaining traction in several industries and a variety of use cases
  • Tracking and monitoring supply chains
  • Cross-border financial business transactions

• Current Examples
  • MediLedger Project
    • Collaborative effort to track supply chain issues for pharmaceuticals
      • *Pfizer and Others Join Working Group to Use Blockchain Protocol for Supply Chain Management, Forbes* (May 2, 2019, 07:00 AM).
  • IBM Blockchain Platform
    • Commercially available blockchain developer tools

• Are there potential applications in bankruptcy proceedings?
Potential Application of Blockchain in Bankruptcy

- **Auctions**: Blockchain technology could streamline this process by automating portions, if not the entirety of, the auction process — *i.e.*, by cutting out the “middleman.”
  - The debtor, the stalking-horse bidder, the debtor’s lender and any other parties in interest can agree to the parameters of the auction process and, once approved by the bankruptcy court, build a blockchain environment based on those parameters.
  - In lieu of professionals, computers on the network would verify a proposed bid to check, among other things, whether the bid is a “qualified bid” under those pre-approved rules.
  - Each bid, once accepted onto the blockchain, would be stamped with a hash so that its position in the relative order would be incorruptibly established.
Potential Application of Blockchain in Bankruptcy

• **Claims Administration**: Blockchain technology can be employed throughout the entire claims-administration process, from the creation of the claims registry to distribution to allowed claimholders.

  • Rather than having professionals tasked with sifting through thousands of claims to determine whether they are time-barred or duplicative, the technology can verify that the claim is timely and nonduplicative before recording the claim onto the blockchain.

  • Similarly, once the bankruptcy court confirms a chapter 11 plan outlining what constitutes an “allowed claim,” the priority scheme of such claims and the distribution mechanisms, all of those parameters can be programmed into the blockchain to ensure a timely and automated distribution process.

  • Because the blockchain is a decentralized network, all parties-in-interest (i.e., those who have requested notice) can be given access to the blockchain to see for themselves which transactions have been recorded.

  • Notice parameters can be built in such that any “rejections” can trigger the generation of a notice of rejection (which could, in turn, cause the debtor’s professionals to file an objection).
Potential Application of Blockchain in Bankruptcy

- **Vote Tabulation**: Given the vaunted security of blockchain technology, it is no surprise that states have viewed its potential for fighting election tampering and low voter participation.
  - West Virginia offered mobile blockchain voting applications for overseas votes in the past November 2018 election for this exact reason. A similar concept can be applied to the voting process under 11 U.S.C. § 1126.
  - For example, one of the rules programmed into the blockchain could be that a vote can only be counted if it is an “allowed claim” under 11 U.S.C. § 502. In other words, if an objection has been lodged against the claimant attempting to cast a vote, the vote will be rejected.
  - As with the sale process and claims administration, blockchain technology has the potential to alleviate some of the inherent inefficiencies of vote-tabulation under the current system.
Any Questions?
The end
Distinctions with a Difference – Considering Canadian and U.S. Substantive Law in Cross-Border Restructurings
## Comparison of U.S. and Canadian Substantive Law in Restructuring Proceedings

**NCBJ INTERNATIONAL PROGRAM, THURSDAY, OCTOBER 31, 2019**

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<th>SUBSTANTIVE DIFFERENCE</th>
<th>Treatment in Canadian Proceeding</th>
<th>Treatment in U.S. Proceeding</th>
<th>Potential Effect / Cross Border Examples/Tips</th>
</tr>
</thead>
</table>
| 1. Courts/Judges       | • Courts are trial courts of general jurisdiction generally without jurisdictional limitations.  
                          • In some provinces certain judges with insolvency related experience are designated as commercial judges  
                          • Specialized courts that handle bankruptcy cases and vast majority of related matters and proceedings.  
                          • Article I in theory limits judges final jurisdiction to enter orders in “core matters” and all related matters with consent of the parties. In practice most matters are handled by the bankruptcy judges.  
                          Although many areas of the restructuring law between the CCAA and Ch. 11 have become similar it is a mistake for US Practitioners to presume or assume this to be the case absent precedent. To do so will lead to both strategic and substantive errors |
| 2. Relevant Statutes   | • Bankruptcy is within the federal domain addressing allocation of assets and liabilities, priorities and liens. Provincial law addresses unaddressed issues of property rights and security interests (e.g. PPSA like UCC) receiverships and certain labor and employment laws and some pension plans. Provincial law cannot frustrate the Canadian bankruptcy regime.  
                          • Bankruptcy and Insolvency Act (BIA) can be used to restructure or liquidate companies but is not as flexible as CCAA  
                          • Article I of the Constitution authorizes Congress to enact uniform laws on bankruptcy. State law fills in gaps not addressed in the Bankruptcy Code (BC), including property laws, security interests and other unaddressed areas of the law.  
                          • Chapter 11 is the only BC restructuring provision available to address non-farm and non-municipal corporate restructuring, although may be used by individuals and may involve liquidation of all assets.  
                          • Receiverships less common in many states due to limited jurisdiction and outdated statutes. There is a federal receivership statute that permits sales |

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1 Except where otherwise indicated the comparisons are limited to a comparison of restructuring proceedings under the Canadian *Companies Creditors' Arrangement Act* (CCAA) and Chapter 11 of the U.S. *Bankruptcy Code*
| **3. Cultural Differences** | • CCAA\(^2\) which is the preferred statute for complicated restructurings has only 63 sections in total.  
• Receiverships are common. | • Receiverships are common.  
• Comprehensive *Bankruptcy Code* and strong reliance on precedent.  
• Broad and extensive discovery permitted and in large cases more litigious.  
• Institutionalized creditors’ committee professional involvement increases likelihood of disputes | •  |
| **4. Stay of Proceedings** | • Less litigious. Discovery rules not as broad based.  
• Clear statutory power for Judge to “make any Order that it considers appropriate in the circumstances” on notice, or without notice.  
• More discretionary judge-made law because of less detailed statute | • Automatic stay upon filing of Petition and generally remains in place until confirmation of the Chapter 11 plan, unless stay relief order entered earlier  
• Electronic filing of Petition gives immediate effect.  
• Parties may seek relief from stay for “cause” including lack of “adequate protection” and/or lack of equity together with an asset being unnecessary for an effective reorganization. | • Square Two Financial: Pre-filing stay obtained in Canada to permit solicitation period to run prior to filing in U.S. or Canada |
| **5. Insolvency Threshold Requirement** | • No automatic stay of proceedings. Stay is discretionary and only by way of Court Order.  
• Typically granted as part of Initial Order, is very broad and is tied to milestone’s in the case.  
• No electronic filing to commence proceeding. Court attendance is required.  
• Stay does not obligate a person to make additional advances or stop a person from requiring immediate payment for goods services, licensed property after the stay is ordered | • Debtor must be cash-flow or balance sheet insolvent or facing a looming liquidity crisis.  
• No formal insolvency requirement.  
• However, if challenged in a dismissal or conversion motion that the filing is made in good faith. | • Forum shopping for non-insolvent debtors.  
• Chapter 11 in theory may encourage earlier filing. |
| **6. Professionals/Oversight Roles** | • DIP Remains in Possession; appointment of Chapter 11 Trustee and examiner are infrequent. | • DIP Remains in Possession; appointment of Chapter 11 Trustee and examiner are infrequent. | • Potential coordination issues and/or conflicts |
| 7. Ability to Invade Secured Creditor’s Collateral and Proceeds for Payment of Administrative Claims |

- Reasonable costs and fees of administrative claimants including the Monitor can be charged against the secured collateral or proceeds.

- Absent consent which frequently occurs through a “carve out” in connection with financing orders, strict standard for invading secured creditors collateral limited to “reasonable, necessary costs and expenses of preserving or disposing of estate but only to extent of benefit to the claim holder.

* Caterpillar Financial Services Corporation v. Boale Wood & Company, 2013 BCSC 1593, 2014 BCCA 419 (2014-10-31) The order creating the “Administrative Charge” was made in accordance with the CCAA and the U.S Court’s “Recognition Order” did limit in any way the process of realization to be undertaken under the CCAA. Once the CCCAA proceedings were recognized as the foreign main proceeding, it was entirely for the British Columbia Supreme Court to determine priority. Thus, although the “Administrative Charge” was made in accordance with the CCAA and the U.S Court’s “Recognition Order” did limit in any way the process of realization to be undertaken under the CCAA, once the CCCAA proceedings were recognized as the foreign main proceeding, it was entirely for the British Columbia Supreme Court to determine priority. Thus, although the “Administrative Charge” was made in accordance with the CCAA and the U.S Court’s “Recognition Order” did limit in any way the process of realization to be undertaken under the CCAA, once the CCCAA proceedings were recognized as the foreign main proceeding, it was entirely for the British Columbia Supreme Court to determine priority.
8. Classification of Creditors / Voting

- Debtor divides creditors into separate classes based on “commonality of interest” for the purpose of voting on a Plan, based on a “non-fragmentation test”.
- Classification is based on a creditor’s legal rights in relation to the debtor – not their rights as creditors in relation to one another.
- All unsecured creditors generally constitute one class.
- No “deemed acceptance” of a Plan by an entire class. Plan is not binding on any class that doesn’t vote to approve it.
- No secured creditor cramdown if the class does not approve the Plan.
- Cram down / cram up of other classes is not permitted.
- Plan must be accepted by each class of creditors (2/3 in value and simple majority in number)
- Plan subject to sanction by the Court based on whether it is “fair and reasonable”.
- Equality of treatment (as opposed to equitable treatment) is not a necessary or desirable goal.

- Creditors may be grouped into classes based on “substantially similar” claims.
- Can have impaired and unimpaired classes of creditors, and can include different treatment for classes of equal rank and priority. Unimpaired classes deemed to accept plan.
- A class of claims is deemed to accept the Plan if creditors holding 2/3 in value and a simple majority in number of the allowed claims in the class vote in favor. Determined by only those voting.
- If required acceptance is achieved within a class those not voting or rejecting plan within the class are bound by plan terms.
- If all other confirmation requirements are met, except for class acceptance cram down of both unsecured classes and secured classes is permitted subject to specific requirements including that the plan be “fair and equitable and does not unfairly discriminate
- Cramdown of secured claims claimants requires claimant generally to retain liens and receive the present value of the secured claim or otherwise receive its “indubitable equivalent.”
- For cramdown of unsecured claims absent full payment in property on the plan effective date of allowed amount of claim.

Charge” did not attach in rem, it does attach to the proceeds from the sale of the U.S. vessel.

Can influence pre-filing considerations (including arguments as to COMI, foreign main/non-main), based on proposed treatment & position of creditor groups.
or junior claimants or interest holders may not receive or retain property under the plan. There is a new value exception to this absolute priority rule, but generally new value must be substantial to avoid the rule and may require making the right to commit new value open to all parties.

9. Equity Claims
   - Equity holders are not entitled to vote on a Plan
   - No payment or preservation of equity claims (i.e., dividends or returns of capital) unless and until all creditors have been paid in full.
   - Equity claims must be all in the same class.
   - Equity holders may be classified
   - The “absolute priority rule” applies, and no ability to retain pre-filing equity interest unless all creditors are paid in full.
   - Limited exceptions exist, where equity holders provide “substantial new value” to the reorganized debtor.

10. Labor and Employment/Collective Bargaining Agreements/Pensions
    - Collective Bargaining Agreements (CBA) cannot be unilaterally terminated or disclaimed although may apply for order authorizing the debtor to serve notice to bargain under applicable labour laws upon stringent showing of irreparable damage, good faith efforts to renegotiate and absence of viable compromise or arrangement taking CBA into account.
    - Prior to approving sale of assets outside the OCB Court must be satisfied that Debtor will make Pension contributions like what would have been required in Court order approving plan or proposal.
    - Debtor may assume or reject a CBA in accordance with the criteria set out in section 1113(c) of the Bankruptcy Code with many Courts applying a flexible approach requiring debtor show that proposal contains necessary changes but not minimal changes enabling completion of the reorganization successfully.
    - Open issue of whether sale free and clear of liens is free of ERISA liabilities or whether there is successor liability.
    - Nortel resolution of Pension Claimants Claims.
      - Indalex Ltd, 2011 ONCA 265 (Pension plan beneficiaries not given notice of CCAA could not be bound by DIP lender priority).

11. Sales Process
    - Integrity of the process (rather than price) is paramount.
    - Can be administered by the Debtor, the Monitor, a CRO or a third party
    - Generally, administered by DIP. Frequently a two-step process involving bidding and other procedural order and then actual sale order following bid or auction process.

12. Third Party Releases
    - There must be a “reasonable connection” between the third-party claim being released and the restructuring.
    - Conflicting case law among the Circuits. Some have concluded that section 105(a)
• Court will consider the following factors:
  o Whether parties to be released are necessary and essential to the restructuring;
  o Whether the claims to be released are rationally connected to the purpose of the plan;
  o Whether the plan can succeed without the releases;
  o Whether the parties being released were contributing to the plan;
  o Whether the releases benefit the debtor(s) as well as the creditors generally;
  o Whether the creditors voting on the plan have knowledge of the nature and the effect of the releases; and
  o Whether the releases are fair, reasonable, and not overly-broad.

  of the *Bankruptcy Code* provides the requisite statutory authority.

• Court will consider the following factors:
  o Whether the interested parties consent to the release.
  o Whether the release is integral to the agreement among the various parties in interest and is essential to the formulation and implementation of the plan;
  o Whether the release confers substantial benefits on the debtor’s estate;
  o Whether the release is fair, equitable and reasonable; and
  o Whether the release is in the best interests of the debtor, its estate, and the parties in interest.

• US Courts have accepted third party releases as part of Chapter 15 recognition of Canadian proceedings.

<table>
<thead>
<tr>
<th>13. Disclaimer of Contracts</th>
<th>• Debtor may disclaim any pre-filing contracts. If Monitor approves, court approval of disclaimer is not required. If Monitor does not approve, Debtor may apply to court for an order that the agreement is disclaimed.</th>
<th>• Debtor may “reject” or assume and/or assign most pre-filing executory contracts and leases. Counterparty is left with unsecured claim for damages except in certain cases (e.g. debtor lessor, licensor of certain IP).</th>
<th>• Pope and Talbot ordered cure costs on insistence of CC counsel which benefitted Canadian contract holders though no cure costs required by CCAA.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Counterparty may challenge disclaimer.</td>
<td>• The following contracts may not be disclaimed:</td>
<td>• Debtor can &quot;cherry-pick&quot; the contracts it wants to assume, or assign based on economic conditions.</td>
<td>• Debtor may be deemed to be a breach, not a termination and claimant has a general unsecured claim for breach damages</td>
</tr>
<tr>
<td>• The following contracts may not be disclaimed:</td>
<td>o Eligible financial contracts;</td>
<td>• If executory contracts are assumed, DIP must cure any defaults within reasonable time. Any later default is admin. claim</td>
<td>• Pope and Talbot ordered cure costs on insistence of CC counsel which benefitted Canadian contract holders though no cure costs required by CCAA.</td>
</tr>
<tr>
<td>o Collective agreements;</td>
<td>o Financing agreement if Debtor is borrower; and</td>
<td>• IF rejected it is deemed to be a breach, not a termination and claimant has a general unsecured claim for breach damages</td>
<td>• Debtor may “reject” or assume and/or assign most pre-filing executory contracts and leases. Counterparty is left with unsecured claim for damages except in certain cases (e.g. debtor lessor, licensor of certain IP).</td>
</tr>
<tr>
<td>o Real property lease if Debtor is lessor.</td>
<td></td>
<td></td>
<td>• Pope and Talbot ordered cure costs on insistence of CC counsel which benefitted Canadian contract holders though no cure costs required by CCAA.</td>
</tr>
</tbody>
</table>
| 10. Post-Petition Interest | • Post-filing interest continues on secured claims.  
• Common law “interest stops rule” applies, which prohibits the accrual or payment of post-filing interest on unsecured pre-filing claims. This is stated to be a logical and necessary corollary to the *pari passu* principle. | • Unsecured creditors not entitled to assert claims for post-petition interest in most instances though solvent estates may be required to pay interest.  
• Secured creditors may assert claims for post-filing interest only if oversecured (and only up to the value of the collateral).  
• Unclear as to what rate applies for such oversecured claims. | • *Nortel* (settlement in the US / court determination in Canada: [$1.5 Billion] difference in outcome) |
Opening Keynote Session:
Bankruptcy Prediction Models and Their Use In The Courtroom
by
Mark Zandi
Chief Economist
Moody’s Analytics
Bankruptcy Prediction Models and Their Use in the Courtroom

Introduction

A bankruptcy case can have significant implications for the debtor, creditors, and other stakeholders. A debtor may lose assets in exchange for the bankruptcy fresh start. The debtor’s credit also may take a hit. Creditors frequently lose not only money, but also a customer, supplier, or business source. These collective losses, in turn, can impact markets and the economy more generally. Consequently, the factors contributing to an individual’s or business’s decision to file for bankruptcy protection often garner a great deal of attention. Indeed, academics and professionals have long focused on researching and developing bankruptcy prediction models.

Although methodologies vary, some common observations emerge. For example, in business bankruptcy cases, researchers suggest that financial ratios and corporate governance indicators, such as board structure, ownership structure, cash flow, contract rights, and key officer retention are effective bankruptcy predictors.¹ The primary indicators for individual bankruptcy cases consist of cash flow, unexpected expenses, unemployment, medical bills, and mortgage delinquencies.² Researchers use all of these factors as metrics to measure an entity’s or individual’s financial position, or they evaluate significant events or structural characteristics of the entity or individual that directly impact this position.


* These materials were prepared by the Honorable Michelle M. Harner and Jayne Chung, one of Judge Harner’s former externs, for purposes of the 2019 National Conference of Bankruptcy Judges Annual Meeting. The materials are intended to provide general background information for the November 1, 2019, keynote address. The materials do not represent the views or work of the keynote speaker.

Judge Harner serves on the United States Bankruptcy Court for the District of Maryland. This article is presented as an academic paper and does not express any opinions or positions regarding any issues that may arise, or any parties that may appear, in any cases before Judge Harner. Judge Harner appreciates the assistance of her law clerk, Emily Lamasa, and her paralegal, Kimberly Goodwin. Ms. Chung is a juris doctorate candidate at the University of Maryland Francis King Carey School of Law, Class of 2020.
This paper focuses primarily on business bankruptcy cases. As discussed below, litigators using bankruptcy prediction models generally do so when the dispute involves a business entity. Studies focusing on individual bankruptcy predictors are no less important, but often contribute value in other contexts.

For business bankruptcies, balance sheets and income statements appear to provide the most relevant information to depict an entity’s financial position. Many studies indicate that, to a certain degree, it is possible to forecast bankruptcy by using this financial information. Specifically, modern studies estimating the risk of bankruptcy focus heavily on financial ratios, as well as non-ratio financial information. According to research analyzing 208 relevant studies between 1966 and 2004, 79% of the studies used financial ratio information while only 15% used non-ratio financial information. These studies suggest that financial ratios based on financial statements can offer strong insights into a company’s possible future financial distress and bankruptcy.

The research on financial ratio utilization in bankruptcy prediction can be traced to the model proposed by William Beaver in 1966, followed by one of the most well-known bankruptcy prediction models, the “Z-Score” model, proposed by Edward Altman in 1968. Altman’s Z-Score model uses multiple discriminant analysis, which combines traditional financial statement ratios

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3 Balance sheet is defined broadly as “a statement reflecting the financial position of an enterprise as of a specific date.” Felix P. Kollaritsch, Can the Balance Sheet Reveal Financial Position?, 35 The Accounting Rev. 482, 482 (1960).


5 Id. at 74.

6 Id. (citing to Hossari, G., A Ratio-Based Multi-Level Modelling Approach for Signalling Corporate Collapse: A Study of Australian Corporations, Dissertation, Australian Graduate Sch. of Entrepreneurship Swinburne U. of Tech., Australia (2006)).

7 Id. at 62.

with a statistical multiple variant technique. Altman’s Z-Score model has remained a dominant method in bankruptcy prediction while other models also have sprung up, as elaborated below.

Bankruptcy Prediction Models Using Financial Ratios

The following discussion summarizes a few of the key models utilizing financial metrics to predict financial distress and bankruptcy:

Beaver’s Analysis (1966)

The first notable prediction model utilizing financial ratios stems from Beaver’s study, titled Financial Ratios as Predictors of Failures and published in 1966. Beaver analyzed the financial-statement ratios of 79 industrial and publicly owned corporations which were bankrupt, had defaulted on interest or bond payments, had an overdrawn bank account, or failed to pay a preferred stock dividend between 1954 and 1964. The financial ratios included the following: cash flow/total debt, net income/total assets, total debt/total assets, working capital/total assets, and current ratio. Evaluating the predictive ability of each ratio in bankruptcy, the study found that the ability to predict failure was the strongest in the cash flow/total debt ratio, and the second strongest in the net income/total asset ratio.

Altman’s Z-Score Model (1968)

Two years after Beaver’s work, Altman published a paper on the Z-Score model, which remains a dominant prediction model. The Z-Score model is an equation that calculates a score using the financial ratios of a firm, where the score can distinguish bankrupt from non-bankrupt

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10 Jarmila Horváthová and Martina Mokrišová, Risk of Bankruptcy, Its Determinants and Models, 6 RISKS 1, 3 (2018); Aktan, supra note 4 at 75.
12 Id. at 71, 72.
13 Id. at 85.
14 Id.
15 Horváthová and Mokrišová, supra note 10 at 3.
companies. The sample population for Altman’s study was composed of 33 publicly-held manufacturing corporations bankrupted between 1946 and 1965, and 33 non-bankrupt corporations of a similar size and industry that were paired to each of the 33 bankrupt corporations. The asset sizes of the testing population ranged from $0.7 million and $25.9 million; the mean asset size was $6.4 million. Analyzing the balance sheet and income statement of the selected corporations, Altman created a function to calculate the overall Z-Score using the following five financial ratios: working capital/total assets, retained earnings/total assets, earnings before interest and taxes/total assets, market value equity/book value of total debt, and sales/total assets. A score above 2.99 indicates a low chance of bankruptcy while a score below 1.81 means the firm is likely to go bankrupt. Scores between 1.81 and 2.99 are defined as “a gray area.” When tested on a new set of samples, the Z-Score model correctly predicted 79% of the sample firms. After publication of his original article, Altman continued to calibrate and update his model.

Ohlson’s O-Score (1980)

James Ohlson developed the O-Score model by studying 105 bankrupt public industrial firms and 2,058 non-bankrupt firms between 1970 and 1976. Compared to the relatively limited sample size of the other prediction models, this study is noteworthy for its extensive sample size.
Analyzing the financial data obtained from 10-Ks of these companies, Ohlson introduced his O-Score model that calculates the probability of bankruptcy by using the following financial ratios: total liabilities/total assets, working capital/total assets, current liabilities/current assets, net income/total assets, and funds provided by operations/total liabilities.\textsuperscript{25} According to his study, the four basic, statistically significant factors in predicting bankruptcy within one year were the size of the company and the measures of financial structure, performance, and current liquidity.\textsuperscript{26}

Shumway’s Hazard Model (2001)

Tyler Shumway pointed out that the aforementioned models produced biased and inconsistent bankruptcy predictions due to their failure to account for the firms’ changing characteristics over time.\textsuperscript{27} He analyzed 300 bankruptcy cases from between 1962 and 1992 to create the Hazard Model which employs both accounting based and market driven variables to forecast bankruptcy by incorporating time-varying variables.\textsuperscript{28} His study found that about half of the accounting ratios that have been recognized by the previous models were not as significant, while other factors, such as market size and past stock return, are strongly related to the risk of bankruptcy.\textsuperscript{29} The accounting ratios used in his model consisted of net income/total liabilities and total liabilities/total assets.\textsuperscript{30}

Courts’ Consideration of Bankruptcy Prediction Models

Although the aforementioned models have been studied by academics, employed in the industry to a certain extent, and used by parties in litigation, courts are split on the models’ utility in resolving disputed matters. The judicial split is perhaps not surprising given the inherent

\textsuperscript{25} Id. at 115, 118.
\textsuperscript{26} Id. at 110.
\textsuperscript{28} Id. at 101, 102, 113.
\textsuperscript{29} Id. at 101, 102.
\textsuperscript{30} Id. at 103.
uncertainty in any prediction model. The statistical models are never 100% accurate; rather, they indicate a correlation between various factors and the projected phenomenon to a certain degree.

To date, the primary statistical model presented in the courtroom is the Z-Score model. The popularity of the model does not, however, translate to acceptance by the courts. Some courts acknowledge the merits of the Z-Score model in the context of litigation. Other courts, however, limit its application because, for example, the small sample populations used to create the model, other non-financial factors attributing to bankruptcy, and the broad definition of “bankruptcy” used in the model. The following cases illustrate the different approaches of courts on this issue.

In National Wildlife Federation v. E.P.A, the plaintiff challenged the rule promulgated by the Environmental Protection Agency (“EPA”) under the Clean Water Act.\(^{31}\) To justify the reasonableness of its decision to promulgate the rule, the EPA argued in court that its analysis using the Z-Score model had indicated no additional risk of bankruptcy for entities subject to the rule after factoring in the cost of compliance.\(^{32}\) The court stated that the EPA’s application of the model was reasonable due to the Z-Score’s accurate prediction of some notable bankruptcy cases.\(^{33}\) The court also noted that the inaccuracy rate of the model is not so large as to question the model’s reliability considering influencing factors other than mere financial distress.\(^{34}\)

In addition, in American Pegasus SPC v. Clear Skies Holding Company, LLC, the Z-Score model was used in combination with the discounted cash flow analysis to explain the financial position of an entity.\(^{35}\) The court mentioned other courts’ acceptance of the Z-Score model by citing to Figueroa v. Sharper Image Corp.\(^{36}\) and Litman v. U.S.,\(^{37}\) where the courts acknowledged

\(^{31}\) 286 F.3d 554 (D.C. 2002).
\(^{32}\) Id. at 564.
\(^{33}\) Id. at 565.
\(^{34}\) Id.
\(^{36}\) 517 F.Supp.2d 1292, 1316 (S.D. Fla. 2007).
\(^{37}\) 78 Fed. Cl. 90, 126 (Fed. Cl. 2007).
the Z-Score as a widely accepted indicator of bankruptcy risk and a reliable predictor of a firm’s potential bankruptcy.\textsuperscript{38} Considering other courts’ acceptance of the model and the use of the discounted cash flow model to corroborate the result, the court in \textit{American Pegasus SPC} rejected the argument that the Z-Score model rendered the EPA’s analysis unreasonable.

On the other hand, in \textit{DiFelice v. U.S. Airways, Inc.}, the court did not allow the plaintiff to use the Altman Z-Score model to prove that the defendant was on the cusp of bankruptcy.\textsuperscript{39} The court’s position stemmed from the fact that the model was “based on almost entirely on [the entity’s] historical financial metrics,” and does not “take account of future events that might impact the likelihood of bankruptcy,” such as the possibility of resolving “its liquidity problems by obtaining a federal loan guarantee” or “restruct[ing] voluntarily.”\textsuperscript{40} The court also noted that because the model was built upon the statistical data generated from an empirical study of real-life bankruptcy cases, its applications would be limited to the entities that conform to the characteristics of the firms used in the study.

In \textit{In re Riso}, the court declined to apply the Z-Score model for at least two reasons. First, the court questioned the model’s application to small firms having less than $1 million dollars in total assets, noting that “the mean asset size of the[] firms [used in the Z-Score model] was $6.4 million, with a range between $0.7 million and $25.9 million.”\textsuperscript{41} Second, the court considered the model’s use of the term “bankruptcy” for both liquidation and reorganization cases without controlling for differences in those two types of bankruptcy cases. For example, the primary purpose of a liquidation-based bankruptcy is to liquidate a debtor’s assets and distribute the proceeds to creditors, and the primary purpose of the reorganization-based bankruptcy is the

\textsuperscript{38} \textit{American Pegasus SPC}, 2015 WL 10891937, at *44.
\textsuperscript{39} 436 F.Supp.2d 756 (E.D. Va. 2006), aff’d, 497 F.3d 410 (4th Cir. 2007).
\textsuperscript{40} \textit{Id.} at 769, 770.
rehabilitation of a debtor by reorganizing his/her/its financial position through a court-approved repayment plan. As such, the court in Riso observed that the lack of a clear distinction between reorganization and liquidation cases in the study significantly limited the relevance of the model in the case.42

Conclusion

The use of financial information to develop bankruptcy prediction models is not a new or novel concept. Since the first notable study in 1966, academics have continued to develop and refine statistical models to predict financial distress and bankruptcy. Although courts remain split on the utility of such models, courts considering the models have emphasized the need to critically evaluate the studies and their application to the disputed matter before the court. That thoughtful approach appears appropriate considering the unique circumstances of each case and the inherent shortcomings in any statistically developed prediction model.

42 Id. at 288.
Judicial Merry-Go-Round on Hot Topics – Business Cases


Navigating Administrative Insolvency to Optimize Value: *Czyzewski v. Jevic Holding Corp.* and Its Implications

**The Honorable Brendan L. Shannon**, U.S. Bankruptcy Court for the District of Delaware  
**The Honorable Jeffery A. Deller**, U.S. Bankruptcy Court for the Western District of Pennsylvania

**Topic:** Judges Shannon and Deller will lead discussions of the state of the law regarding distributions of estate assets outside a plan and related topics after the Supreme Court’s decision two years ago in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017), which held that the structured dismissal of a chapter 11 case may not include a distribution of estate assets in violation of the priority rules that would apply under a chapter 11 plan (absent the affected creditors’ consent).

1. **Background**

The *Jevic* case arose after Jevic Transportation ("Jevic"), a New Jersey trucking company, was acquired by Sun Capital Partners ("Sun"), a private equity firm, in a 2006 leveraged buyout ("LBO"). The acquisition was financed by an $85 million loan from a consortium of lenders led by CIT Group ("CIT"), secured by a lien on all of Jevic’s assets. Soon afterwards, Jevic defaulted on the loan. By the end of 2007, CIT had entered into a forbearance agreement with Jevic and obtained a guarantee from Sun of $2 million of Jevic’s debt. But when the forbearance agreement expired in May 2008, Jevic was still in default. On May 19, 2008, Jevic terminated its truck drivers without notice. The next day, it filed a chapter 11 petition.

The truckers brought a class action against Jevic and its owner, Sun, for violating the Worker Adjustment and Retraining Notification ("WARN") Act and analogous New Jersey law, which require advance notice of such a termination. Ultimately, the truckers prevailed on their state-law claims against Jevic (but not against Sun), leaving them with back-pay claims against Jevic in its bankruptcy case. Section 507(a)(4) of Title 11 of the United States Code (the "Bankruptcy Code") grants priority to certain claims for unpaid employee wages and benefits, including back pay awards under WARN laws. About $8.3 million of the truckers’ claims against Jevic were priority claims under section 507(a)(4). In a chapter 7 case, or in a confirmed chapter 11 plan, the Bankruptcy Code indisputably required that those priority claims be paid in

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1 Materials prepared with the assistance of Danielle Spinelli, Esq., WilmerHale, LLP.
full before claims of lower priority—such as general unsecured trade debt—could be paid anything.\(^2\)

Failed LBOs commonly give rise to fraudulent transfer litigation, and did so here. After Jevic’s bankruptcy filing, the official committee of Jevic’s unsecured creditors was authorized to litigate fraudulent transfer claims on the estate’s behalf. The committee sued Sun and CIT under § 548 and § 544(b) of the Bankruptcy Code, alleging that the LBO transferred Jevic’s value to Sun and CIT for less than reasonably equivalent value and left Jevic unable to pay its creditors. The suit sought to avoid the liens Sun and CIT asserted on Jevic’s assets and recover other property transferred in connection with the LBO for the estate. That property would then be distributed to Jevic’s creditors in the bankruptcy case.

During the course of the bankruptcy case, the estate’s assets dwindled to the fraudulent-transfer suit and $1.7 million in cash, on which Sun claimed to hold a lien. At that point, Jevic, the committee, Sun, and CIT agreed to settle the fraudulent-transfer suit. The settlement agreement provided that (1) the bankruptcy court would dismiss the fraudulent-transfer suit with prejudice; (2) CIT would deposit $2 million into an account earmarked to pay the committee’s legal fees; and (3) Sun would assign its lien on the remaining $1.7 million in cash to a trust, which would pay administrative expenses (which have second priority under section 507(a)) and taxes (which have eighth priority), and then distribute the remainder to non-priority general unsecured creditors. Critically, the truck drivers would get nothing on account of their $8.3 million in fourth-priority wage claims. Finally, (4) the bankruptcy court would dismiss the chapter 11 case.

The bankruptcy court approved the settlement and dismissal over the objections of the truck drivers and the U.S. Trustee. The court reasoned that while the proposed distribution of assets violated the priority scheme in section 507, that in itself did not bar approval, since the distribution was occurring in connection with a structured dismissal of the chapter 11 case, rather than a plan. Moreover, the court believed that without the settlement and dismissal, there was “no realistic prospect” of a meaningful distribution for anyone other than the secured creditors; that is, the settlement made general unsecured creditors better off without making the truck drivers worse off.\(^3\)

The district court and Third Circuit affirmed. The Third Circuit reasoned that the Bankruptcy Code codified the priority scheme only in the context of a Chapter 11 plan, and that “in rare instances,” a court could thus approve a deviation from priority in the context of a structured dismissal.\(^4\)

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\(^4\) Id.
2. **Supreme Court Decision**

   a. **Majority Opinion (Breyer, J.)**

   The Supreme Court granted the truckers’ petition for certiorari and reversed the Third Circuit by a 6-2 vote. In a majority opinion written by Justice Breyer, the Court held that “[a] distribution scheme ordered in connection with the dismissal of a Chapter 11 case cannot, without the consent of the affected parties, deviate from the basic priority rules that apply under the primary mechanisms the Code establishes for final distributions of estate value in business bankruptcies”—i.e., a chapter 11 plan or a chapter 7 liquidation.5

   The Court first rejected Jevic’s argument that the truckers had no standing to challenge the settlement because they suffered no cognizable injury; in Jevic’s view, the truckers would not have received anything for their claims even if the settlement had not been approved.6 Without the priority-violating distribution, Jevic argued, Sun and CIT would not have agreed to settle, and absent that settlement, the fraudulent-transfer suit had no value.7 The Supreme Court disagreed, finding that “the record indicates that a settlement that respects ordinary priorities remains a reasonable possibility” and that “the fraudulent-conveyance claim could have litigation value.”8 Because the truckers had lost the ability to continue to fight for a settlement that respected their priority—as well as the ability to pursue the fraudulent-transfer action on their own behalf and potentially obtain a recovery—they were injured and had standing for Article III purposes.9

   Analyzing the merits of the question presented, the Court explained that “Chapter 11 foresees three possible outcomes[:] a bankruptcy-court-confirmed plan[,] . . . conversion of the case to a Chapter 7 proceeding . . . [, or] dismissal of the Chapter 11 case.”10 “The Code also sets forth a basic system of priority, which ordinarily determines the order in which the bankruptcy court will distribute assets of the estate.”11 That system includes both the rule of absolute priority—senior creditors must be paid in full before junior creditors may recover anything, and junior creditors must be paid in full before equity-holders may recover anything—and the priorities set out in section 507.12 “The Code makes clear that distributions of assets in a Chapter 7 liquidation must follow this prescribed order,” and “a bankruptcy court cannot confirm

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5 Id. at 978.
6 Id. at 982.
7 Id.
8 Id.
9 Id.
10 Id. at 979.
11 Id.
12 Id.
a [Chapter 11] plan that contains priority-violating distributions” over the affected creditors’ objection.13

“The question here,” the Court explained, “concerns the interplay between the Code’s priority rules and a Chapter 11 dismissal.”14 “The Code does not explicitly state what priority rules—if any—apply to a distribution in these circumstances.”15 Rather, the Bankruptcy Code provides only that the dismissal of a bankruptcy case “revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case”—in other words, it aims to return to the status quo.”16 But, the Court noted, “the Code permits the bankruptcy court, ‘for cause,’ to alter a Chapter 11 dismissal’s ordinary restorative consequences.”17 The question is whether that provision permits a non-consensual distribution of estate assets in violation of priority.

Holding that the Bankruptcy Code does not permit such a distribution, the Court explained that “[t]he priority system . . . has long been considered fundamental to the Code’s operation.”18 It reasoned that “[t]he importance of the priority system leads us to expect more than simple statutory silence if, and when, Congress were to intend a major departure.”19 In other words, “we would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the Code prohibits in Chapter 7 liquidations and Chapter 11 plans.”20

But the Court found no such affirmative indication in the Bankruptcy Code. “Insofar as the dismissal [provisions] foresee any transfer of assets, they seek a restoration of the prepetition financial status quo.”21 And the provision that the bankruptcy court may “for cause, order otherwise,” the Court determined, was “designed to give courts the flexibility to ‘make the appropriate orders to protect rights acquired in reliance on the bankruptcy case,’” not to permit priority-violating distributions.22 “Nothing else in the Code authorizes a court ordering a dismissal to make general end-of-case distributions of estate assets to creditors of the kind that

13 Id.
14 Id.
15 Id. at 980.
16 Id. at 979 (quoting 11 U.S.C. § 349(b)(3)).
17 Id.
18 Id. at 984.
19 Id.
20 Id.
21 Id.
22 Id.
normally take place in a Chapter 7 liquidation or Chapter 11 plan—let alone final distributions . . . that would be flatly impermissible in a Chapter 7 liquidation or a Chapter 11 plan because they violate priority without the impaired creditors’ consent. That being so, the word ‘cause’ is too weak a reed upon which to rest so weighty a power.”

The Court acknowledged that in some instances lower courts have “approved interim distributions that violate ordinary priority rules.” But it drew a distinction between such interim distributions, made when “‘the nature and extent of the [e]state and the claims against it are not yet fully resolved,’” from “final distribution[s]” like that here. Moreover, the Court observed that in cases where courts have permitted interim distributions that might violate priority, “one can generally find significant Code-related objectives that the priority-violating distributions serve.” “Courts, for example, have approved ‘first-day’ wage orders that allow payment of employees’ prepetition wages, ‘critical vendor’ orders that allow payment of essential suppliers’ prepetition invoices, and ‘roll-ups’ that allow lenders who continue financing the debtor to be paid first on their prepetition claims.” But in doing so, the Court noted, “courts have usually found that the distributions at issue would ‘enable a successful reorganization and make even the disfavored creditors better off.’” “By way of contrast, in a structured dismissal like the one ordered below, the priority-violating distribution is attached to a final disposition; it does not make the disfavored creditors better off; [and] it does not promote the possibility of a confirmable plan . . . . In short, we cannot find in the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy-related justification.”

Finally, the Court rejected the Third Circuit’s view that a priority-violating distribution like this one could be authorized in “‘rare case[s]’ in which courts could find ‘sufficient reasons’ to disregard priority.” “[I]t is difficult to give precise content to the concept ‘sufficient reasons.’ That fact threatens to turn a ‘rare case’ exception into a more general rule.” Noting that the approval of the priority-violating settlement in this case “turn[ed] on . . . dubious predictions” regarding what would happen in the absence of the settlement, the Court concluded that “[t]he result is uncertainty,” and “uncertainty will lead to similar claims being made in

23 Id. at 984-85.

24 Id. at 985 (emphasis added).

25 Id. (emphasis in original) (quoting Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007)).

26 Id.

27 Id.

28 Id. (quoting In re Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004)).

29 Id. at 985-86.

30 Id. at 986.

31 Id.
many, not just a few, cases.” 32 “The consequences are potentially serious. They include departure from the protections Congress granted particular classes of creditors . . . . They include changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals . . . . They include risks of collusion, i.e., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors.” 33 “For these reasons, . . . we conclude that Congress did not authorize a ‘rare case’ exception. We cannot ‘alter the balance struck by the statute,’ . . . not even in ‘rare cases.’” 34

b. Dissenting Opinion (Thomas, J.)

Justices Thomas and Alito dissented, not on the merits or on mootness grounds, but because they believed that the substance of the question presented in the petition for certiorari was altered in the petitioner’s brief on the merits, and the case should thus have been dismissed as improvidently granted. 35

3. Implications and Questions

The Jevic decision resolves an important question and is an illuminating example of the way today’s Supreme Court tends to approach bankruptcy issues. But the decision also leaves open many questions.

a. Effect on Structured Dismissals

The Court made clear that it was “express[ing] no view about the legality of structured dismissals in general.” 36 But it did suggest at least the beginning of a framework for evaluating them. Given that structured dismissals are not explicitly authorized anywhere in the Bankruptcy Code, the lower courts did not focus their analysis on a particular provision of the Code. The Supreme Court noted, however, that section 349 of the Bankruptcy Code sets out the normal consequences of dismissal of a bankruptcy case, and reasoned that while section 349 allows the bankruptcy court to depart from those normal consequences “for cause,” that phrase could not be stretched far enough to include what happened here, given that the other final dispositions of chapter 11 cases required adherence to priority. What does the Court’s analysis suggest regarding the kind of structured dismissals that might be acceptable? Does the decision significantly reduce the flexibility that structured dismissals provide to address cases of administrative insolvency, and is this a good thing, a bad thing, or both?

32 Id.

33 Id. at 986-87.

34 Id. at 987.

35 Id. at 987-88 (Thomas, J., dissenting)

36 Id. at 985 (majority opinion).
b. “Interim Distributions”

One of the most interesting aspects of the Court’s decision is its discussion of what it called “interim distributions”—distributions of estate assets (including sale proceeds) to junior creditors while the case is being administered. While the discussion is dicta, courts have already begun applying it to decide whether to approve a particular interim distribution, generally focusing on the Court’s observation that certain interim distributions may serve “significant Code-related objectives” (e.g., increasing the value of the estate sufficiently, by enabling reorganization or otherwise, that the seemingly disfavored priority creditors receive more in the end). However, the Court’s language can be interpreted various ways, and lower courts’ interpretations have differed.

Examples of distributions that have been approved:

- *In re Hansen*, Bk. No. 12-11907-JMD, 2017 WL 1491765, 2017 Bankr. LEXIS 1120 (Bankr. D.N.H. Apr. 25, 2017) (approving sale resulting in partial payment of all claims and priority skipping, where alternative offer that would theoretically have paid all claims in full was contingent on litigation outcome).

- Transcript of Oral Argument, *In re Short Bark Indus.*, No. 17-11502 (KG) (Bankr. D. Del. Sept. 11, 2017), ECF No. 209 (approving priority-skipping distribution of settlement proceeds over U.S. Trustee’s and priority claimant’s objection because settlement did not end the case and it furthered important bankruptcy objectives by saving 500 jobs and preserving committee’s right to object to payments to insiders).

Examples of distributions that have not been approved:

- *In re Fryar*, 570 B.R. 602 (Bankr. E.D. Tenn. 2017) (disapproving priority-skipping distribution of settlement proceeds that was “more of a preamble to a conversion or structured dismissal” than a situation where “a reorganization [is] anticipated”; parties seeking approval of a priority-skipping settlement must prove that it serves “a significant Code-related objective, . . . such as enabling a successful reorganization” and must show “that it makes even the disfavored creditors better off”).

- *In re Pioneer Health Servs., Inc.*, 570 B.R. 228 (Bankr. S.D. Miss. 2017) (reading *Jevic* to endorse *Kmart’s* “restrictive view of critical vendor payments”; not authorizing critical-vendor payments where there was insufficient evidence that payments were critical to reorganization and no “significant . . . bankruptcy-related justification” for departing from priority was evident).

proceeds that would have paid general unsecured creditors while skipping higher priority claimants).

Does Jevic implicitly approve of at least some priority-violating interim distributions? If so, how does one discern when such a distribution is permissible? Does the debtor merely need to show that a “significant bankruptcy objective” is being served (and what counts as a “significant bankruptcy objective”)? Or must it be demonstrated that the disfavored creditors will in fact ultimately be better off if the priority-violating distribution is approved?

c. Gifting

Jevic was not a gifting case. Sun and CIT were not “gifting” their own money to the general unsecured creditors. Rather, they were paying to settle the estate’s fraudulent-transfer claims against them, and those payments were thus necessarily property of the estate, which were then distributed in violation of priority. Nonetheless, what effect might Jevic have on gifting cases? Jevic expressed disapproval of creative efforts to evade the priority scheme and of senior secured creditors and general unsecured creditors banding together to squeeze out disfavored intermediate priority creditors. Does Jevic suggest taking a second look at cases like In re ICL Holding Co.,37 where the funds paid to the unsecured creditors could arguably have been characterized as, in substance, part of the consideration paid for the sale of the debtor’s business?

d. “Rare Case” Exceptions

Jevic disapproved of a “rare case” exception to the rule it set out against priority-violating final distributions of estate assets. It observed that the uncertain boundaries of such an exception would lead to similar claims being made in many cases. And it opined more broadly that clear background rules are a preferable backdrop for parties’ chapter 11 negotiations than are murky standards. Could Jevic suggest that other “rare case” exceptions that have now become commonplace, such as nonconsensual third-party releases, should be reexamined?

e. Scope of the Bankruptcy Power

Jevic arguably reflects a trend in recent Supreme Court cases to take a narrow view of bankruptcy courts’ power. It has been well-established for some time that bankruptcy courts cannot exercise their equitable powers in contravention of the Code’s express commands.38 In Jevic, however, the Court recognized that the Code did not expressly prohibit a priority-skipping structured dismissal. Nonetheless, examining the overall architecture of the Bankruptcy Code, as well as its text commanding adherence to priority when using the methods of distribution that the Code expressly contemplates, the Court held that bankruptcy courts have no power to approve such priority-violating dismissals, even if the courts believe it is in everyone’s best interest to do

37 In re ICL Holding Co., 802 F.3d 547 (3d Cir. 2015).

38 See, e.g., Law v. Siegel, 571 U.S. 415, 421-22 (2014) (bankruptcy court had no equitable authority to “surcharge” debtor’s homestead exemption to repay trustee’s administrative expenses even though expenses were incurred due to debtor’s fraud); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (“[W]hatsoever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of” the Bankruptcy Code).
so. The Court’s more recent decision in *Mission Product Holdings, Inc. v. Tempnology, LLC*\(^{39}\) arguably reflects a similar understanding that the Bankruptcy Code gives debtors specific tools that can be used to maximize the value of the estate, but it does not grant any general power to alter the parties’ background entitlements in the service of reorganization or of an equitable resolution more broadly. Is this view correct, or is it overly constrained? Whether or not it is correct, is it having an effect on day-to-day bankruptcy practice?

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The Uncertain Intersection of Arbitration and Bankruptcy

The Honorable Daniel P. Collins, U.S. Bankruptcy Court for the District of Arizona
The Honorable Sandra R. Klein, U.S. Bankruptcy Court for the Central District of California

Topic: Judges Collins and Klein will lead discussions of the state of the law regarding the intersection of arbitration clauses, the Federal Arbitration Act, and bankruptcy.

1. Introduction

The Federal Arbitration Act (the “FAA”) provides that courts must stay proceedings subject to arbitration agreements “save upon such grounds as exist at law or in equity for the revocation of any contract.” The FAA was enacted “to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts.” The Supreme Court has stated on numerous occasions that the central purpose of the FAA is to ensure that “private agreements to arbitrate are enforced according to their terms.”

The underlying purposes of Title 11 of the United States Code (the “Bankruptcy Code”) are to: (1) provide debtors and creditors with orderly and effective administration of debtors’ estates, and (2) centralize disputes over debtors’ assets and obligations in one forum. This centralization of claims provides protection for debtors and creditors, by preventing protracted, piecemeal litigation.

In some cases, there appear to be a conflict between the purposes of the FAA and the Bankruptcy Code. Recent Supreme Court decisions addressing non-bankruptcy related claims have raised issues that could implicate the intersection of the Bankruptcy Code and the FAA.

43 Moses v. CashCall Inc., 781 F.3d 63, 72 (4th Cir. 2015).
2. **Pre-2018 Supreme Court and Courts of Appeal Decisions**


Facts: Brokerage firm customers brought claims against their broker and brokerage house alleging violations of the Securities Exchange Act of 1934 (the “Exchange Act”) and the Racketeer Influenced and Corrupt Organizations Act (“RICO”). The broker sought to compel arbitration pursuant to the parties’ underlying agreements. The district court found that the customers’ Exchange Act claims, but not the RICO claims, were arbitrable. On appeal, the Court of Appeals for the Second Circuit determined that neither the Exchange Act nor RICO claims were arbitrable.

**Holding:** The Supreme Court reversed and held that:

- The FAA’s policy favoring arbitration requires courts to rigorously enforce arbitration agreements. A court’s responsibility to enforce arbitration agreements is not diminished when a party raises claims based on statutory rights.44

- The FAA’s mandate to enforce agreements to arbitrate statutory claims may be overridden by contrary congressional command. The party opposing arbitration has the burden of showing that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue. Such an intent could be inferred from the statute’s text, the statute’s legislative history, or from an inherent conflict between the statute’s underlying purpose and arbitration.45

- Customers’ agreement to submit disputes to arbitration was not an impermissible waiver of their rights under the Exchange Act.46

- Claims brought under the Exchange Act and RICO are arbitrable.47


Facts: A debtor filed a class action adversary proceeding against a creditor/bank asserting that the bank’s continued monthly withdrawals from her account constituted a willful violation of the automatic stay. The bank moved to stay or dismiss the adversary proceeding based on an

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44 *Shearson*, 482 U.S. at 226.

45 *Id.* at 226-27.

46 *Id.* at 234.

47 *Id.* at 238, 242.
arbitration clause in the parties’ account agreement. The bankruptcy court denied the bank’s motion, and the district court affirmed.

**Holding:** On appeal, the Second Circuit Court of Appeals reversed and held that the bankruptcy court had no discretion to refuse to stay the proceeding pending arbitration.

- Courts have a duty to stay proceedings if an issue is arbitrable, which is “not diminished when a party bound by an agreement raises a claim founded on statutory rights.”48

- In resolving conflicts between the Bankruptcy Code and the FAA, bankruptcy courts generally do not have discretion to refuse to compel arbitration of “non-core” bankruptcy matters or matters that are simply “related to” bankruptcy cases.49

- Bankruptcy courts do not have discretion to override an arbitration agreement—even involving “core” matters—unless the court finds that the proceeding is based on provisions of the Bankruptcy Code that inherently conflict with the FAA, or arbitration would necessarily jeopardize the objectives of the Bankruptcy Code.50


**Facts:** A chapter 11 trustee sued a debtor’s securities broker. The broker moved to compel arbitration pursuant to terms contained in its agreement with the debtor. The bankruptcy court and district court denied the broker’s motion.

**Holding:** The Third Circuit Court of Appeals reversed, ruling in favor of the broker and noting:

- Trustees are bound by arbitration agreements to the same extent as debtors.51

- Arbitration clauses should be enforced unless doing so would seriously jeopardize the Bankruptcy Code’s objectives.52

48 *MBNA Am. Bank*, 436 F.3d at 108.

49 *Id.*

50 *Id.*

51 *Hays & Co.*, 885 F.2d at 1154.

52 *Id.* at 1161.
- The Bankruptcy Code does not conflict with the FAA. Courts do not have
discretion to deny enforcement of an arbitration clause in “non-core”
adversary proceedings brought by a trustee against a debtor’s securities
broker.\(^{53}\)

d. Moses v. CashCall Inc., 781 F.3d 63 (4th Cir. 2015)

Facts: A debtor sued a loan servicer and sought damages for alleged illegal debt collection
activities and to have the loan declared illegal and void. The loan servicer moved to dismiss or
stay the proceeding and compel arbitration. The bankruptcy court denied the loan servicer’s
motion. The district court affirmed.

Holding: The Fourth Circuit Court of Appeals affirmed in part and reversed in part, holding that
the bankruptcy court properly exercised discretion to adjudicate the declaratory relief claim but
erred in denying arbitration of the damages claim.

- Although FAA policies are to be robustly followed, Congress intended to
grant bankruptcy courts comprehensive jurisdiction to deal efficiently and
expeditiously with all matters connected to a bankruptcy.\(^{54}\)

- A debtor’s claim seeking a declaration that a loan was both illegal and void
was statutorily and constitutionally “core” because it involved allowance or
disallowance of claims against the estate. Arbitrating statutorily and
constitutionally “core” claims would pose an inherent conflict with the
Bankruptcy Code and such claims should be adjudicated by the bankruptcy
court.\(^{55}\)

- A debtor’s claim seeking damages was statutorily but not constitutionally
“core.” The district court erred in denying enforcement of the agreement to
arbitrate debtor’s damages claim against the loan servicer.\(^{56}\)

- For “core” matters, “the discretion to deny arbitration should be limited to
cases where arbitration would ‘substantially interfere with the debtor’s efforts
to reorganize.’”\(^{57}\) Such substantial interference “occurs when the resolution
of the claim will necessarily affect reorganization in a significant way, and

\(^{53}\) Id. at 1150.

\(^{54}\) Moses, 781 F.3d at 71.

\(^{55}\) Id. at 70.

\(^{56}\) Id.

\(^{57}\) Id. at 84-85 (Gregory, J., concurring).
arbitration will thus inherently conflict with the purposes of [the] Bankruptcy Code.”

e. **Gandy v. Gandy (In re Gandy), 299 F.3d 489 (5th Cir. 2002)**

**Facts:** Pre-petition, a debtor filed a state court lawsuit against her former business associates, alleging breach of contract, fraud, breach of fiduciary duty, negligence, and constructive trust. The state court granted the former business associates’ motion to compel arbitration, staying debtor’s lawsuit. The debtor immediately filed bankruptcy. The state court lawsuit was transferred to bankruptcy court and consolidated with other claims in an adversary proceeding. The bankruptcy court denied the former business associates’ motion to compel arbitration, finding that the debtor’s complaint sought avoidance of fraudulent transfers. The district court affirmed, holding that the debtor had raised “core” issues. The former business associates appealed.

**Holding:** The Court of Appeals for the Fifth Circuit affirmed, holding:

- Bankruptcy courts generally have no discretion to refuse to compel arbitration of “non-core” proceedings, but a bankruptcy court may refuse to do so if the underlying nature of a claim derives exclusively from the Bankruptcy Code.\(^{59}\)

- Even if a claim derives from rights provided by the Bankruptcy Code, the bankruptcy court can deny arbitration only when enforcement would conflict with the purpose or provisions of the Bankruptcy Code.\(^{60}\)

- A bankruptcy court’s discretion to refuse to compel arbitration permits courts to assess whether arbitration would be consistent with the purposes of the Bankruptcy Code (including centralized resolution of the issues) and the need to protect creditors and reorganizing debtors.\(^{61}\)

f. **Cont'l Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir. 2012)**

**Facts:** The debtor and its insurer executed a settlement agreement containing an arbitration provision. The insurer alleged that the debtor violated the agreement and sought to arbitrate its claim. The debtor filed bankruptcy, staying the arbitration. The bankruptcy court denied the insurer’s motion to compel arbitration. The district court affirmed. The insurer appealed, asserting that its claim was “non-core,” but even if it were “core,” the dispute should be arbitrated because arbitration would not inherently conflict with the Bankruptcy Code.

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58 *Id.* at 85.

59 *In re Gandy*, 299 F.3d at 495.

60 *Id.* at 498.

61 *Id.* at 495.
Holding: The Ninth Circuit affirmed and indicated that:

- In “non-core” proceedings, bankruptcy courts generally do not have discretion to deny enforcement of a prepetition arbitration agreement.\(^{62}\)

- “Non-core” proceedings are less likely to present a conflict sufficient to override the presumption in favor of arbitration, whereas “core” proceedings potentially implicate more pressing bankruptcy concerns.\(^{63}\)

- In “core” proceedings, if a bankruptcy court finds a conflict with bankruptcy law, it has discretion to deny enforcement of an arbitration agreement.\(^{64}\)

- The “core”/”non-core” distinction is not dispositive; a bankruptcy court has discretion to decline to enforce an otherwise applicable arbitration provision if it would conflict with underlying purposes of the Bankruptcy Code.\(^{65}\)

3. Relevant Supreme Court Decisions from 2018 to Present: Epic, Schein and New Prime


Facts: Employees’ contracts provided for individualized arbitration to resolve disputes. They sought to bring a Fair Labor Standards Act (“FLSA”) class action, arguing that the National Labor Relations Act (“NLRA”) mandated collectively pursuing their claims. The employees contended that the FAA’s savings clause, which provides that courts can refuse to enforce arbitration agreements “upon such grounds as exist at law or in equity for the revocation of any contract,” rendered their class and collective action waivers illegal.

Holding: In a 5-to-4 opinion, written by Justice Gorsuch, the Supreme Court held that:

- Courts must interpret Congress’s statutes as a harmonious whole rather than at war with one another. *Id.* at 1619.

- When two acts of Congress allegedly address the same topic, the court cannot pick and choose among congressional enactments and must instead strive to give effect to both. *Id.* at 1624.

- The party arguing that two federal statutes cannot be harmonized bears a heavy burden of showing a “clear and manifest” congressional intent. *Id.*

\(^{62}\) *In re Thorpe Insulation Co.*, 671 F.3d at 1021.

\(^{63}\) *Id.*

\(^{64}\) *Id.*

\(^{65}\) *Id.*
When considering a potential conflict between statutes, there is a strong presumption “that repeals by implication are ‘disfavored’ and that ‘Congress will specifically address’ preexisting law when it wishes to suspend its normal operations in a later statute.” *Id.*

The NLRA does not expressly approve or disapprove of arbitration. The absence of any specific discussion of arbitration in a federal statute is an important and telling clue that Congress has not displaced the FAA. *Id.* at 1628.


**Facts:** A dental equipment distributor sued its manufacturer, alleging federal and state law antitrust violations and seeking monetary damages and injunctive relief. The manufacturer sought to enforce an arbitration provision contained in the distributor’s contract, which provided for arbitration of all disputes other than those seeking injunctive relief. The manufacturer objected, claiming the dispute was not subject to arbitration. The issue was very narrow: who should decide whether the dispute was subject to arbitration? The district court determined that it could resolve the threshold arbitrability question because the request for arbitration was “wholly groundless.” The Fifth Circuit affirmed.

**Holding:** The Supreme Court, in a unanimous opinion (the first authored by Justice Kavanaugh) held that:

- The FAA does not contain a “wholly groundless” exception to arbitration.66 *Id.* at 530.

- When a contract delegates the “‘gateway’ questions of ‘arbitrability,’ such as whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy,” a court may not override the contract and resolve the merits of the dispute, even if the claim is wholly groundless.67 *Id.* at 529.

- The FAA must be interpreted as written, which requires that the contract be interpreted as written.68 *Id.*

- A court has “no business weighing the merits of [a] grievance” that is subject to an arbitration agreement if the parties agreed “to submit all grievances to arbitration, not merely those which the court will deem meritorious.”69 *Id.*

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66 *Henry Schein*, 139 S. Ct. at 530.

67 *Id.* at 529.

68 *Id.*

69 *Id.*

**Facts:** An interstate trucking company attempted to compel arbitration with one of its independent contractor drivers, whose contract contained a mandatory arbitration clause. The driver, who sued the company for failing to pay minimum wage, contended that the district court had no authority to compel arbitration based on section 1 of the FAA, which provides that “‘nothing herein’ may be used to compel arbitration in disputes involving the ‘contracts of employment’ of certain transportation workers.” The trucking company asserted that the parties’ contract contained a “delegation clause,” providing an arbitrator authority to decide the threshold question of arbitrability. The trucking company also argued that the FAA’s “severability principle” required parties to resolve disputes through arbitration.

**Holding:** In a unanimous opinion, the Supreme Court determined that it lacked authority under the FAA to order arbitration.

- The court’s authority to compel arbitration under the FAA is not unconditional and does not apply to every private contract.\(^{70}\)

- The FAA does not authorize a court to compel arbitration when a dispute falls within an exception clearly set forth in the FAA.\(^{71}\)

- A court should determine whether the underlying contract itself falls within the boundaries of the FAA or an exclusion applies before ordering arbitration.\(^{72}\)

- The parties’ private agreement may “require arbitration of every question under the sun, but that does not necessarily mean the [FAA] authorizes a court to stay litigation and send the parties to an arbitral forum.”\(^{73}\)

4. **Harmonizing the Bankruptcy Code and the FAA**

The Supreme Court has yet to address whether the FAA and the Bankruptcy Code inherently conflict. To date, however, the Supreme Court has not found an inherent conflict between any statute and the FAA.\(^{74}\)

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\(^{70}\) *New Prime Inc.*, 139 S. Ct. at 537.

\(^{71}\) *Id.* at 544.

\(^{72}\) *Id.* at 537.

\(^{73}\) *Id.* at 537-38.

\(^{74}\) *Epic Sys. Corp. v. Lewis*, 138 S. Ct. 1612, 1627 (2018) (“In many cases over many years, this Court has heard and rejected efforts to conjure conflicts between the [FAA] and other federal statutes. In fact, this Court has rejected every such effort to date . . . .”).
As noted in *Shearson/Am. Express, Inc. v. McMahon*, an agreement to arbitrate can be overridden by a showing of contrary congressional intent through: (1) the text of a statute, (2) a statute’s legislative history, or (3) an inherent conflict between the statute’s underlying purpose and arbitration.75

Neither the text of the Bankruptcy Code nor its legislative history indicates a congressional intent to prohibit arbitration. The question is whether the Supreme Court will find that there is an inherent conflict between the Bankruptcy Code and the FAA.

Although the Court has consistently held that enforcing arbitration agreements has not created conflicts with other statutes, there are a number of unique bankruptcy issues that arguably could result in the Court determining that arbitration agreements do conflict with the Bankruptcy Code:

- A fundamental purpose of the Bankruptcy Code is centralization of claims. Arbitration would tend to decentralize claims, potentially resulting in debtors being required to litigate in many different forums. This tension troubled the Court in *Thorpe Insulation*, which noted that arbitrating claims would prevent “coordinated resolution of debtor-creditor rights,” which could delay confirmation of a reorganization plan, and result in piecemeal litigation.76 Bankruptcy is designed so that one judge, a bankruptcy judge, decides all disputes.

- *Epic’s* requirement that a statute must demonstrate Congress “clear[ly] and manifest[ly]” intended an exception to arbitration could also be found in the automatic stay, one of the fundamental tenets of the Bankruptcy Code.77

- Even if there is a valid arbitration agreement, a creditor seeking to compel arbitration would be required to obtain relief from the automatic stay before proceeding post-petition to arbitration.78

- *Henry Schein* reaffirmed courts’ power to determine whether arbitration agreements are valid.79 An arbitration agreement, which includes a provision


76 *Cont’l Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1023 (9th Cir. 2012)

77 *Epic Sys.*, 138 S. Ct. at 1617; *see also Midlantic Nat’l Bank v. New Jersey Dep’t of Envtl. Prot.*, 474 U.S. 494, 503 (1986) (“The automatic stay provision of the Bankruptcy Code, § 362(a), has been described as ‘one of the fundamental debtor protections provided by the bankruptcy laws.’”).


providing that the parties agreed to submit all disputes in bankruptcy to arbitration, could be viewed as an invalid agreement.

As one court noted almost 100 years ago, “[i]t would be repugnant to the purpose of the Bankruptcy Act to permit the circumvention of its object by the simple devise of a clause in the agreement, out of which the provable debt springs.”

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80 In re Weitzen, 3 F. Supp. 698 (S.D.N.Y. 1933).
Rejection of License Agreements after *Mission v. Tempnology*81

The Honorable Mary F. Walrath, U.S. Bankruptcy Court for the District of Delaware  
The Honorable Keith L. Phillips, U.S. Bankruptcy Court for the Eastern District of Virginia

**Topic:** Judges Walrath and Phillips will lead discussions of the Supreme Court’s decision in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), which held that when the licensor of a trademark files for bankruptcy, its rejection of the trademark license agreement under § 365 of the Bankruptcy Code does not terminate the licensee’s rights in the mark. Areas for discussion may include the decision’s effect on trademark licensing, its effect on our understanding of rejection and the nature of the bankruptcy estate more generally, and what the decision tells us about the Supreme Court’s approach to interpreting the Bankruptcy Code and the Court’s view of the powers the Code grants debtors.

1. **Legal Background**

Section 365 of Title 11 of the United States Code (the “Bankruptcy Code”) permits a trustee or (in chapter 11) a debtor-in-possession, subject to the bankruptcy court’s approval, to “assume or reject any executory contract”—that is, any contract the debtor entered before bankruptcy where each party still owes a duty of performance to the other.82 Executory contracts pose a special problem because they are both assets and liabilities: The debtor’s right to receive the counterparty’s performance under the contract is an asset, while the debtor’s obligation to perform is a liability. Section 365 permits the trustee to weigh the asset against the liability. The trustee will assume the contract—that is, have the estate step into the debtor’s shoes and perform the debtor’s obligations—if doing so creates a net benefit for the estate, and will reject the contract if performing would be a net loss to the estate.

For example, imagine that before bankruptcy the debtor, a widget merchant, entered into an agreement with a buyer in which the debtor agreed to ship the buyer 1,000 widgets a month for 10 months, and the buyer agreed to pay $1 per widget on delivery. Before shipping any widgets, the debtor files for bankruptcy. Moreover, say that between the time the parties enter the contract and the bankruptcy filing, the market price of a widget falls to 50 cents. The value of the buyer’s performance—$10,000—now exceeds the cost of the debtor’s performance, since

81 Materials prepared with the assistance of Danielle Spinelli, Esq., WilmerHale, LLP.

the debtor can buy the widgets for $5,000 and make a $5,000 profit. Under these circumstances, a rational trustee will assume the contract, meaning that the estate will become a party to the contract and will be obligated to perform under it. Moreover, any breach of an assumed contract may lead to an administrative-expense claim against the estate, which must be paid in full before a Chapter 11 plan can be confirmed.83

On the other hand, say that between the contract signing and the bankruptcy filing the market price of a widget rises to $2. Now, the value of the buyer’s performance—still $10,000—is less than the cost of the debtor’s performance, which would be $20,000. A rational trustee would reject the contract, since assuming it would create a net loss to the estate of $10,000.

What happens to a contract that is rejected? Section 365(g) provides that rejection of an executory contract “constitutes a breach of such contract ... immediately before the date of the filing of the petition.”84 Accordingly, the counterparty whose contract is rejected—for example, the buyer in the widget contract—may bring a claim for damages in the bankruptcy stemming from the debtor’s failure to perform. But such a claim will be treated as a pre-petition unsecured claim,85 and will likely be paid at cents on the dollar. The statute does not specify any other consequences of rejection.

Nonetheless, courts have not always agreed on the precise consequences of rejection—particularly in the case of contracts that are more complex than the widget contract. Namely, there has been confusion over the consequences of rejection of contracts that conveyed rights in a particular asset to the counterparty before bankruptcy—for instance, a lease of real property or a license to intellectual property. In such cases, is rejection merely the equivalent of a breach of contract outside bankruptcy, or does it terminate all the counterparty’s rights and restore unencumbered ownership and possession of the underlying asset to the estate? That was the very fundamental question at issue in Mission.86

The seeds for Mission were sown in 1985, when the Fourth Circuit addressed the same question in the context of a patent license.87 Lubrizol held that the debtor-licensor’s rejection of the license agreement was not merely the equivalent of a non-bankruptcy breach by the licensor. Outside bankruptcy, the licensor could not take back the patent rights it had granted to the licensee merely on account of the licensor’s own breach. But in bankruptcy, Lubrizol held, rejection did entitle the estate to take back the patent rights the debtor had granted to the licensee before bankruptcy and sell or license those rights to a third party.88 Lubrizol was widely

83 Id. §§ 507(a)(2), 1129(a)(9).
84 Id. § 365(g).
85 Id. § 502(g)(1).
87 Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).
88 See id. at 1047-48.
criticized, with some commentators noting that the Fourth Circuit had apparently confused rejection with the trustee’s power to avoid certain prebankruptcy transactions.89

In response to Lubrizol, Congress amended section 365 by adding a new provision governing rejection of licenses of “intellectual property,” which provided that licensees could choose either to treat such licenses as terminated or to retain their rights (and obligations) under the licenses.90 As the Senate Report explained, section 365(n) “corrected the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent licensee[s] of rights” to the licensed intellectual property.91 Notably, however, Congress defined “intellectual property” to include patents, copyrights, and trade secrets,92 but deliberately omitted trademarks, meaning that section 365(n), by its terms, does not apply to trademark licenses. The Senate Report explained that “it was determined to postpone congressional action” on trademark licenses to permit “more extensive study,” noting that “such contracts raise issues beyond the scope of this legislation,” such as “control of the quality of the products . . . sold by the licensee.”93

After section 365(n) was enacted, courts divided over whether Lubrizol was still good law for trademark licenses. Some lower courts concluded that the omission of trademark licenses from section 365(n) meant that Congress had implicitly endorsed Lubrizol’s reasoning in the trademark licensing context. In 2012, however, the Seventh Circuit held to the contrary, reasoning that under section 365, rejection is simply a breach and thus, like a breach outside bankruptcy, cannot take away the licensee’s rights in the mark.94

2. **Factual Background**

That was where matters stood when the Mission case originated. Tempnology had developed a patented technology for cooling fabric to be used in sportswear, towels, and the like, marketed under the COOLCORE trademark. In 2012, it licensed its patents and trademark to Mission, granting Mission the exclusive right to distribute certain COOLCORE products in the United States. In 2014, Tempnology filed a chapter 11 petition and rejected the license agreement with Mission, contending that rejection terminated Mission’s right to use the trademark. Ultimately, the First Circuit agreed with Tempnology, and split with the Seventh Circuit’s decision in Sunbeam, reasoning that allowing Mission to continue using the mark would be too burdensome for Tempnology and could impair its ability to reorganize.

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94 See Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012).
3. **Supreme Court Decision**

The Supreme Court granted Mission’s petition for certiorari to resolve the circuit split and reversed the First Circuit, ruling in Mission’s favor.95


After rejecting Tempnology’s argument that the case was moot,96 the Court turned to the fundamental question presented: “What is the effect of a debtor’s . . . rejection of a contract under Section 365 of the Bankruptcy Code?”97 The Court’s answer was unequivocal: “Rejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach.”98 Accordingly, rejection “leave[s] intact the rights the counterparty has received under the contract.”99 “Both Section 365’s text and fundamental principles of bankruptcy law command [that] approach.”100

Beginning with the text, the Court observed that section 365 provides that rejection “‘constitutes a breach’” of the rejected contract, and that “‘breach’ ‘means in the Code what it means in contract law outside bankruptcy.’”101 And outside bankruptcy, one party’s breach of contract does not terminate the other party’s rights. The Court used the example of a contract in which a dealer leases a photocopier to a law firm and agrees to service the copier monthly. If the dealer stops servicing the machine, materially breaching the contract, the law firm may choose to terminate the contract, but the dealer cannot do so. “The contract gave the law firm continuing rights in the copier, which the dealer cannot unilaterally revoke.”102 Rejection in bankruptcy works the same way, for a trademark license as well as a photocopier lease: “The debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed. So the licensee can continue to do whatever the license authorizes.”103

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96 See id. at 1660-61.

97 Id. at 1661.

98 Id.

99 Id.

100 Id.

101 Id.

102 Id. at 1662.

103 Id. at 1662-63.
That reading of section 365, the Court noted, “reflects a general bankruptcy rule: The estate cannot possess anything more than the debtor itself did outside bankruptcy.”\textsuperscript{104} Citing \textit{Board of Trade of Chicago v. Johnson},\textsuperscript{105} the Court explained that “if the not-yet debtor was subject to a counterparty’s contractual right (say, to retain a copier or use a trademark), so too is the trustee or debtor once the bankruptcy petition has been filed. The rejection-as-breacht rule . . . ensures that result.”\textsuperscript{106} Moreover, the Court observed, “the rejection-as-rescission approach would circumvent the Code’s stringent limits on ‘avoidance’ actions—the exceptional cases in which trustees (or debtors) may indeed unwind the bankruptcy process.”\textsuperscript{107} If trustees (or debtors) could use rejection to rescind previously granted interests, then rejection would become functionally equivalent to avoidance,” subverting the limitations on avoidance actions, such as (for constructive fraudulent transfers) the requirements of insolvency and less than reasonably equivalent value.\textsuperscript{108}

The Court found Tempnology’s contrary arguments unpersuasive. Tempnology had contended that because section 365(n) (along with other similar provisions enacted over time dealing with specific types of contracts, such as section 365(h)’s special provisions for leases) specifies that counterparties may retain their rights after rejection, one should draw the negative inference that “the ordinary consequence of rejection” is termination of those rights.\textsuperscript{109} But, after examining the history and context of those provisions, the Court concluded that “no negative inference arises.”\textsuperscript{110} “Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g)—that rejection and breach have the same results.”\textsuperscript{111} Rather, § 365(g) and other similar provisions could be read to “reinforce or clarify the general rule that contractual rights survive rejection.”\textsuperscript{112}

Finally, the Court dismissed Tempnology’s contention that, if trademark licensees retained their rights after rejection, the debtor-licensor would need to continue to exercise quality control over the goods bearing the mark or else risk losing the mark—which, Tempnology argued, would impede the debtor’s ability to reorganize.\textsuperscript{113} As an initial matter, the Court noted that there was no support in the text of the Bankruptcy Code for a trademark-specific rule of

\begin{thebibliography}{9}
\item \textsuperscript{104} \textit{Id.} at 1663.
\item \textsuperscript{105} \textit{Id.} at 1663.
\item \textsuperscript{106} \textit{Id.} at 1663.
\item \textsuperscript{107} \textit{Id.}
\item \textsuperscript{108} \textit{Id.}
\item \textsuperscript{109} \textit{Id.}
\item \textsuperscript{110} \textit{Id.} at 1665.
\item \textsuperscript{111} \textit{Id.}
\item \textsuperscript{112} \textit{Id.} at 1664.
\item \textsuperscript{113} \textit{Id.} at 1665.
\end{thebibliography}
rejection; the relevant statutory provisions govern all executory contracts. “So Tempnology is essentially arguing that distinctive features of trademarks should persuade us to adopt a construction of Section 365 that will govern not just trademark agreements, but pretty nearly every executory contract . . . . [T]hat would allow the tail to wag the Doberman.”114 In any event, Tempnology’s argument based on the policy in favor of reorganization proved too much: The Code “aims to make reorganizations possible,” “[b]ut it does not permit anything and everything that might advance that goal.”115

The Court summed up: “[W]e hold that under Section 365, a debtor’s rejection of an executory contract in bankruptcy has the same effect as a breach outside bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor’s rejection cannot revoke the trademark license.”116

b. Concurring Opinion (Sotomayor, J.)

Justice Sotomayor joined the Court’s opinion but wrote a separate concurrence “to highlight two potentially significant features of today’s holding.”117 “First, the Court does not decide that every trademark licensee has the unfettered right to continue using licensed marks postrejection . . . . [T]he baseline inquiry remains whether the licensee’s rights would survive a breach under applicable nonbankruptcy law. Special terms in a licensing contract or state law could bear on that question in individual cases.”118 Second, Justice Sotomayor noted that because trademark licenses are not subject to section 365(n), trademark licensees’ rights after rejection “are more expansive in some respects” than those of other intellectual property licensees (who must, for example, waive any right of setoff to retain their rights to the intellectual property).119 However, she explained, “these differences . . . do not alter the outcome here. The Court rightly rejects Tempnology’s argument that the presence of § 365(n) changes what § 365(g) says.”120

c. Dissenting Opinion (Gorsuch, J.)

The lone dissenter, Justice Gorsuch, would have dismissed the case as improvidently granted rather than reaching the merits.121 He believed that it was “unclear” whether the case was moot, given that the underlying license agreement had expired and that, in his view, Mission

114 Id.
115 Id.
116 Id.
117 Id. at 1666 (Sotomayor, J., concurring).
118 Id.
119 Id.
120 Id. at 1667.
121 Id. at 1667-68 (Gorsuch, J., dissenting).
had not articulated a viable legal theory supporting its claim for damages incurred during the period before the agreement expired.122

4. Implications and Questions:

The *Mission* decision has many noteworthy aspects. Indeed, one commentator has predicted that it “will prove to be one of the Supreme Court’s most important bankruptcy decisions of the decade.”123 Here are a few (not at all exhaustive) points and questions for discussion.

a. Effect on Executory Contracts Doctrine and Practice.

As the Court stated, its holding—that rejection has the same consequences as breach—is not limited to trademark licenses, but applies to all executory contracts. *Mission* may thus have the potential to simplify what has become a complex and sometimes confused area of the law. For example, courts sometimes conduct lengthy analyses of whether a particular contract is executory seemingly because of the draconian consequences rejection would have if it terminated the counterparty’s rights.124 Once rejection is understood as the bankruptcy analogue of breach, and not as a special power to terminate the other party’s rights under a contract, whether a contract is executory arguably becomes less important, because rejection does not grant the debtor or estate anything that it could not obtain outside bankruptcy. Will *Mission* simplify executory contracts doctrine, or will it merely shift the inquiry to the consequences of breach outside bankruptcy (or might it do both)?


The trademark bar broadly supported a rule under which rejection of a trademark license agreement would not deprive the licensee of its rights in the mark. (Several amicus briefs were filed on the petitioner’s side in the Supreme Court, and none on the respondent’s.) Among other things, they argued that such a rule was better for licensors and licensees alike: Assurance that the licensees’ rights will not evaporate due to a bankruptcy filing increases the value of the rights conveyed to licensees (and thus increases the value of a licensing arrangement to the licensor as well). And greater certainty makes such agreements easier to negotiate. Justice Sotomayor noted, however, that the parties to a licensing agreement could potentially contract around the result in *Mission*. What is the upshot? How will licensing likely be affected?

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122 *Id.*


124 See, e.g., *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (holding that trademark license agreement was not executory and licensor thus could not reject it and terminate licensee’s right to use the mark); *id.* at 967-68 (Ambro, J., concurring) (noting the inequity of using rejection “to let a licensor take back trademark rights it bargained away”).
c. Interpreting the Bankruptcy Code.

Mission reaffirms that, in deciding any question arising under the Bankruptcy Code, the Code’s language comes first—but it approaches that language contextually. As the Court observed, section 365’s statement that rejection “constitutes a breach” “does much of the work” in the Court’s analysis. That is not surprising: As Justice Kagan, who wrote the Court’s opinion, said in a lecture at Harvard Law School a few years ago, “We’re all textualists now.” Significantly, however, the Court did not limit its inquiry to the text of section 365 considered in isolation. Rather, it also relied on the “fundamental principle[]” that the estate has no greater rights in property than the debtor had before bankruptcy—a principle reflected in the overarching structure of the Code and its various provisions governing the estate and its property—to confirm its interpretation. Does Mission reflect a greater willingness on the Court’s part to grapple with the overall architecture of the Code, and is that a good thing for bankruptcy law?

d. Scope of the Bankruptcy Power.

Mission reflects the Court’s view that, to understand the workings of the Bankruptcy Code, one must start with the parties’ rights and obligations outside bankruptcy. To be sure, the Code can and sometimes does alter those rights and obligations. But the Court will not be quick to jump to the conclusion that Congress intended such an alteration unless the Code clearly indicates it. Likewise, the interpretation of the Code that best promotes reorganization will not always be the correct interpretation; the Code carefully balances the interests of different constituencies, and courts must respect the balance Congress struck. In short, as the Court has also held in previous cases, the Bankruptcy Code gives debtors specific tools that can be used to maximize the value of the estate, but it does not grant any general power to alter the parties’ background entitlements in the service of reorganization or of an equitable resolution more broadly. Is this view correct, or is it overly constrained? Whether or not it is correct, is it having an effect on day-to-day bankruptcy practice?

125 Mission, 139 S. Ct. at 1661.

126 It occasionally has in past bankruptcy cases. See, e.g., RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 645-49 (2012).

127 Mission, 139 S. Ct. at 1661, 1663.

Are “Make-Whole” Provisions Enforceable in Bankruptcy?

The Honorable Martin Glenn, U.S. Bankruptcy Court for the Southern District of New York
The Honorable Barbara J. Houser, U.S. Bankruptcy Court for the Northern District of Texas

**Topic:** Judges Glenn and Houser will lead discussions on the enforceability of “make-whole” provisions in bankruptcy.

1. **Introduction**

   State law generally prohibits voluntary prepayment of debt prior to the maturity date unless the debt instrument permits it. Permitted early payments are typically made pursuant to “make-whole” provisions that require a premium. A “make-whole” premium is usually based on the discounted value of the future stream of interest payments that would have been received if the debt is not prepaid.

   Debt instruments often provide that the debt can be accelerated upon certain events of default and that the debt is automatically accelerated if the borrower files for bankruptcy. There is not always clarity in the debt instrument regarding the impact of acceleration on the premium.

   Outside of bankruptcy, make-whole premiums are generally enforceable. In bankruptcy, the enforceability of make-whole provisions is far less certain because of conflicting precedent. As a result, even with careful drafting, a make-whole premium may still not be allowed and enforceable in chapter 11.

2. **Issues Regarding Enforceability of Make-Whole Provisions in Bankruptcy.**

   Bankruptcy courts engage in a two-part analysis to determine whether a make-whole premium is allowed in bankruptcy. The first step is to examine the express language of the debt instrument and to determine if the make-whole provisions are enforceable under state law. If the provisions are enforceable under state law, then the bankruptcy court moves to the second step, which is to determine if applicable bankruptcy law disallows the make-whole premium.

   Courts have recently grappled with two key bankruptcy-related issues: (1) the impact of automatic acceleration caused by bankruptcy filing on make-whole premiums where debt instrument is silent on effect of such acceleration; and (2) whether make-whole premiums are disallowed in bankruptcy as “unmatured interest” under section 502(b)(1) of Title 11 of the United States Code (the “Bankruptcy Code”).
a. Impact of Automatic Acceleration Due to Bankruptcy Filing on Make-Whole Premiums

i. Momentive Performance Materials Inc. v. BOKF, NA (In re MPM Silicones, L.L.C.), 874 F.3d 787 (2d Cir. 2017)

Facts: In 2012, the debtor issued certain senior secured notes. The indenture provided for a make-whole premium if the debtor redeemed the senior notes “at its option” before October 2015. It also provided that if the debtor filed for bankruptcy, “the principle of, premium, if any, and interest on all the Notes” would become immediately due and payable.

In October 2014, the debtor issued replacement notes to the senior noteholders pursuant to its chapter 11 plan that did not account for any make-whole premium. The noteholders argued that they were entitled to a make-whole premium for two main reasons. First, the debtor voluntarily redeemed the notes prior to maturity by issuing replacement notes pursuant to its plan. Second, the reference to the term “premium, if any” in the acceleration clause required payment of the make-whole premium upon automatic acceleration.

The bankruptcy court ruled that debtor owed no make-whole premium. The bankruptcy court found that automatic acceleration eliminated entitlement to a make-whole premium because (1) the debtor’s default was not intentionally; and (2) the indenture did not contain clear and unambiguous language providing for payment of a make-whole premium notwithstanding acceleration. The district court affirmed the bankruptcy court’s ruling.

Holding: The Second Circuit affirmed, holding that the senior noteholders were not entitled to any make-whole premium.

- The court reasoned that, upon automatic acceleration of the debt, the maturity date became the petition date. As a result, payment of the debt by the debtor was a post-maturity date payment. Under the indenture, a make-whole premium was owed only if there was a prepayment, which by definition could only occur prior to the maturity date.129

- The court also rejected any distinction between the use of the words “prepayment” and “redemption” in the indenture. The court explained that the plaining meaning of the term “redeem” is to replay a debt security “at or before maturity.”130

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130 Id.
- It was meaningful that no explicit provision in the indenture provided that make-whole premium was due notwithstanding acceleration.131

- The court further concluded that the payment or redemption of the debt was not “at [the debtor’s] option” because automatic acceleration made payment mandatory.132 The court did not address argument that debtors could have reinstated the senior notes under section 1124 of the Bankruptcy Code.

- Finally, the court rejected the argument that the term “premium, if any” in the acceleration clause triggered any payment obligation.133


Facts: Prior to bankruptcy, the debtor issued first lien notes due in 2020 and second lien notes due in 2021 and 2022. The applicable indentures provided for a make-whole premium if the debtor choose to redeem the notes, at its option, before certain dates. The indentures also provided that if the debtor filed for bankruptcy, the notes would become immediately due and payable. The second lien indenture further made clear that the make-whole premium, if any, would be due and payable immediately upon acceleration.

In November 2013, the debtor filed a Form 8-K disclosing its proposal to file for chapter 11 and refinance the notes without paying any make-whole premium. In 2014, the debtor filed for chapter 11.

The bankruptcy court authorized the debtor to refinance the first lien notes and a portion of the second lien notes on a postpetition basis. The bankruptcy court ruled that the debtor was not required to pay any make-whole premium as a result of those loan refinancings. The district court affirmed.

Holding: The Third Circuit reversed, holding that the noteholders were entitled to make-whole premiums notwithstanding automatic acceleration.

- The court rejected the debtor’s argument that there was no prepayment because the maturity date had been accelerated.134

131 Id. at 803.

132 Id. at 802-03.

133 Id. at 804.

- The court distinguished between “redemption” and “prepayment,” noting that make-whole premium was due upon a redemption. Redemption includes both pre- and post-maturity repayments of debt.\footnote{Id. at 259.}

- The court also concluded that the redemption by the debtor was optional. As evidenced by its Form 8-K, the debtor filed for chapter 11 with the intent to refinance the notes. The debtor could have reinstated the accelerated notes under section 1124(2) of the Bankruptcy Code.\footnote{Id. at 255.}

- Finally, the court emphasized that the indentures did not explicitly provide that acceleration eliminates the make-whole premium.\footnote{Id. at 258-61. In contrast, the indenture in \textit{U.S. Bank National Ass’n v. AMR Corp. (In re AMR Corp.)}, 730 F.3d 88, 97 (2d Cir. 2013), provided that no make-whole premium would be due upon acceleration.}

### iii. Can the Second and Third Circuits’ Rulings Be Reconciled?

The rulings conflict notwithstanding that courts interpreted nearly identical debt instruments. The Third Circuit in \textit{EFH} relied upon a distinction between redemption and prepayment, whereas the Second Circuit in \textit{Momentive} relied upon “rule of explicitness.”

One commentator has suggested that the courts reached the right result but for the wrong reasons.\footnote{Sam Lawand, \textit{Make-Whole Claims in Bankruptcy}, 27 Norton J. Bankr. L. & Prac., no. 4, art. 1, 2018.} The rulings are fair because the \textit{EFH} debtor’s default was “voluntary” while the \textit{Momentive} debtor’s default was “involuntary.” Focusing on the “voluntariness” of a debtor’s default is consistent with state law, but it is difficult to determine a debtor’s primary intent for filing for bankruptcy. The bankruptcy court in \textit{EFH} found that the debtor’s bankruptcy filing was not an intentional default because it was caused by a liquidity crisis, not an attempt to avoid make-whole premium. The Second Circuit interpreted the facts differently.

#### b. Is a Make-Whole Premium “Unmatured” Interest?

##### i. \textit{Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors (In re Ultra Petroleum Corp.)}, 913 F.3d 533 (5th Cir. 2019)

Facts: Prior to bankruptcy, the debtor issued unsecured notes. The indenture provided for make-whole premium upon prepayment of the notes. The make-whole premium “provided compensation for the deprivation of” a noteholder’s “right to maintain its investment in the Notes free from repayment.” The indenture also provided that if the debtor filed for bankruptcy, the outstanding principal, any accrued interest and the make-whole premium would become immediately due and payable.
The bankruptcy court ruled that the debtor was required to pay the noteholders a make-whole premium as liquidated damages. It did not address the debtor’s argument that make-whole premium should be disallowed as “unmatured interest.” The debtor directly appealed to the Fifth Circuit.

**Holding:** The Fifth Circuit reversed and suggested that the make-whole premium should be disallowed by section 502(b)(2) of the Bankruptcy Code

- The make-whole premium was the “economic equivalent of interest.” The formula for the make-whole premium calculated the value of the loss interests.\(^{139}\)

- It was “unmatured” within the meaning of section 502(b)(2) of the Bankruptcy Code. Automatic acceleration is not relevant under section 502(b)(b) because maturity is determined without reference to any ipso facto bankruptcy clauses.\(^{140}\)

- The court found contrary precedent unpersuasive for two reasons. Those courts inappropriately considered the impact of automatic acceleration when deciding maturity under section 502(b)(2). Liquidated damages and unmatured interests are not mutually exclusive.\(^ {141}\)

**c. Majority View**

The Fifth Circuit’s decision in *Ultra Petroleum Corp.* is contrary to the majority view. Most courts find that make-whole premiums are not disallowed as “unmatured interest” under section 502(b)(2) because they fully mature upon acceleration.\(^ {142}\)

\(^{139}\) *Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors (In re Ultra Petroleum Corp.),* 913 F.3d 533, 547-49 (5th Cir. 2019).

\(^{140}\) *Id.* at 548.

\(^{141}\) *Id.*

3. **Drafting Considerations**

Lenders will want:

- Explicit provisions requiring payment of make-whole premium upon acceleration, including automatic acceleration due to bankruptcy filing. The provision may distinguish between “stated maturity” and “final maturity” to accomplish this goal.

- Provision for cumulative remedies (argument is that acceleration should not render make-whole premium unenforceable if debt instrument permits lender to pursue alternative remedies).

- Make-whole premium should not be explicitly based on lost interest. Rather the formula should be based on actual damages suffered by lender.

Borrowers will want:

- Explicit provisions terminating make-whole premium upon automatic acceleration or at least silence on the issue (i.e., a make-whole premium triggered by “prepayment” as opposed to “redemption” will be preferable to borrower).

- Explicit provision providing that acceleration terminates right to optional redemption or prepayment.

- Make-whole premium based on future interest.
How Do I Get My Litigation out of/into Bankruptcy: Issues of Removal, Remand, Abstention and Withdrawal of the Reference

The Honorable John K. Sherwood, U.S. Bankruptcy Court for the District of New Jersey
The Honorable Kathey A. Surratt-States, U.S. Bankruptcy Court for the Eastern District of Missouri

Topic: Judges Sherwood and Surratt-States will lead discussions on the various ways to bring litigation into bankruptcy court and to move litigation out of bankruptcy court, including discussion of removal, remand, abstention, withdrawal of the reference, and relief from stay to continue with pre-petition date litigation.

1. Getting Litigation Matters INTO Bankruptcy Court: Removal Pursuant to Section 1452 and Rule 9027

   a. Statutory Framework

      Under 28 U.S.C. § 1452(a), "[a] party may remove any claim or cause of action in a civil action . . . to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of [title 28]."

      To remove a case from non-bankruptcy court to bankruptcy court, the case’s subject matter must fall within bankruptcy jurisdiction pursuant to 28 U.S.C. § 1334. That means the case must:

      - Arise under Title 11. These are matters expressly created by Title 11. These are core proceedings.

      - Arise in cases under Title 11. These are general matters that are not expressly created by Title 11, but would have no existence but for the fact the bankruptcy was filed. These are also core proceedings.

143 Materials prepared with the assistance of Victoria L. Creason, VLC Associates, Ltd.
- **Be related to a case under Title 11.** These are non-core proceedings.144

Procedurally, Rule 9027 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”) requires the notice of removal to be filed in the bankruptcy court in the district in which the state court sits where the action to be removed is pending.

**b. Relevant Cases**


In this case, former officer of corporate chapter 7 debtor brought lawsuit against chapter 7 trustee’s attorney for slander. The lawsuit was removed from the Circuit Court of the City of St. Louis to the United States Bankruptcy Court for the Eastern District of Missouri, where the chapter 7 debtor’s case was pending. Although the plaintiff contended that the adversary proceeding was a core proceeding under §157(b), the Bankruptcy Court held that it could not exercise even “related-to” jurisdiction over former officer’s slander action. The Bankruptcy Court found that the slander lawsuit was not directly related to the bankruptcy case, determining that the suit is an action by a non-debtor plaintiff against a non-debtor defendant (the trustee’s attorney) and that the outcome of the suit will not have any effect on the administration of the estate.


Non-debtor plaintiff filed a state court action against the chapter 7 trustee for malicious prosecution and defamation. The chapter 7 trustee removed the case to bankruptcy court. On plaintiff’s motion to remand, the Bankruptcy Court found that the action was a core proceeding because it arose out of the administration of the bankruptcy estate. Therefore, the Bankruptcy Court denied the motion to remand.


A state court fraudulent transfer action was removed to bankruptcy court based on the debtor’s bankruptcy filing. The Bankruptcy Court found that the action was timely removed and a core proceeding, therefore mandatory abstention was not proper. The Bankruptcy Court found the action to be a core proceeding because fraudulent conveyance is specifically listed in section 157(b), therefore it invoked a substantive right created by the Bankruptcy Code.

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144 28 U.S.C. § 1334(a), (b).
2. Getting Litigation Matters OUT OF Bankruptcy Court: Remand Pursuant to Sections 1452 and 1446

a. Statutory Framework

Under 28 U.S.C. § 1452(b), the court to which the claim was removed to may remand the claim or cause of action on any equitable ground. Equitable grounds may include the factors listed in 28 U.S.C. § 1334(c)(2) for mandatory abstention.

A motion to remand the case on the basis of any defect other than lack of subject matter jurisdiction must be made within 30 days after the filing of the notice of removal under 28 U.S.C. § 1446(a). But if at any time before the final judgment it appears that the district court lacks subject matter jurisdiction, the case shall be remanded.

Under Bankruptcy Rule 9027, a motion for remand of the removed claim shall be governed by Bankruptcy Rule 9014 and served on the parties to the removed claim.

b. Relevant Cases

i. Nat’l Benevolent Ass’n of Christian Church (Disciples of Christ) v. Weil, Gotshal & Manges, LLP, 437 B.R. 342 (B.A.P. 8th Cir. 2010)

The reorganized debtor filed a state court action against former counsel, alleging legal malpractice, negligence and breach of fiduciary duty. Former counsel then removed action. The reorganized debtor moved to remand. The Bankruptcy Appellate Panel of the Eighth Circuit held that in the absence of subject-matter jurisdiction over the reorganized debtor’s claims, the bankruptcy court was required to remand the entire case to state court, not just the claims over which federal jurisdiction was lacking.


The Bankruptcy Court found that the removed state actions for breach of contract, defamation and civil conspiracy should be remanded to state court because the bank could not seek federal forum but for debtor’s bankruptcy case and that state court was the appropriate forum and could adjudicate the matter more timely.


Creditor brought an action pre-petition date against the debtor and the debtor removed the case to bankruptcy court. Creditor filed a motion to remand. The Bankruptcy Court held that it had related-to jurisdiction over the proceeding, but remand was warranted because the claims raised only state-law matters, the proceeding was only merely related to the bankruptcy case, and the proceeding would not impact the bankruptcy case.
3. **Withdrawal of the Reference**

A motion to withdraw the reference is another mechanism that can be used to get a bankruptcy case, or a proceeding related to the case out of the bankruptcy court and into the district court.

28 U.S.C. § 157(a) provides that the district courts can direct that any or all bankruptcy cases and proceedings arising in or related to the bankruptcy case be “referred” to the bankruptcy judges in the district. This is usually done by a standing order or by local rule.

28 U.S.C. § 157(d) provides that the district court may “withdraw the reference” for any case or proceeding, in whole or in part, that has been previously referred. The district court can withdraw the reference on its own motion or upon the timely motion of a party. Motions to withdraw the reference are to be heard by the district court. The party filing the motion must do so in a “timely” manner. The best course is to file the motion as soon as possible after the grounds for withdrawal become clear.

The party filing a motion to withdraw the reference must show “cause.” In applying the “for cause” standard, courts have noted that this relief is reserved for the exceptional cases. Certain cases have applied a six-factor analysis.

- Whether the claim is core or non-core.

- What is the most efficient use of judicial resources?

- What is the delay and what are the costs to the parties?

- What will promote uniformity of bankruptcy administration?

- What will prevent forum shopping?

- Other related factors.

Another important factor is whether one of the parties has a right to a jury trial. Bankruptcy courts rarely conduct jury trials so such cases are prime candidates for withdrawal.


147 This is an important factor due to the bankruptcy court’s limited jurisdiction in non-core matters.

But, some district courts might delay the decision to withdraw the reference and allow the bankruptcy court to continue to address pretrial discovery and motion practice.\textsuperscript{149}

Finally, the text of 28 U.S.C. § 157(d) says that the District Court has to consider whether the proceeding involves the consideration of other United States laws affecting interstate commerce. Examples of such laws include challenges under the United States Constitution, federal labor law issues, federal tax issues, and federal environmental matters. The mere presence of a federal law affecting interstate commerce is probably not enough to compel withdrawal of the reference. Bankruptcy courts can apply these laws in the cases before them. But if a case involves analysis of a significant unsettled issue, it is more likely that the reference would be withdrawn.\textsuperscript{150}

In general, district courts are inclined to allow bankruptcy courts to handle bankruptcy cases and related litigation. Thus, a motion to withdraw the reference will not be granted unless a party can show special circumstances. The case that has been before the district court for some time, where the district court has invested its time to become familiar with the parties and issues, is the type that a district court judge might not want to give up if one of the parties files a bankruptcy proceeding. To the extent that the district court perceives the bankruptcy filing to be forum shopping, it might exercise its power under 28 U.S.C. § 157(d) to resolve the case itself.

4. \textbf{Granting Relief from the Automatic Stay of Section 362 to Allow Pending Litigation in Another Court to Proceed}

\textbf{a. Statutory Framework}

There are cases where parties involved in pre-petition litigation would prefer to continue litigation even though the bankruptcy proceeding is still pending. However, section 362 of Title 11 of the United States Code (the “Bankruptcy Code”) stays all proceedings against the estate. Under certain circumstances, a party can move for relief from the automatic stay so that it may continue its state court action in the non-bankruptcy court.

Section 362(d)(1) provides an avenue for creditors to obtain relief from the stay by showing “cause.” While cause is not defined in the Bankruptcy Code, bankruptcy courts have adopted a flexible definition and often look to “the totality of the circumstances” when determining whether cause exists. More specifically, courts have adopted several factors and tests that they consider; most of which are similar.

\begin{footnotesize}
\footnotesize\textsuperscript{149} See Schneider v. Riddick (\textit{In re Formica Corp.}), 305 B.R. 147 (S.D.N.Y. 2004).
\footnotesize\textsuperscript{150} See \textit{In re Vicars Ins. Agency, Inc.}, 96 F.3d 949, 954 (7th Cir. 1996).
\end{footnotesize}
b. Relevant Cases by Circuit


The Bankruptcy Court denied a landlord’s motion for stay relief to proceed against the debtor in state court. While the First Circuit has not adopted its own set of factors to determine whether cause exists, the Bankruptcy Court acknowledged the tests used in other circuits such as those in the Curtis and Football Weekly cases.151 The Football Weekly test includes the following factors:

- Whether any great prejudice to either the bankrupt estate or the debtor will result from continuation of the civil suit.
- Whether the hardship to the non-bankrupt party by maintenance of the stay considerably outweighs the hardship of the debtor.
- Whether the creditor has a probability of prevailing on the merits.152

Considering these factors, the Bankruptcy Court found that while the landlord had a probability of prevailing in state court, the hardship to the debtor outweighed the hardship to the landlord and the debtor would be greatly prejudiced if it was required to defend an eviction proceeding during the early stages of its reorganization.153

ii. Second Circuit: Sonnax Indus. v. Tri Component Prods. Corp. (In re Sonnax Indus., Inc.), 907 F.2d 1280 (2nd Cir. 1990)

The Second Circuit held that granting a preliminary injunction against the debtor, an automobile parts manufacturer, in favor of a competitor would prevent the debtor from competing in its business market.154 In denying the request for stay relief, the Court adopted the Curtis test used by the Tenth Circuit.155 The Curtis test provides 12 factors that courts consider when determining whether cause exists.

1. Whether relief would result in a partial or complete resolution of the issues.
2. Lack of any connection with or interference with the bankruptcy case.

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152 See In re Pro Football Weekly, 60 B.R. at 826.
154 In re Sonnax Indus., Inc., 907 F.2d at 1287.
155 Id. at 1286-87.
3. Whether the other proceeding involves the debtor as a fiduciary.

4. Whether a specialized tribunal with the necessary expertise has been established to hear the cause of action.

5. Whether the debtor’s insurer has assumed full responsibility for defending it.

6. Whether the action primarily involves third parties.

7. Whether litigation in another forum would prejudice the interests of other creditors.

8. Whether the judgment claim arising from the other action is subject to equitable subordination.

9. Whether the movant’s success in the other proceeding would result in a judicial lien avoidable by the debtor.

10. The interests of judicial economy and the expeditious and economical resolution of litigation.

11. Whether the parties are ready for trial in the other proceeding.

12. The impact of the stay on the parties and the balance of harms.156


The Bankruptcy Court also adopted the *Curtis* test and granted stay relief to the creditor, a forklift distributor, to pursue its tortious interference claim against the debtor in state court.157 The Court determined that granting stay relief would resolve the issue of the debtor’s liability and because the damages would be fixed, it would not prejudice other creditors. The Court also found that after extensive discovery and procedural “jockeying” among the parties, substantial time and resources had already been expended and judicial economy compelled it to conclude that the stay should be lifted.158

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156 *See In re Curtis,* 40 B.R. at 799-800.


158 *Id.* at 118 and 131.

The Fourth Circuit granted stay relief for a wife to pursue a state court action against her husband to determine the distribution of the property they owned. The Court considered the following four factors:

1. Balancing potential prejudice to the debtor’s estate against the hardships that would be incurred by the person seeking relief.
2. Whether the issues in the pending litigation involve state law only, so the expertise of the Bankruptcy Court is unnecessary.
3. Whether it will promote judicial economy and whether there would be greater interference with the bankruptcy case if the stay were not lifted because matters would have to be litigated in Bankruptcy Court.
4. Whether the estate can be protected properly by a requirement that creditors seek enforcement of any judgment through the bankruptcy court.

The Court held the determination of marital property distribution was primarily within the expertise of the state court, and judicial economy was promoted by allowing the state court action to continue. It noted that the debtor’s wife did not seek authority to pursue any action against the debtor beyond a determination of title to the property in the state court proceeding. And, it is often be more appropriate to permit proceedings to continue in their place of origin when no great prejudice to the bankruptcy estate would result, in order to leave the parties to their chosen forum and to relieve the bankruptcy court from many duties that may be handled elsewhere.


The Bankruptcy Court denied stay relief for a creditor to pursue counterclaims against the debtor in state court. The Court indicated that the Fifth Circuit has not adopted a single approach and addressed several approaches used in other circuits. Ultimately, the Court considered:

- Whether judicial economy is better achieved through continuing litigation in District Court or estimating the claims in Bankruptcy Court.
- Whether either forum avoids unnecessary expense and delay.

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159 In re Robbins, 964 F.2d at 348.

160 Id. at 344-45.
- Whether the claim is critical to success or failure of the reorganization.
- The nature of the abilities of the Bankruptcy Court.161

The Court held the interests of judicial economy favor proceeding in the bankruptcy court because discovery and pre-trial motions were complete and the parties could use the discovery to liquidate the counterclaims in the bankruptcy court. It found that granting stay relief would be a greater burden on the estate and that by retaining the counterclaims, the Court could rapidly proceed through the claims estimation process. It further concluded that Congress intended for all claims to be dealt with in bankruptcy proceedings and that the bankruptcy court was the proper venue.162


An agency brought a state court action against an LLC for unpaid sales commissions. When the arbitration panel awarded $930k to the agency, the LLC filed for chapter 7 bankruptcy. The agency moved for relief from the automatic stay and for remand. The district court granted both, allowing the agency to obtain confirmation of the arbitration award and judgment in state court. The debtor appealed and the Sixth Circuit affirmed this decision on the basis that they could not grant effectual relief on the debtor’s appeal challenging the bankruptcy court’s granting of relief. The Court found that once the state court entered a valid order confirming the arbitration award, this eliminated any ongoing proceeding for the court to stay.

The Court made the point that although bankruptcy courts may void state court actions that violate the automatic stay, here, the bankruptcy court granted relief, so the state court was free to act. A later determination that the bankruptcy court erroneously granted relief would not retract the express permission the state court received at the time to go forward. When a state court finishes its proceedings while an appeal challenging relief is pending, that appeal becomes moot.


Plaintiff filed state court action against vehicle lessor alleging negligence. The lessor declared bankruptcy. The bankruptcy court granted relief from the automatic stay to permit the plaintiff to resume the suit. The lessor removed case to federal court. After the stay was lifted, the plaintiff filed a new suit asserting the same claims in federal court. The district court dismissed the complaint and the Sixth Circuit vacated the district court’s order because the district court dismissed the complaint without addressing whether the stay relief was intended to be retroactive or merely prospective.


162 Id. at *5-6, 2015 Bankr. LEXIS 689, at *13-17.
viii. Seventh Circuit: *In re Williams*, 144 F.3d 544 (7th Cir. 1998)

The city housing authority sought relief from automatic stay to proceed with forcible entry action that it had commenced pre-petition date against a chapter 13 debtor-tenant. The bankruptcy court granted relief and the debtor appealed. The district court reversed, then the housing authority appealed to the Seventh Circuit. The Court held that lifting the stay to allow the housing authority to proceed with its forcible entry action was not an abuse of discretion.

The Seventh Circuit weighed several factors and decided that it was better for the state court to determine the merits of the debtor’s defenses to the action because they had more expertise. If the bankruptcy court had not lifted the stay, then that court would have had to determine the merits of the debtor’s defenses with no particular expertise in the narrow area of state law. Having the bankruptcy court decide this case would not have been a particularly efficient use of judicial resources.

ix. Eighth Circuit: *Farley v. Henson*, 2 F.3d 273 (8th Cir. 1993)

The Eighth Circuit clarified the phrase “the commencement or continuation of a judicial proceeding against a debtor” used in section 362 of the Bankruptcy Code. In this case, the Eighth Circuit explored whether an appeal brought by a debtor from a judgment obtained against it as a defendant is a continuation of a proceeding against a debtor and therefore subject to the automatic stay. The Court ruled that it was subject to the automatic stay, therefore, the stay would need to be lifted in order for it to proceed.


Secured creditor filed motion seeking a ruling that a proposed state court action against property-owner’s improvement districts would not violate the automatic stay. The bankruptcy court held that the automatic stay applied to the proposed lawsuit and denied stay relief. The creditor appealed and the Eighth Circuit BAP affirmed. The Creditor appealed again to the Eighth Circuit. The Eighth Circuit held that the automatic stay did not bar the creditor’s proposed action because the automatic stay does not generally apply to actions against third parties who have factual or legal relationships with a debtor.

xi. Ninth Circuit: *Griffin v. Wardrobe (In re Wardrobe)*, 559 F.3d 932 (9th Cir. 2009)

A creditor filed a state court action against a building contractor for breach of contract. Three days before trial, the contractor filed for bankruptcy, thereby staring the state court action. The bankruptcy court granted a limited lifting of the stay to permit the pending state court actions to go forward. After the stay was lifted, the creditor then amended her complaint to include a claim for fraudulent misrepresentation, which the bankruptcy court permitted. The debtor appealed to the BAP. The BAP found that the addition of this claim that was not pending before the limited lifting of the stay resulted in a violation of the automatic stay.
The Ninth Circuit affirmed the BAP’s holding because an order granting limited relief from the automatic stay to allow creditor to proceed to judgment in pending state court action is effective only as to those claims actually pending in state court at the time that order modifying the stay issues.

xii. Ninth Circuit: Ducharme v. JR Capital Grp. (In re Ducharme), 358 F. App’x 921 (9th Cir. 2009)

The debtor filed for chapter 13 bankruptcy. The bankruptcy court granted relief from the automatic stay to allow enforcement of state court unlawful detainer judgment pertaining to the debtor’s rental agreement with creditor, which was entered before the debtor’s filing. The debtor appealed and the Ninth Circuit affirmed. The Ninth Circuit held that the bankruptcy court did not abuse its discretion by granting relief and that the order granting relief was not invalidated by the bankruptcy court’s approval of the debtor’s chapter 13 plan because the rental agreement was not addressed in the plan.

xiii. Tenth Circuit: Wedel v. Centra Bank (In re Wedel), 107 F. App’x 824 (10th Cir. 2004)

The debtors appealed the bankruptcy court’s order granting relief from the automatic stay. The BAP dismissed their appeal. The debtors then appealed the BAP’s dismissal. The Tenth Circuit found that the debtors’ appeal was moot. The Tenth Circuit held that where the debtors failed to obtain stay of the order lifting their stay pending appeal and the creditor has conducted a foreclosure sale, the appeal is moot because the court can no longer grant effective relief.

xiv. Tenth Circuit: Jim’s Maint. & Sons Inc. v. Target Corp. (In re Jim’s Maint. & Sons Inc.), 418 F. App’x 726 (10th Cir. 2011)

Former customers of the debtor moved for relief from automatic stay to continue litigating its crossclaims against the debtor in pre-petition date actions. The bankruptcy court granted relief, and the debtor appealed. The debtor claimed abuse of discretion alleging that the bankruptcy court did not properly balance the factors that it considered to lift the stay. The Tenth Circuit found that the granting of the relief was not an abuse of discretion because the bankruptcy court’s analysis was appropriately tailored to the debtor’s limited argument regarding prejudice. The debtor failed to show that the bankruptcy court’s consideration of its prejudice argument and that the bankruptcy court’s decision to lift the stay constituted a clear error of judgment or exceeded the bounds of permissible choice in the circumstances.

xv. Eleventh Circuit: Ware v. Deutsche Bank (In re Ware), 562 F. App’x 850 (11th Cir. 2014)

The bankruptcy court granted relief from automatic stay to allow foreclosure litigation in state court which resulted in the debtor and his wife to being ejected from foreclosed property. The debtor appealed the order granting relief. The district court dismissed the debtor’s appeal as moot, and the debtor appealed again. The Eleventh Circuit held that the appeal became moot.
when, as a result of the debtor’s failure to obtain stay pending appeal, the debtor and his wife
were removed from the property.

xvi. Eleventh Circuit: *Disciplinary Bd. of the Sup. Ct. of Penn. v. Feingold (In re Feingold)*, 730 F.3d 1268 (11th Cir. 2013)

The Eleventh Circuit looked at whether the nondischargeability of the debt owed to the
Disciplinary Board by Feingold sufficed as the showing of cause necessary for the Board to
obtain relief from the automatic stay to enforce its judgment against Feingold. In so doing, the
Eleventh Circuit named the following factors to evaluate in whether to grant stay relief.

- Whether the debtor has acted in bad faith,

- The hardships imposed on the parties with an eye towards the overall goals of
  the Bankruptcy Code, and

- Pending state court proceedings

The Court found that looking at the dischargeability of the debt alone is not enough to determine
whether relief from stay should be granted.
Judicial Merry-Go-Round on Hot Topics – Consumer Cases
Judicial Merry-Go-Round on Hot Topics – Consumer Cases

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Bifurcated Fee Arrangements and Unbundling of Services In Chapter 7 and Fee Only Chapter 13 Cases

Access to Justice in Compliance with the Code, Rules, and Ethics Requirements

Honorable Suzanne H. Bauknight, USBC, E.D. Tenn.
Honorable Clifton R. Jessup, USBC, N.D. Ala.

Bifurcated Fee & Unbundled Services in Chapter 7

I. Framing the Problem of Fee Bifurcation and Service Unbundling
   a. Unbundling v. Bifurcation
      Unbundling:
      Defined: attorney is contractually limiting services to a discrete task(s), such as filing the bankruptcy petition
      Problem: leaves the client to his own devices to complete the legal process and leaves the debtor at risk of not receiving a discharge
      Bifurcated fee arrangement:
      Defined: attorney is contracting to represent the debtor during the entire case, contingent on the debtor signing the postpetition agreement
      Problem: without adequate disclosure, the client might not fully understand his options and the automatic stay and/or discharge injunction might be violated
   b. Access to Justice Implications
      i. Fees Discharged
         Fees owed after a bankruptcy petition is filed are discharged. Lamie v. United States Tr., 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004) (holding that Chapter 7 debtor’s counsel cannot be paid from property of the bankruptcy estate and the balance of any attorney’s fee owed at the time of the filing is dischargeable).
      ii. Debtors’ Four Options:
          (1) pay up-front retainer;
          (2) file the petition with assistance of counsel and proceed pro se;
          (3) file the petition with the assistance of a bankruptcy petition preparer and otherwise proceed pro se; or
          (4) file the petition with assistance of counsel and enter into postpetition agreement with filing counsel or new counsel to complete the case.
      iii. Pro Se Debtors
In some districts, 30% of pro se Chapter 7 debtors fail to receive a discharge. *See In re Hazlett,* No. 16-30360, 2019 WL 1567751, at *5 n.25 (Bankr. D. Utah Apr. 10, 2019) (Anderson, J.).

c. For more information about the problem and possible solutions, see several recent articles published in the ABI Journal and one law review article:

i. Daniel E. Garrison, *There’s No Such Thing as Too Much Information: Disclosure of Bifurcation and Financing in Chapter 7 Cases,* AM. BANKR. INST. J., July 2019, at 20 (addressing the problem in the context of inadequate disclosure under Federal Rule of Bankruptcy Procedure 2016(b) and Form B2030).


iii. Hon. Maureen A. Tighe, *Seeking Innovation to Address Low-Income Access to Bankruptcy,* AM. BANKR. INST. J., Nov. 2018, at 38 (“Paying for an attorney is simply not possible for many who need the benefits of the Bankruptcy Code. Not having $ 1,000 or more for an up-front fee causes many to choose the wrong chapter or seek out fraudulent services. Without adequate access for all to our nation’s bankruptcy laws, our courts are, very simply, failing to meet the Constitution’s promise of equal justice for all. It is an odd situation when the nation’s debt-relief laws are only meaningful to the well-heeled, but cash-strapped, debtor or large corporations.”).


vi. Pamela Foohey *et al., Life in the Sweatbox,* 94 NOTRE DAME L. REV. 220 (2018) (using data from the Consumer Bankruptcy Project and finding that people are living longer in the financial “sweatbox” before filing bankruptcy than they have in the past and discussing how waiting to file can undermine a debtor’s ability to realize a fresh start).

II. Code Requirements
   a. 11 U.S.C. § 329 mandates disclosures
   b. 11 U.S.C. § 330 requires that all fees paid be reasonable
   c. 11 U.S.C. § 362 prohibits violations of the automatic stay from collection activity
   d. 11 U.S.C. § 524 prohibits violations of the discharge injunction from collection activity
   e. 11 U.S.C. § 526(a)(4) prohibits counsel from advising a debtor to incur debt
   f. 11 U.S.C. § 528(a)(1) requires a written contract with the debtor
   g. 11 U.S.C. § 526(c)(2)(B) creates a duty for filing information required by § 521

III. Rules Requirements
   a. FED. R. BANKR. P. 2016(b): requires disclosure of all compensation paid/agreed to be paid
b. **FED. R. BANKR. P. 2016(b):** requires timely supplementation of disclosure

c. **Form B2030 Disclosure of Compensation:** all aspects of any compensation agreement should be explained; the Instructions state: “A copy of the retainer agreement, if any, should be attached to form.”

d. Local rules may provide limitations on unbundling. *See, e.g.*, Bankr. N.D. Ga. R. 9010–2 (requiring the lawyer to represent the debtor unless and until the attorney is permitted to withdraw); Bankr. D. Utah R. 2091-1 (requiring debtor’s counsel to represent and advise the debtor concerning all aspects of the case, absent the client’s decision to terminate the lawyer’s services); Bankr. E.D. Tenn. R. 2091-1(a) (requiring debtor’s counsel to obtain leave of court upon showing of cause to withdraw from representation of a debtor in a bankruptcy case).

e. **FED. R. BANKR. P. 1006(b)(3):** prohibits receipt of attorney’s fees before filing fee is paid

IV. **Ethical Requirements**

a. **MODEL RULES OF PROF’L CONDUCT R. 1.1 (AM. BAR ASS’N 2018) (Competence):** “Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.”

b. **MODEL RULES OF PROF’L CONDUCT R. 1.2 (AM. BAR ASS’N 2018) (Scope of Representation & Allocation of Authority Between Client & Lawyer):** An attorney may limit the scope of representation if the limitation is reasonable under circumstances and the client gives informed consent. Does a bifurcated agreement with unbundling provide the client with the “core services” for which the client is seeking representation?

c. **MODEL RULES OF PROF’L CONDUCT R. 1.4(b) (AM. BAR ASS’N 2018) (Communications):** “A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.”

d. **MODEL RULES OF PROF’L CONDUCT R. 1.5(b) (AM. BAR ASS’N 2018) (Fees):** Fee agreements must communicate to the client, “preferably in writing” the scope of representation and the basis or rate of the fee. “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.” *Cmt. 5 To MODEL RULES OF PROF’L CONDUCT R. 1.5 (Am. Bar Ass’n 2018).*

e. **MODEL RULES OF PROF’L CONDUCT R. 1.7(a)(2) (AM. BAR ASS’N 2018) (Conflicts of Interest: Current Clients):** Unbundling can result in a significant risk that the representation will be materially limited by a personal interest of the lawyer.

f. **MODEL RULES OF PROF’L CONDUCT R. 7.1(a) (AM. BAR ASS’N 2018) (Communication Concerning a Lawyer’s Services):** Failure to disclose the dischargeability of an unpaid prepetition fee might violate the prohibition of false or misleading communications about the lawyer’s services.

V. Case Progression

*In re Castorena*, 270 B.R. 504, 530 (Bankr. D. Idaho 2001) (Myers, J.) (stating that “an attorney must be prepared to assist that debtor though the normal, ordinary and fundamental aspects of the process . . ., includ[ing] the proper filing of all required [documents] . . .; attendance at the § 341 meeting; turnover of assets to the trustee, and cooperation with the trustee; compliance with the tax turnover and other orders of the Court; performance of the duties imposed by § 521[a](1), (3) and (4); counseling in regard to § 521[a](2) and the reaffirmation, redemption, surrender or retention of consumer goods securing obligations to creditors, and assisting the debtor in accomplishing those aims; and responding to issues that arise in the basic milieu of the bankruptcy case, such as violations of stay and stay relief requests, objections to exemptions and avoidance of liens impairing exemptions, and the like”).


*In re Waldo*, 417 B.R. 854 (Bankr. E.D. Tenn. 2009) (Stair, J.) (finding debtors’ counsel’s firm violated the automatic stay by calling and dunning debtors regarding postdated checks delivered prepetition for fees when checks were returned for insufficient funds and by the post-discharge deposit of postdated checks).

*In re Lawson*, 437 B.R. 609 (Bankr. E.D. Tenn. 2010) (Stair, J.) (disallowing, in round two of litigation concerning the same firm as in the Waldo case, the firm’s attempted fee bifurcation and unbundling and stating, “[t]he contract must clearly identify the services to be included within the pre-petition fee and the services to be included within the post-petition fee. It must also unambiguously disclose, at a minimum, that all pre-petition fees must be paid prior to filing and any unpaid pre-petition fee will be discharged and that all post-petition fees, which are not subject to the discharge, will be billed only when services are rendered and only for the specific amount of time for each activity at an agreed-upon hourly rate”).

*U.S. Trustee v. Clark & Washington, P.C. (In re Walton)*, 469 B.R. 383 (Bankr. M.D. Fla. 2012) (Williamson, J.) (after twice disallowing the firm’s approaches to fee bifurcation, allowing a bifurcated procedure with two contracts and three options for debtors, including a “cooling-off period” for clients to choose and a cancellation period, so long as the arrangement was fully disclosed to the client and the court).

*In re Slabbinck*, 482 B.R. 576, 595-96 (Bankr. E.D. Mich. 2012) (Shefferly, J.) (setting forth a series of questions necessary for informed consent: “For instance, did [counsel] explain to the Debtors that if they did not file all of their required documents post-petition, such as schedules of assets and liabilities, statement of financial affairs and other documents, then they would not obtain a Chapter 7 discharge despite filing their bankruptcy petition, cover sheet, statement of social security number, and matrix? Did [counsel] explain the consequences of dismissal and serial filings on the automatic stay? Did [counsel] explain to the Debtors that a failure to attend the § 341 meeting would mean no discharge? Did [counsel] explain to the Debtors that failure to cooperate with the Chapter 7 trustee could provide a basis to object to their discharge?”).

*Dignity Health v. Seare (In re Seare)*, 493 B.R. 158, 199-200 (Bankr. D. Nev. 2013) (Markell, J.) (requiring counsel to conduct a thorough client interview and investigation to evaluate the client’s circumstances, stating that [b]ecause the risks occur at different levels of
scale — the macro when considering challenges that all lawyers and clients face under a limited scope arrangement, and the micro when assessing a client’s particular situation — a lawyer can only understand the risks by careful examination of the client’s situation and objective”).

In re Davis, No. 13-40938-JJR, 2014 WL 3497587 (Bankr. N.D. Ala. July 11, 2014) (Robinson, J.) (rejecting the argument that debtors in more than 200 cases were merely making voluntary payments on postpetition agreements by putting into envelopes 15 postdated $100 checks to be mailed postpetition after the attorney called to direct the mailing of the checks and rejecting the Ninth Circuit’s 1998 “doctrine of necessity” that blessed a postdated-check fee agreement).

In re Jackson, No. 14-11415, 2014 WL 3722019 (Bankr. W.D. La. July 24, 2014) (Callaway, J.) (finding that the “no money down” bifurcated fee arrangement under which the debtor was to pay $200 per month for 12 months was not reasonable under Rules of Professional Responsibility 1.2 and 1.7(a)(2) and violated §§ 526(c)(2)(B) and 528(a)(1) because the agreement did not adequately include terms of payment and the arrangement did not cover the “core duties” of bankruptcy representation).

In re Grimmett, No. 16-01094-JDP, 2017 WL 2437231 (Bankr. D. Idaho June 5, 2017) (Pappas, J.) (finding that “counsel’s use of the agreement created irreconcilable conflicts of interest with Debtor as its client” because the agreement contained threats to terminate the representation and coercive collective procedures).

In re Wright, 591 B.R. 68 (Bankr. N.D. Okla. 2018) (Michael, J) (holding that the fee bifurcation and failure to disclose the factoring arrangement violated fee disclosure requirements and was a “fraud on his clients and on the court”).

In re Hazlett, No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019) (Anderson, J.) (approving fee bifurcation and unbundling with appropriate informed consent and disclosures, with third-party factoring, stating “in this case, the purpose of the bifurcated fee agreements is decidedly not to abandon the debtor, but to enable the attorney to be paid for the post-petition services. . . . [T]he bifurcated fee agreement is not for unbundling but to facilitate the debtor’s post-petition payment for the attorney’s post-petition services. And the fact that the post-petition payments can be made in installments only increases the affordability of the attorney’s services and thereby increases a debtor’s access to legal representation.”).

VI. General Requirements
   a. Written Informed Consent: “The propriety of using bifurcated fee agreements in consumer Chapter 7 cases is directly proportional to the level of disclosure and information the attorney provides to the client, and the existence of documentary evidence that the client made an informed and voluntary election to enter into a post-petition fee agreement.” In re Hazlett, No. 16-30360, 2019 WL 1567751, at *8 (Bankr. D. Utah Apr. 10, 2019).
   b. Accurate Pre and Postpetition Fee Agreements: “[T]he Court is likewise adamant that fees for pre-petition services should not be directly or surreptitiously slipped into the fee charged for post-petition services.” Id. at *9.
   c. All provisions “must be based on the client’s best interest, not the lawyer’s financial interests.” Id.
   d. All fees must be reasonable and necessary, including that the attorney must charge the same to a client who can pay an up-front retainer as a client who chooses a bifurcated arrangement. Id. at *10.
e. Full disclosure on Form B2030, filed within 14 days of the petition and supplemented within 15 days after any payment or agreement not previously disclosed. Fed. R. Bankr. P. 2016(b).

f. Compliance with local rules concerning withdrawal or substitution of counsel.

VII. Recommended Don’ts

a. Postdated checks written and provided to counsel prepetition. In re Lawson, 437 B.R. 609, 668 (Bankr. E.D. Tenn. 2010) (“Under no type of contract will the court condone acceptance of post-dated checks from debtors written on their accounts, to be cashed post-petition, as payment of attorneys’ fees. There are serious ethical implications in such a practice, raising the question and the appearance of a conflict of interest between debtor’s counsel and the affected debtors.”).

b. Knowingly allowing debtors to incur debt to pay legal fees in violation of § 526(a)(4). See Cadwell v. Kaufman, Englett & Lynd, PLLC (In re Cadwell), 886 F.3d 1153 (11th Cir. 2018) (credit card); In re Lawson, 437 B.R. 609, 668 (Bankr. E.D. Tenn. 2010) (“find[ing] the practice of accepting post-dated checks from third parties to be suspect and borderline violative of the Bankruptcy Code’s prohibition on advising debtors to incur debt in anticipation of filing for bankrupt”); see also In re Hazlett, No. 16-30360, 2019 WL 1567751, at * 6 (Bankr. D. Utah Apr. 10, 2019) (“[D]ebtors’ counsel have employed a number of processes with unsatisfactory results . . . includ[ing] issuing post-dated checks, paying legal fees with a credit card, withdrawing funds from a retirement plan, or taking out a home equity loan”).

c. Failing to obtain informed consent, especially concerning a factoring arrangement. See In re Hazlett, No. 16-30360, 2019 WL 1567751, at *12 (Bankr. D. Utah Apr. 10, 2019) (“The client must be offered the same discounted price. The client must consent in writing to the sale [of the account receivable] and must be informed that the legal fees for post-petition work are not dischargeable. The lawyer must inform the client that the legal financing company will collect the fee and if there were to be a dispute between the finance company and the client, the lawyer would not represent the client.” (quoting Utah Ethics Advisory Opinion Committee, Op. No. 17-06, ¶ 4 (2018))).

d. Factoring the fee agreement with the client, absent strict compliance with ethical requirements. See In re Hazlett, No. 16-30360, 2019 WL 1567751, at *12 (Bankr. D. Utah Apr. 10, 2019) (“[T]he Court would discourage the use of the BK Billing arrangement, or a similar factoring mechanism, unless it strictly complies with the guidance in the Utah Ethics Opinion. And even then, such must be fully disclosed, and the Court may review these arrangements for compliance with § 329 and any applicable rules.”).

e. Inadequate Rule 2016 disclosure: In In re Hazlett, the disclosure failed to reveal the factoring arrangement by which counsel was paid $1,800 from BK Billing, which collected $2,400 from the debtor.

f. Accepting fees postpetition before the filing fee is paid in full in violation of Rule 1006(b)(3).

VIII. One Possible Solution

a. True prepetition and postpetition agreements (meaning the postpetition agreement is signed postpetition);

b. Advising debtors prepetition of their options in conspicuous language in the written agreement: (1) wait to file the petition until the fee is paid in full; (2) proceed pro se after hiring
counsel for prepetition services only; (3) proceed postpetition with prepetition counsel by postpetition agreement (with the decision to do so being made postpetition); or (4) proceed postpetition with new postpetition counsel;

  c. Giving debtors specific informed consent for unbundling, after a thorough client interview that includes an explanation of the consequences of (1) failure to file all required § 521 documents postpetition, i.e., that they would not obtain a Chapter 7 discharge despite filing their bankruptcy petition, cover sheet, statement of social security number, and matrix; (2) dismissal and the effect of serial filings on the automatic stay; (3) failure to attend § 341 meeting, i.e., no discharge; and (4) failure to cooperate with the Chapter 7 trustee providing a basis for objection to entry to discharge;

  d. Accurate and complete disclosure(s), including filing of the retainer agreement(s) and timely supplemental disclosures;

  e. Payment in full of the filing fee before any postpetition payments are made to counsel;

  f. Compliance with any local rule that requires court approval for withdrawal; and

  g. Cooperation for substitution of counsel if the client retains other counsel for postpetition services.

Fee Only Chapter 13 Cases

*Brown v. Gore (In re Brown)*, 742 F.3d 1309 (11th Cir. 2014): Chapter 13 plan provided for 17% distribution of $2,806 to unsecured creditors and $2,000 for attorney fees. The Eleventh Circuit affirmed order denying confirmation of “attorney-fee-centric” plan, the main purpose of which was to finance attorney fees. Given the “abysmal failure rate of chapter 13 cases,” the bankruptcy court explained that the 17% distribution to unsecured creditors would “be of little consequence.” Applying the Eleventh Circuit factors from *Kitchens v. Georgia RR Bank & Tr. Co. (In re Kitchens)*, 702 F.2d 885 (11th Cir. 1983), i.e. essentially a totality of circumstances test, the Court of Appeals determined that the Chapter 13 plan was for the benefit of the lawyer, not in the best interest of the debtor, and found no “unique circumstances” present to support a finding of good faith. The Eleventh Circuit discounted the proposed 17% distribution to creditors given the “reasonable likelihood” the debtor would not complete his plan. Further, allowing payment of attorney’s fee in Chapter 13 would circumvent the Supreme Court’s holding in *Lamie v. United States Tr.*, 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004), which prohibits the payment of attorney’s fees out of Chapter 7 estate.

*Sikes v. Crager (In re Crager)*, 691 F.3d 671 (5th Cir. 2012): Rejected finding by district court that a Chapter 13 plan was a per se violation of the “good faith” requirements under § 1325(a)(3) and (7). The debtor had a legitimate fear that a future medical problem might leave her in a situation where she needed to seek future bankruptcy relief. As explained by the bankruptcy court, it would have bordered on malpractice for counsel to advise her to file Chapter 7. The debtor’s plan was not an attempt to abuse the spirit of the Code, but rather a responsible decision under the particular circumstances.

*Berliner v. Pappalardo (In re Puffer)*, 674 F.3d 78 (1st Cir. 2012): Chapter 13 plan provided for 2% distribution to unsecured creditors or $400 with an attorney fee of $2,900. The First Circuit overruled decision finding “fee-only” Chapter 13 plans are per se filed in bad faith. Instead, the presence or absence of good faith should be ascertained on a case by case basis applying the totality of circumstances test. While fee-only plans leave fundamental purpose undergirding Chapter 13 unsatisfied, i.e. paying creditors over time, and should not be used as a matter of course, there is no blanket rule against fee-only plans. However, given that the dangers
of such plans are manifest, debtors carry a heavy burden of demonstrating “special circumstances” justify submission. Circuit Judge Lipez, concurring in judgment, disagreed with imposing duty upon debtors to demonstrate “special circumstances” to justify fee-only petitions. Fee-only plans have emerged as a result of “Lamie problem” and, as well as, BAPCPA which made bankruptcy more expensive for all debtors. Some debtors who cannot afford an “attorney-assisted Chapter 7 filing” can afford to pay for an attorney to assist with Chapter 13 by paying fees in installments. Fee-only plans may be “essential to free ‘the honest but unfortunate debtor’ from intolerable circumstances.”

See also In re Dunson, 550 B.R. 537 (Bankr. D. Kan. 2016) (fee only plan filed by debtor with numerous health related garnishments filed in good faith); In re Doucet, No. 15-21531, 2016 WL 2603072 (Bankr. D. Kan. May 3, 2016) (fee only case paying $0 to unsecureds filed in good faith where debtor faced 17 garnishments and eviction); In re Banks, 545 B.R. 241 (Bankr. N.D. Ill. 2016) (fee only plan paying $4,000 no-look fee and $285 to trustee filed in good faith); Berliner v. Pappalardo (In re Buck), 509 B.R. 737 (D. Mass. 2014) (overruling bankruptcy court decision finding fee only plans are per se filed in bad faith).
Rule 3002.1 Issues

Honorable D. Sims Crawford, USBC, N.D. Ala.¹
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Rule 3002.1 Issues

At the NCBJ seminar two years ago, one of your authors reviewed the impact of Bankruptcy Rule 3002.1 and the fact that the Rule was implemented to add transparency for Debtors regarding their mortgage loans. The materials provided:

Rule 3002.1 is a potent and multi-faceted tool for debtors, debtors' attorneys, chapter 13 trustees and bankruptcy courts. If used effectively, it ensures that chapter 13 debtors receive accurate post-petition mortgage statements, reduces the likelihood that chapter 13 debtors will be charged improper or unwarranted mortgage fees, and prevents conduct that could otherwise jeopardize the fresh starts earned by chapter 13 debtors.

Colleen A. Brown and Ha Young Chung, The Not-So-New Rule 3002.1: It Only Works if We Use It, XXXVI ABI Journal 1, 18, 56 (Jan. 2017), available at abi.org/abi-journal. Since that time, there were additional amendments to the Rule in 2018, and several important issues have developed for bankruptcy courts to address. The current materials focus on issues that have arisen under sections (e), (f), and (h) of Rule 3002.1.

¹ Written Materials prepared with the assistance of Janna Ifshin, Law Clerk to the Honorable D. Sims Crawford.
Section (e)

The 2018 amendments include a change to section (e) that allows a party in interest, in addition to the debtor or the trustee, to file a motion for determination of fees, expenses, and charges.

There have been several recent cases where the debtor filed the motion challenging whether the fees were collectible, whether the fees were reasonable, or both. Most of the cases being reviewed here are from the federal judicial districts of Alabama, where the bankruptcy courts have interpreted the relevant sections of Rule 3002.1 differently.

Are the Fees Collectible?

“A lender is only permitted to collect Mortgage Fees, Expenses, and Charges in bankruptcy if the underlying agreement or applicable nonbankruptcy law so permit. 11 U.S.C. § 1322(a).” In re England, 586 B.R. 795, 801 (Bankr. M.D. Ala. 2018). “Once a debtor files a Motion to Determine Fees pursuant to Rule 3002.1(e), the burden shifts to the creditor to substantiate the fees, expenses, and charges stated in the Rule 3002.1 Notice.” Id. at 802 (citations omitted). Most of the disputes have been based on the following or nearly identical language in the mortgage:

If Borrower fails to make these payments or the payments required by paragraph 2, or fails to perform any other covenants and agreements contained in this Security Instrument, or there is a legal proceeding that may significantly affect Lender’s rights in the Property (such as a proceeding in bankruptcy, for condemnation or to enforce laws or regulations), then Lender may do and pay whatever is necessary to protect the value of the Property and Lender’s rights in the Property, including payment of taxes, hazard insurance and other items mentioned in paragraph 2. Any amounts disbursed by Lender under this paragraph shall become an additional debt of Borrower and be secured by this Security Instrument. These amounts shall bear interest from the date of disbursement, at the Note rate, and at the option of Lender, shall be immediately due and payable.

The “other items mentioned in Section 2” of the Mortgage included

(a) taxes and special assessments levied or to be levied against the Property, (b) leasehold payments or ground rents on the property, and (c) premiums for
insurance required under paragraph 4. In any year in which the Lender must pay a mortgage insurance premium to the Secretary of Housing and Urban Development ("Secretary"), or in any year in which such premium would have been required if Lender still held the Security Instrument, each monthly payment shall also include either: (i) a sum for the annual mortgage insurance premium to be paid by Lender to the Secretary, or (ii) a monthly charge instead of a mortgage insurance premium if this Security Instrument is held by the Secretary, in a reasonable amount to be determined by the Secretary. Except for the monthly charge by the Secretary, these items are called "Escrow Items" and the sums paid to Lender are called "Escrow Funds."

In re Harten, No. 17-04511-DSC13, at *2-*3 (Bankr. N.D. Ala. June 5, 2019). This language has been reviewed and construed differently by the Alabama bankruptcy courts. Each court has provided an interesting interpretation of the language and the cases have been evolving. The courts have not only examined whether the mortgage language provides for the fees, but which fees listed are collectible. Judge Oldshue in the Southern District of Alabama considered a Notice of Postpetition Mortgage Fees, Expenses, and Charges that disclosed $300 for “filing fees and court costs” and $350 for “plan review” after the debtor filed a Motion to Determine Mortgage Fees and Expenses. The court determined that the underlying mortgage did not authorize the collection of the fees from the debtor. He found:

Even if the language in the mortgage was intended to create an obligation by the debtor to repay attorney fees incurred after a default, the language is unclear and ambiguous to that effect. Such ambiguous provisions will not be enforced by this Court. See England at 795 (provisions in a mortgage permitting fees must be unambiguous and will only be enforced to the extent so provided for by the language of the mortgage) (citations omitted)). Here, within the four corners of the loan document, there exists no unambiguous language establishing a mortgagor obligation for mortgagee attorney fees incurred after an event of default.


Chief Judge Robinson in the Northern District of Alabama examined this issue when the debtor filed a Motion for Determination of Fees, Expenses, or Charges after the creditor filed their
Notice of Postpetition Mortgage Fees, Expenses, and Charges that included a $300 flat fee for the debtor’s most recent chapter 13 case. He interpreted the language as providing for and allowing the collection of the fee based on the Department of Housing and Urban Development (“HUD”) provision in the mortgage. He stated:

Congress directed HUD to promulgate rules and regulations pertaining to federally-insured mortgages. 12 U.S.C. § 1715b. And as quoted above, paragraph 8 of the Mortgage provides that “Lender may collect fees and charges authorized by [HUD].” “Where HUD rules and regulations are incorporated into an insured mortgage, they are binding upon both the mortgagor and mortgagee.” In re Ruiz, 501 B.R. 76, 79 (Bankr. E.D. Penn. 2013) (citing Application of Fleetwood Acres, Inc. 186 Misc. 299, 303, 62 N.Y.S. 2d 669, 673 (1945) ). Pursuant to HUD regulations, “(a) The mortgagees may collect reasonable and customary fees and charges from the mortgagor .... [including] (13) [w]here permitted by the mortgage, attorney's fees and expenses actually incurred in defense of any suit or legal proceeding wherein the mortgagee shall be made a party thereto by reason of the mortgage ....” 24 C.F.R. § 203.552(a).


This issue arose before Chief Judge Calloway in the Southern District of Alabama when the debtor filed a Motion to Determine Mortgage Fees and Expenses after the creditor filed a Notice of Postpetition Mortgage Fees, Expenses, and Charges for $300 for filing a proof of claim. Judge Calloway considered both Chief Judge Robinson’s and Judge Oldshue’s opinions and determined the $300 fee for filing a proof of claim was not collectible. He stated:

The HUD regulation discussed in In re Mandeville states in pertinent part: “Where permitted by the security instrument [i.e., the mortgage], [the mortgagee may recover] attorney’s fees and expenses actually incurred in the defense of any suit or legal proceeding wherein the mortgagee shall be made a party thereto by reason of the mortgage. . . .” 24 C.F. R. § 203.552(a)(13). The HUD regulation thus points the court back to the underlying mortgage to determine if the mortgagee can recover attorney’s fees; it does not provide an independent basis for recovery of fees.

Even if unambiguous, paragraph 7 only allows for the recovery of fees “to protect the value of the Property and Lender’s rights in the Property . . . .” The purpose of filing a proof of claim in a chapter 13 case is to get paid by the chapter 13 trustee from the debtor’s postpetition earnings through a confirmed plan. Unlike filing a motion for relief from stay to institute a foreclosure or force-placing insurance, for
example, preparing and filing a proof of claim does not protect the value of the property and the lender’s rights in the property. See In re Barrett, No. 10-05854-8-RDD, 2011 WL 5902780, at *4 (E.D.N.C. 2011) (“The attorney’s preparation and filing a proof of claim are not services that are necessary to protect the value of [the lender]’s rights in its collateral, but only preserves its ability to collect arrearages due under the Note.”); see also In re Zanner, 396 B.R. 265, 266 (Bankr. W.D.N.Y. 2008) (interpreting nearly identical mortgage language and finding that a broker’s price opinion was not an expense that would protect the collateral and thus its cost could not be allowed as a claim under the mortgage). The court does not need to reach the issue of ambiguity since the proof of claim fees would not be covered in any case.


Judge Crawford in the Northern District of Alabama recently decided whether a $300 fee for preparing and filing the proof of claim and a $350 fee for plan review were collectible after the Debtor filed a Motion for Determination of Fees, Expenses, or Charges opposing the creditor’s Notice of Postpetition Mortgage Fees, Expenses, and Charges. He first considered the Note, which he determined authorized the fees, and then the terms of the mortgage with the mortgage language quoted above. Regarding the fees for the proof of claim he followed Chief Judge Calloway’s analysis that the proof of claim does not protect the value of the property. He also followed Eleventh Circuit precedent concerning the necessity of filing a proof of claim. He explained:

This Court is persuaded that preparing and filing the proof of claim in this chapter 13 case were not necessary to protect the value of the Home and the Creditor’s rights in the Home. The relevant terms of the Mortgage, paragraphs 7 and 2, did not include recovery of this particular fee from the Debtor. Based on precedent, the Creditor’s decision to file, or not file, a proof of claim did not affect the value, the Creditor’s security interest, or the Creditor’s lien on the Home.

[A] secured creditor need not do anything during the course of the bankruptcy proceeding because it will always be able to look to the underlying collateral to satisfy its lien. In re Folendore, 862 F.2d 1537, 1539 (11th Cir. 1989) (“Because an unchallenged lien survives the discharge of the debtor in bankruptcy, a lienholder need not file a proof of claim under section 501.”). Bateman American Mortgage Co. v. Bateman (In re Bateman), 331 F.3d 821, 827 (11th Cir. 2003). Also, the Creditor cannot be forced to file a proof of claim. “Although the filing of a proof of claim may be a prerequisite to the allowance of certain claims, no creditor
is required to file a proof of claim.” *Simmons v. Savell (In re Simmons)*, 765 F.2d 547, 551 (5th Cir. 1985).

**Harten, No. 17-04511-DSC13**, at *7-*8.

However, he found the fee for plan review was collectible. He stated:

> A Creditor’s decision whether to review a chapter 13 plan has different consequences from the decision to file a proof of claim. As Chief Judge Robinson cautioned in *In re Mandeville*, 596 B.R. 750, 764 (Bankr. N. D. Ala. 2019), the Creditor is bound by the confirmed plan. *See Bateman*, 331 F.3d at 834. “[A] creditor must be vigilant in examining a proposed chapter 13 plan, and a creditor ignores a plan’s provisions that are contrary to the Code at its peril.” *Mandeville*, 596 B.R. at 765.

This Court is persuaded that reviewing the plan was necessary for the Creditor to protect the value of the Home and its rights in the Home as contemplated under paragraph 7 of the Mortgage. As such, the attorney’s fee of $350 disbursed by the Creditor for plan review in this case became an additional debt of the Debtor and was secured by the Mortgage.

**Harten, No. 17-04511-DSC13**, at *8.

**Are the Fees Reasonable?**

If a creditor meets the burden establishing that the postpetition fees are collectible, it must next prove the fees are reasonable. Chief Judge Sawyer in the Middle District of Alabama provided a detailed analysis of the reasonableness of attorney’s fees and the relevant factors to determine the reasonableness of the fees in *In re Ochab*, 586 B.R. 803 (Bankr. M.D. Ala. 2018). In *Ochab* the creditor filed a Notice of Postpetition Mortgage Fees, Expenses, and Charges for $400 for “Attorney’s Fees” and $500 for “Bankruptcy/Proof of claims fees”, and the debtor filed a Motion for Determination of Fees, Expenses, or Charges. In this case the mortgage provided a choice of law provision that made the laws of Alabama applicable to the mortgage. Judge Sawyer determined “the reasonableness of fees is determined on a case-by-case basis by the trial court.” *Ochab*, 586 B.R. at 808 (citations omitted). He further found:

> “Alabama law reads into every agreement allowing for the recovery of attorney's fees a reasonableness limitation.” *Willow Lake Residential Ass'n, Inc. v. Juliano*,
Within Alabama state courts, the factors enumerated in Alabama Rule of Professional Conduct 1.5 must be considered in determining the reasonableness of an attorney's fees. Ala. State Bar, Formal Opinion 1994–07. Likewise, federal courts applying state law to determine the reasonableness of an attorney's fee must look to Rule 1.5 of the Alabama Rules of Professional Conduct. Rule 1.5 provides, in part, as follows:

(a) A lawyer shall not enter into an agreement for, or charge, or collect a clearly excessive fee. In determining whether a fee is excessive the factors to be considered are 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[.]

*Id.* He found the fees unreasonable in this case because the lender was protected by the antimodification rule, reviewing the plan and filing a proof of claim were “relatively simple” matters, and that the creditor “failed to explain the fees in any detail and failed to provide supporting documentation.” *Id.* at 809-10.

Chief Judge Robinson in the Northern District of Alabama, although agreeing with Judge Sawyer that the fees should be determined on a case-by-case basis, took a different approach in *Mandeville*. Again, in *Mandeville* the debtor filed a Motion for Determination of Fees, Expenses, or Charges after the creditor filed their Notice of Postpetition Mortgage Fees, Expenses, and Charges that included a $300 flat fee for the debtor’s most recent chapter 13 case. He found:

Although the attorneys charged a flat fee for their work, the court is convinced that the time expended and legal expertise required to perform the tasks described by [the creditor’s] attorneys justified the $300, and was comparable with what other attorneys charge in this district for similar work. Thus, the fee is reasonable under Alabama law, and notably was less than half the maximum fee authorized by HUD for preparing a proof of claim and plan review. 2016 HUD Letter, Attachment 3, n. 13.

*Mandeville*, 596 B.R. at 766. Following *Mandeville*, a bankruptcy court in the Western District of Oklahoma recently found that $900 was a reasonable fee for plan review and filing the proof of claim. That court stated:
The Court’s decision today should not be read as holding that in this Court an attorney's flat fee arrangement with its mortgagee client is *prima facie* evidence of the reasonableness of the fee. The amount of a reasonable fee is based on a case-by-case factual basis; there is no precise rule or formula applied. Rather, the essential inquiry is one of reasonableness; and the court exercises discretion to reach an equitable award.


Judge Crawford recently addressed the issue of reasonableness in three separate cases, *Harten*, No. 17-04511-DSC13 (Bankr. N.D. Ala. June 5, 2019); *In re Gaiter*, No. 17-04374-DSC13 (Bankr. N.D. Ala. June 5, 2019); and *In re Ollie*, No. 17-05067-DSC13 (Bankr. N.D. Ala. June 5, 2019). He too followed Judge Sawyer’s case-by-case analysis. He heard testimony from the attorneys who prepared the proof of claims and performed the plan reviews. In all three cases there was testimony presented regarding the industry standard rates and the actual work performed by the attorney and their office staff. In both *Gaiter* and *Ollie* the debtors conceded the fees were due pursuant to the terms of the underlying mortgages and questioned only the reasonableness of the fees. Based on Chief Judge Robinson’s holding in *Mandeville*, Judge Crawford found the fees were “comparable with what attorneys in the district charge for similar work” and that the fees were reasonable based on the amount of work performed. *Ollie*, No. 17-05067-DSC13, at *5 (quoting *Mandeville*, 596 B.R. at 766). Using the same analysis, he found the fees for plan review were reasonable in *Harten*.2

2 Since the fees for the proof of claim were not collectible, determining whether the fees were reasonable was moot.
Section (f) and Section (h)

The NCBJ seminar materials from two years ago also addressed whether a debtor was entitled to a discharge if his or her postpetition mortgage payments were not current. The materials specifically addressed the ruling in *In re Gonzalez*, 532 B.R. 828 (Bankr. D. Colo. 2015), where the court revoked the debtors’ discharge after it was determined the debtors were not current on their direct postpetition mortgage payments. Since this ruling there have been more decisions and a split in authority. These decisions hinge on whether or not the court finds the direct postpetition mortgage payments to be payments under the plan pursuant to § 1326.

The majority of bankruptcy courts hold that the direct postpetition mortgage payments are “payments under the plan” and that the debtor is not entitled to receive a discharge if they default on these payments. The Fifth Circuit affirmed the bankruptcy court’s denial of discharge finding:

The Kesslers’ Chapter 13 plan included terms for curing their pre-petition mortgage arrears and provided for maintenance of post-petition payments. Because the Kesslers failed to complete post-petition mortgage payments that fall under the plan, they do not qualify for discharge under the plain terms of § 1328(a), which instructs a court to grant discharge only after completion of all payments under the plan. 11 U.S.C. § 1328(a).

*Kessler v. Wilson (In re Kessler)*, 655 F. App’x 242, 244 (5th Cir. July 8, 2016) (*per curiam*).


A minority of bankruptcy court decisions hold that direct postpetition mortgage payments are not “payments under the plan” and the debtor is still entitled to receive a discharge. Judge Perkins in the Central District of Illinois reasoned:

In section 1328(a), “all payments under the plan” is used to define when completion of payments occurs (thus triggering entitlement to a full compliance discharge), while the similar but different alternative phrase “provided for by the plan” is used
to describe the scope of the discharge. 11 U.S.C. § 1328(a). The use of different terminology implies an intended distinction. “Provided for by the plan,” has been expansively construed to mean that a plan “makes a provision” for, “deals with,” or even “refers to” a claim. Rake v. Wade, 508 U.S. 464, 474, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993). Congress could have defined the event of plan completion as “completion by the debtor of all payments provided for by the plan.” Instead, Congress chose to use a different phrase. In this Court's view, the alternative phrase “under the plan” was intended to have a narrower effect, allowing for the possibility that not all creditors holding debts provided for by the plan are receiving payments under the plan. There may be some payments made to creditors who are provided for by the plan that are not payments under the plan. The most logical line of demarcation is between payments made by the trustee from funds received from the debtor versus payments made by the debtor direct to a creditor. It follows that the resolution of the difference in phraseology is to construe the requirement under section 1328(a) of “completion by the debtor of all payments under the plan,” to mean the payments that the debtor is required to make to the trustee.

In re Gibson, 582 B.R. 15, 19 (Bankr. C.D. Ill. 2018). Judge Perkins further explained:

[A] Chapter 13 debtor’s direct payments on a nonmodifiable, nondischargeable residential mortgage loan, provided for under section 1322(b)(5), are not “payments under the plan” for purposes of section 1328(a). A debtor’s failure to complete all such direct payments is not grounds to dismiss the case without a discharge. The Debtors’ failure to make their 2nd mortgage payments to PNC was the result of a misunderstanding of the requirements of their plan. The failure was not the result of a scheme to defraud or an intent to deceive anyone and unsecured creditors suffered no harm as a result of the mortgage payment default. The payments that the Debtors were required to make to the Trustee, i.e., “all payments under the plan,” have been completed. Under these circumstances, the Debtors are entitled to a full compliance discharge under section 1328(a).

Id. at 24.

Perhaps the most interesting part of this opinion was where the court looked at the intent behind Rule 3002.1 and the fact that “countless Chapter 13 debtors received a discharge despite an uncured default in payments to a creditor made direct by the debtor, either because the trustee was unaware of the default or because a default on direct plan payments was not viewed as a basis to seek dismissal without discharge.” Id. at 18. Judge Perkins stated:

It is equally clear that Rule 3002.1 was not intended to serve as the impetus for dismissal without discharge. Rather, it is universally recognized that the Rule was intended to benefit debtors by better ensuring the fresh start to a Chapter 13 debtor
who completes a plan, by providing a mechanism for review and a forum for resolving disputes over whether the debtor's obligations to the mortgage holder are current at the conclusion of the bankruptcy case. See *In re Tollios*, 491 B.R. 886, 888 (Bankr. N.D. Ill. 2013). Thus, the recent trend favoring dismissal without discharge as a punitive remedy for a debtor’s failure to pay all direct payments is occurring not as a consequence of a statutory amendment reflecting a change in legislative policy, but merely by the happenstance of the introduction of Rule 3002.1, a Rule adopted for an entirely different and debtor-friendly purpose.

*Id.* at 19.

Judge Wanslee in Arizona adopted Judge Perkins’s minority position in *In re Rivera*. She noted:

> The mandatory form plan here gave Debtors two choices with respect to their post-petition mortgage payments – either “pay direct ... or ...Trustee will pay creditor.” These two choices cannot mean the same thing, or why even have a choice? Thus, the logical line of demarcation is that “pay direct” means “provided for by the Plan” while “Trustee will pay creditor” means “payments under the plan.”

*In re Rivera*, 599 B.R. 335, 340 (Bankr. D. Ariz. 2019). She also stated that denying the debtor a discharge for failure to make the postpetition mortgage payments defeats the purpose of the Bankruptcy Code which is to grant a “fresh start” to the “honest but unfortunate debtor.” *Id.* at 345 (citations omitted). Interestingly, she also observed:

> The Rule could have specified a penalty or consequence for a debtor with delinquent post-petition payments, but it did not. That is because the principal purpose of this Rule is creditor disclosure including “the scope and timing of the information required, the mechanism for determination of mortgage status during a Chapter 13 case, and the extent of sanctions for creditor non-disclosure.” *Id.* (emphasis added). This Rule, which is directed at creditors and was intended to shield debtors, should not be used as a sword to harm debtors by denying their discharges.

*Id.* at 344.

While *In re Dukes* does not address Rule 3002.1 specifically, the Eleventh Circuit’s ruling is very important in the context of the how a mortgage debt is treated in a chapter 13 plan and whether a mortgage debt is discharged. The Eleventh Circuit found:
[A] plan’s mere statement that payments on a debt will be made outside the plan does not mean that debt is “provided for” by the plan. Even if the Credit Union’s debt was provided for by the plan, we also hold that, because the Credit Union’s claim was secured by Debtor’s primary residence, the antimodification provision of 11 U.S.C. § 1322(b)(2) prohibits the mortgage from being discharged.

Dukes v. Suncoast Credit Union (In re Dukes), 909 F.3d 1306, 1313 (11th Cir. 2018) (footnote omitted). Depending on the wording of a debtor’s chapter 13 plan, counsel may argue that the Dukes decision supports the premise that that direct postpetition mortgage payments are “not provided for” by the plan and thus, a debtor’s default in postpetition mortgage payments may not result in the denial of the debtor’s discharge. Potentially, the mortgage debt would instead be excepted from discharge and the debtor would be left to deal with the mortgage creditor under nonbankruptcy law.

Conclusion

In the last two years, Bankruptcy Rule 3002.1 has had quite an impact on chapter 13 cases and residential mortgage claims against chapter 13 debtors. It appears that the issues will continue to evolve as debtors and their counsel take steps to determine the validity, accuracy, and reasonableness of mortgage fees, expenses, and charges. The bankruptcy courts will likely hear more cases seeking rulings on the question of whether direct postpetition mortgage payments are “payments under the plan” and whether a debtor’s discharge should be denied if postpetition mortgage payments are in default at the time of plan completion. While providing transparency to residential mortgage loans during the chapter 13 process, Rule 3002.1 has certainly created more interesting issues for the bankruptcy courts to consider.
The Intersection of Bankruptcy and Family Law

Honorable Mary Gorman, USBC, C.D. Ill.
Honorable Mindy A. Mora, USBC, S.D. Fla.

1. Both domestic support obligations and property settlement obligations are nondischargeable in Chapter 7 cases. Is it still important to distinguish between the two types of obligations?

- § 362(b)(2)(B) – automatic stay does not apply to collection of domestic support obligation; stay exception does not apply to property settlement obligations.
- § 1328(a)(2) – Chapter 13 discharge does not include domestic support obligations but does include property settlements.
- § 507(1)(A) – domestic support obligations are first priority claims; § 726 – priority claims are paid ahead of other claims in Chapter 7 cases; § 1322(a)(2) – Chapter 13 plans generally must provide for the full payment of priority claims.
- § 362(b)(2)(B) – impact on automatic stay exception for determination and enforcement of domestic support obligations when debtor’s wages are deemed to be property of the estate for debtors in chapters 11 and 13.

2. If a dissolution of marriage action is pending when a bankruptcy is filed, should the bankruptcy court send the case back to state court to resolve the allocation of property and thereby, effectively, abstain from determining what is property of the estate? If one or both parties want to go back to state court for the property division, is requesting relief from stay the correct procedure? What about the rights of a case trustee in property subject to division by the state court?

- District courts (and by reference bankruptcy courts) have jurisdiction over all property of a debtor upon the filing of a case. 28 U.S.C. § 1334.
- Reinbold v. Thorpe (In re Thorpe), 881 F.3d 536 (7th Cir. 2018) (after bankruptcy court granted stay relief and state court entered final judgment dividing marital property, Chapter 7 trustee could not assert any interest in marital home awarded to non-debtor spouse). See also In re Zachman, No. 10 B 32410, 2013 WL 1316647 (Bankr. N.D. Ill. Apr. 2, 2013) (property awarded to non-debtor spouse during pendency of bankruptcy after stay relief granted is no longer property of the estate).
- Sending matters back to state court involves not only stay relief but also issues of subject matter jurisdiction and standing. See generally Bandy v. Delay (In re Delay), No. 16-07040, 2018 WL 1596883, at *1 (Bankr. C.D. Ill. Mar. 29, 2018) (Gorman, J.).
- Is tenancy by the entirety property/community property deemed to be property of the estate when only one spouse files bankruptcy? How does that impact automatic stay exception

3. Is § 541(a)(5)(B) a trap for the unwary, bringing property awarded in a dissolution of marriage within 180 days of the case filing into the estate? See In re Kiley, 595 B.R. 595 (Bankr. D. Utah 2018) (some of the debtor’s interest in her ex-husband’s retirement plan allocated within 180 days after bankruptcy filing was not entitled to an exemption that would only have been available for an interest held as of the date of filing).

4. Are there special provisions in Chapter 13 that should be considered if a client has obligations related to a prior judgment for dissolution of marriage?

- § 1301 – co-debtor stay may protect former spouse from creditors being paid through plan.
- § 1322(b)(1) – plan may treat unsecured claims for consumer debts when there is co-debtor differently than other unsecured claims; such debts could be paid in full to comply with state court orders even if other debts are paid a lower percentage.
- § 1328(a) – a debtor must certify that all domestic support obligations that are due to be paid have been paid in order to obtain a discharge.

5. May a bankruptcy lawyer represent both husband and wife in a joint filing if a dissolution is pending in state court but the parties are still married? Does the answer depend upon whether the parties each have counsel in the dissolution of marriage case? What are the ethical implications for an attorney representing a husband and wife if the clients decide to separate and divorce after a case is filed or after a Chapter 13 plan is confirmed?

- **RULE 1.7: CONFLICT OF INTEREST: CURRENT CLIENTS**
  (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent 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 responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
  (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
    (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;
    (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 or other proceeding before a tribunal; and
    (4) each affected client gives informed consent.
§ 362(c)(3) Stay Matters

Honorable Stephani W. Humrickhouse, USBC, E.D.N.C.
Honorable David E. Rice, USBC, D. Md.

1. The text of § 362(c)(3)

(3) if a single or joint case is filed by or against a debtor who is an individual in a case under chapter 7, 11, or 13, and if a single or joint case of the debtor was pending within the preceding 1-year period but was dismissed, other than a case refiled under a chapter other than chapter 7 after dismissal under section 707(b)--

(A) the stay under subsection (a) with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease shall terminate with respect to the debtor on the 30th day after the filing of the later case;

(B) on the motion of a party in interest for continuation of the automatic stay and upon notice and a hearing, the court may extend the stay in particular cases as to any or all creditors (subject to such conditions or limitations as the court may then impose) after notice and a hearing completed before the expiration of the 30-day period only if the party in interest demonstrates that the filing of the later case is in good faith as to the creditors to be stayed; and

(C) for purposes of subparagraph (B), a case is presumptively filed not in good faith (but such presumption may be rebutted by clear and convincing evidence to the contrary)--

(i) as to all creditors, if--

(I) more than 1 previous case under any of chapters 7, 11, and 13 in which the individual was a debtor was pending within the preceding 1-year period;

(II) a previous case under any of chapters 7, 11, and 13 in which the individual was a debtor was dismissed within such 1-year period, after the debtor failed to--

(aa) file or amend the petition or other documents as required by this title or the court without substantial excuse (but mere inadvertence or negligence shall not be a substantial excuse unless the dismissal was caused by the negligence of the debtor's attorney);

(bb) provide adequate protection as ordered by the court; or

(cc) perform the terms of a plan confirmed by the court; or
(III) there has not been a substantial change in the financial or personal affairs of the debtor since the dismissal of the next most previous case under chapter 7, 11, or 13 or any other reason to conclude that the later case will be concluded--

(aa) if a case under chapter 7, with a discharge; or

(bb) if a case under chapter 11 or 13, with a confirmed plan that will be fully performed; and

(ii) as to any creditor that commenced an action under subsection (d) in a previous case in which the individual was a debtor if, as of the date of dismissal of such case, that action was still pending or had been resolved by terminating, conditioning, or limiting the stay as to actions of such creditor; and


2. When and how does it apply?

- Generally determines the status of the stay as it relates to the debtor, estate property or debtor’s property when there has been a pending, but dismissed case, within one year prior to the case in question

- Instituted with the passage of Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)

- In re Paschal, 337 B.R. 274, 280 (Bankr. E.D.N.C. 2006). Judge Small considers the meaning of the phrase “with respect to any action taken” and determines that the stay only terminates as to formal action taken by a particular creditor prior to the petition date.

- In re Jones, 339 B.R. 360, 362 (Bankr. E.D.N.C. 2006). Judge Small considered the statutory language “the stay . . . shall terminate with respect to the debtor . . .” The court concluded that “the words ‘with respect to the debtor’ encompass ‘actions taken’ against the debtor [and] against property of the debtor, but do not include ‘actions taken against property of the estate.’” Judge Small went on to comment on how protecting property of the estate protects the debtor’s ability to consummate a chapter 13 plan or keep assets in place in a chapter 7 to pay all creditors. In essence it is an important protection for creditors. (Judge Small does not consider legislature history because he finds this particular language is clear).

- In re Jupiter, 344 B.R. 754, 762 (Bankr. D. S.C. 2006). Judge Waites held that “with respect to the debtor” merely defines which debtor and distinguishes a repeat-filer debtor from a first-time filing spouse: He held that the stay terminated with
respect to property of the estate, as well as with respect to the debtor and his property. Judge Waites is persuaded by the fact that § 362(j) allows a party to receive an order confirming that the automatic stay has terminated and that section would be inconsistent with § 362(c)(3)(A) if it did not effect a wholesale termination of the stay because § 362(j) does not carve out an exception for property of the estate. Any other interpretation renders the procedure for extending the stay unnecessary since it would so rarely be used. Ultimately, Judge Waites finds the statute ambiguous and looks to the legislative history: Congress clearly intended to make it more difficult for debtors who engage in bad faith successive filings.

- **In re Tubman**, 364 B.R. 574 (Bankr. D. Md. 2007). Judge Gordon embraces the majority position holding that the stay is lifted only as to the debtor and the debtor’s property.

- **In re Johnson**, 335 B.R. 805, 806 (Bankr. W.D. Tenn. 2006). Judge Boswell held that the plain language of § 362(c)(3)(A) dictates that the 30-day time limit only applies to debts or property of the debtor and not to property of the estate.


- **In re Bender**, 562 B.R. 578 (Bankr. E.D.N.Y. 2016). Judge Grossman criticized both the majority and minority views and focused on the language “with respect to any action taken with respect to a debt or property securing such debtor or with respect to any lease.” Judge Grossman found Congressional intent “to protect the secured creditor or lessor seeking to continue judicial, administrative or other proceedings commenced prepetition with respect to debts, property securing such debts or leases. A narrow interpretation of the ruling is that the stay terminates on the thirteenth day only as to secured creditors having taken prepetition action against specific collateral.

- **In re Dev**, 593 B.R. 435 (Bankr. E.D.N.C. 2018). Judge Warren adopted the minority interpretation of § 362(c)(3)(A) but agreed that a prior action is required by the creditor. The majority interpretation “persuasively gives meaning to each word in the statute, implements a result that flows from the plain language of the statute and does impose some penalty on a debtor and protects the assets upon which the estate relies to ensure all creditors are paid in conformance with the Code’s priority scheme.”

- **In re Wood**, 590 B.R. 120 (Bankr. D. Md. 2018). Judge Harner found no significant reason to deviate from the majority approach and district precedent.

- **Smith v. Maine Bureau of Rev. Serv. (In re Smith)**, 910 F.3d. 576 (1st Cir. 2018). The First Circuit is the only circuit court to address the scope of § 362(c)(3)(A).
The court criticized the reasoning advanced by *Jupiter* but reached the same result—there is no stay after thirty days unless extended. First Circuit warns that vigorous application of the canons of statutory interpretation should be ignored where a statute is inartfully drafted. The First Circuit looked to the purpose behind BAPCPA: to deter individual debtors from filing multiple bankruptcy petitions.


- *Cf.* 3 Collier on Bankruptcy at ¶ 362.06[3], at p. 362-84.11 (Lawrence P. King et al, eds, 15th ed. Revised 2005) (implying that the automatic stay terminates with respect to property of the estate if the property secures a debt of the debtor).

- Courts that focus on the difference in language between § 362(c)(3)(A) and § 362(c)(4)(A)
  - *In re Harris*, 342 B.R. 274, 278-80 (Bankr. N.D. Ohio 2006) (Congress intended to impose stiffer penalties and debtors who had multiple cases dismissed within the previous year.)

3. **Practical Effect and Additional Considerations**

- All debtors will seek comfort orders seeking extension of the stay but will have to satisfy the clear and convincing standard of § 362(c)(3)(B).

- Under § 362(c)(3)(B), the court may extend the stay only “after notice and a hearing completed before expiration of the 30-day period.” Debtors should file a motion promptly after filing a petition and take appropriate steps under local practice to assure the motion will be ruled on and an order entered within the 30-day period.

- If the stay is extended, the court has the discretion under § 362(c)(3)(B) to impose “conditions or limitations.”

- If the debtor’s motion is opposed, debtors may want to resolve the objection by entering into a consent order that conditions continuation of the stay as extended subject to typical lift stay motion terms.
Section 362(c)(3) applies when the debtor’s prior case was dismissed within the prior year. Thus, § 362(c)(3) does not apply when the prior case was closed after completion of administration and/or discharge of the debtor.

What about the debtors who relied upon the previous interpretation and did not seek extension? Judge Brown took that situation into consideration in the case of Goodrich, 587 B.R. at 848-849, and extended the thirty-day period to allow the debtor to file a motion to extend the stay after overturning her prior decision of In re McFeeley, upon which the debtor reasonably relied in not seeking an extension.

What if the stay has expired pursuant to § 362(c)(3)(A) but creditor’s claim is paid through a confirmed plan? In re Lemma, 394 B.R. 315, 323 (Bankr. E.D.N.Y. 2008). The court denied creditor’s motion post-confirmation to lift the co-debtor stay under § 1301(c)(1) because it did not foreclose prior to confirmation nor object to the plan and thus was bound by the terms of the plan.

Can a case continue to confirmation without the stay in effect as to the debtor? In re Smith, 596 B.R. 872 (Bankr. E.D. Tenn. 2019). (Judge Rucker answers in the affirmative: a plan may be confirmed without a stay in effect as to the debtor because an effective stay is not a requirement for confirmation listed under § 1325(a)). In re Dyer, 489 B.R. 637 (B.A.P. 6th Cir. 2013), No. 12-8030, 2013 WL 987729, *5 (B.A.P. 6th Cir. Mar. 14, 2013) (table opinion) (discussing Shaw & Aurgroup Fin. Credit Union, 552 F.3d 447, 450 (6th Cir. 2009) (“[t]he bankruptcy court is required to confirm the plan so long as it satisfies the provisions of 11 U.S.C. § 1325(a)”; In re Fleming, 349 B.R. 444, 446-47 (Bankr. D.S.C. 2006) (finding the code indicates the existence of a stay is not a prerequisite to confirmation under section 1325(a), and “termination of the automatic stay does not necessarily deprive a debtor of the right to continue under Chapter 13, obtain confirmation of a plan, and ultimately obtain a discharge if the debtor, complies with the terms of the plan”); In re Murphy, 346 B.R. 79, 83 (Bankr. S.D.N.Y. 2006) (finding that “[b]ecause termination of the stay under [s]ection 362(c) is not the equivalent of termination of the [c]hapter 13 case, it is still possible for a debtor to confirm a [c]hapter 13 plan when the stay terminates early in the case under [s]ection 362”).

4. Additional Citations

- The majority position:


The minority position:
When the Weak Link Breaks: Supply Chain Insolvencies – Automotive and Elsewhere
### When the Weak Link Breaks: Supply Chain Insolvencies – Automotive and Elsewhere

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WHEN THE WEAK LINK BREAKS: SUPPLY CHAIN INSOLVENCIES

National Conference of Bankruptcy Judges
Washington, D.C.

October 31, 2019

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United States Bankruptcy Court
Western District of Michigan
1 Division Avenue, North
Grand Rapids, Michigan 49503
WHEN THE WEAK LINK BREAKS: SUPPLY CHAIN INSOLVENCIES

Hon. John T. Gregg
United States Bankruptcy Court
Western District of Michigan

131.05 The Workout Process for Troubled Suppliers and Other Automotive Entities

[1] Introduction

Before examining how a bankruptcy case involving a financially distressed tooling fabricator, auto supplier or OEM will be administered in a United States Bankruptcy Court and the important legal issues arising in such a case, it is worthwhile to examine and consider out-of-court restructurings of these business entities. Not only do these restructurings set the stage for a subsequent bankruptcy case but also they will sometimes determine how that case is administered by the bankruptcy court.

[2] Early Warning Signs of Economic Distress

In most cases, an auto supplier or OEM does not become insolvent overnight. Rather, the slide into financial distress normally occurs over time, sometimes over a period of years. General Motors’ financial collapse, for example, arguably began in 2005 and then accelerated at lightning speed during the world financial crisis of 2008–2009. The following is a partial list of early warning signs for financial distress of businesses engaged in the automotive industry:

- increased delays between the delivery of invoices and receipt of payments including bounced checks
- filing of federal or state tax liens against supplier or customer
- freezing of supplier or customer’s bank accounts

* These materials are an excerpt from a chapter in the Collier Bankruptcy Practice Guide entitled “Bankruptcy Cases Involving Automotive Suppliers and Their Customers,” which was written by John T. Gregg and Patrick E. Mears. The materials are reprinted from Collier Bankruptcy Practice Guide with permission. Copyright 2019 Matthew Bender & Co., Inc. All rights reserved.
- increased creditor collection activity, e.g., service of garnishment and attachment writs
- reductions in labor force
- upper-management turnover
- switching of professionals such as lawyers or accountants
- construction or lack of communication with creditors
- institution of collection lawsuits against supplier or customer
- sudden increase in purchases of goods or services, possibly to prepare for bankruptcy
- rumors in industry or local business community
- a supplier’s sudden request for a substantial price increase, or a buyer’s sudden request for “give-backs,” even though the prices of products sold by the supplier have been fixed in long-term customer contracts, coupled with the supplier’s threats not to ship or the buyer’s threats to re-source or validate a new supplier.

[3] Responses of Vendors and Customers of Financially Troubled Supplier If the Demand for a Price Increase Is Not Met

[a] Litigation

Vendors to the financially troubled supplier, such as tooling fabricators and Tier II suppliers, may respond to the failure of its customer to pay for goods purchased in a number of ways. These range from commencing litigation to collect unpaid debts to negotiating an accommodation agreement with the troubled supplier, the troubled supplier’s customers (which often include Tier I suppliers and/or OEMs) and the troubled supplier’s financing bank. The complaint filed by unpaid vendors in these circumstances will normally allege a breach of contract claim and demand the entry of a money judgment against the troubled supplier.

Customers of the troubled supplier also possess this array of options with one very important difference that arises in situations where the troubled supplier demands price increases and threatens not to ship goods to customers under long term contracts unless the customers accede
to these demands. As previously described, the failure to ship goods to a customer under a just-in-time inventory regime may threaten production by shutting down assembly lines and causing the customer to suffer large consequential damages. When faced with this threat, the troubled supplier’s customer will often commence an action for a mandatory injunction requiring the supplier to resume shipments on the ground that the customer facing a line shutdown has no adequate remedy of law. The customer will often seek a temporary restraining order from the court requiring the continuation of shipments immediately upon filing the complaint.

[4] Negotiation of Accommodation and Access and Security Agreements

In instances where a financially distressed, sole source supplier of automotive components to customers who are unable to obtain promptly a substitute source for these goods, the affected parties, i.e., the customers, the troubled supplier, the critical vendors of the troubled supplier and the troubled supplier’s primary secured creditor (which is often a commercial bank or a bank syndicate), will often enter into negotiations to provide for the troubled company’s continued operations. The overriding goal of these negotiations is to maintain the financially distressed supplier in business until (i) another source for these goods can be secured by the customer; (ii) the troubled supplier’s business assets can be sold to a third party on a “going concern” basis; or (iii) the supplier can stabilize and reorganize its business.

[a] Accommodation Agreements

In these multiparty negotiations, the troubled supplier, its customers, its primary secured creditor and its unsecured trade vendors often negotiate what is commonly labeled as an “accommodation agreement.” An accommodation agreement normally provides for the continuation of the troubled company’s business while the supplier attempts to restructure its finances or prepare for an orderly liquidation of its assets. For an example of an accommodation
agreement that was approved in the chapter 11 case of In re Chassix Holdings, Inc.,1 see below at ¶ 131.53. Some provisions that are commonly incorporated into an accommodation agreement are as follows:

1. **Limitation on Resourcing.** Customers concerned with a potential line shutdown will often seek to resource to a new supplier production of the parts made by the troubled supplier. The troubled supplier’s bank, however, may oppose any such resourcing attempts by customers because of the severe negative impact of such a move on the bank’s borrower and the bank’s collateral base. Typically, accommodation agreements resolve this conflict by prohibiting customers from resourcing unless the supplier later defaults on its supply obligations to its customers. These agreements, however, often allow these customers to prepare for a possible resourcing, which may permit customers to make arrangements with replacement suppliers anticipating the supplier’s default under the accommodation agreement or a shutdown of the troubled supplier’s business.

2. **Price Increases and Accelerated Payment Terms.** Accommodation agreements often establish price increases for goods sold by the supplier to its customers or require customers to make accelerated payments to the supplier to strengthen its cash flow.

3. **Customer Loans.** In some workouts and even in chapter 11 cases, the troubled supplier may need to increase its cash flow. However; the financing available from the supplier’s bank may not be enough to provide sufficient working capital. This situation is especially acute when OEMs serviced by the troubled company have scheduled a new product launch that requires the supplier to purchase new tooling and other equipment. To avoid a line shutdown at such a critical time in the production cycle, OEMs sometimes provide financing to the supplier

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1 Case No. 15-10578 (Bankr. S.D.N.Y.).
subordinate to or *pari passu* with existing bank financing in the form of separate loans or participations in existing bank loans.

4. **Limitations on Setoff Rights.** Customers often consent to restrictions being imposed on their setoff and recoupment rights against the troubled supplier.² Specific exceptions to these limitations include (i) claims for new financing; (ii) claims for nonconforming goods; (iii) warranty claims; and (iv) claims for incidental and consequential damages.

5. **Recognition of Customer Rights in Tooling.** In accommodation agreements, customers, especially OEMs, normally insist that all parties to the agreement confirm that the customers’ separately owned tooling in the troubled supplier’s actual or constructive possession is the customers’ exclusive property and that this tooling is subject to a bailment in favor of the customers. If tooling ultimately destined for sale to the customer either directly by the troubled supplier or via a higher-tiered supplier is being fabricated by the financially distressed supplier, the accommodation agreement may provide for the discharge and release of the debtor’s rights in that tooling once its purchase price is paid. In this situation, the agreement will likely provide that, upon receipt of such payment, the supplier’s bank will simultaneously release any security interests in this tooling.

6. **Inventory Purchase Obligations by Customers.** The troubled supplier’s bank often insists that the accommodation agreement include a provision compelling the customers, upon the occurrence of a triggering event such as the supplier’s cessation of business, to purchase all raw material, work-in-process and finished-goods inventory of the troubled supplier pursuant to prescribed formulae. The purchase price for this inventory will be paid to the bank upon closing of the sale, at which point the bank will release its security interest in this property.

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7. **Creation of Inventory Banks.** In order to protect customers of a sole-source supplier from the severe consequences of a production line shutdown, the accommodation agreement will often require the supplier to create inventory banks for its customers to protect against the consequences of the supplier’s liquidation.

8. **Forbearance Period.** In connection with an accommodation agreement, the troubled supplier’s bank often agrees to forbear for a certain period of time from foreclosing on the bank’s collateral and taking other collection actions even though the supplier has defaulted on its obligations to the bank under the loan and security documents. During this period of forbearance, the bank will not demand repayment of its loans, commence other collection actions or file an involuntary bankruptcy petition against the troubled supplier. The bank’s forbearance obligation, however, will be subject to carefully drafted conditions of default. If the supplier subsequently commits a “forbearance default,” the period of forbearance will automatically terminate, thereby permitting the bank to commence foreclosure and other collection actions against the troubled supplier and its assets.

9. **Interest-Rate Cap and Increases in Borrowing Bases.** At the urging of the supplier and its customers, the financing bank may agree to cap its interest rates on its revolving line of credit and term loans and may also increase its borrowing base to permit increased funding of the debtor’s operations during the period covered by the accommodation agreement.

[b] Access and Security Agreements

In conjunction with accommodation agreements, customers of financially distressed auto-suppliers acting as sole-source suppliers to these customers will typically insist upon negotiating and executing “access and security agreements.” Access and security agreements are crafted to ensure that, if the troubled supplier shuts its doors or defaults on its obligations under the
accommodation agreement, the customers will have immediate access to the supplier’s plant to manufacture required components for their assemblies, at least until they have built up sufficient inventory banks and have made appropriate arrangements for resourcing. In these access and security agreements, suppliers will often grant to customers, with the consent of the supplier’s secured lender, security interests in the distressed supplier’s production assets coupled with a mortgage or leasehold assignment of the underlying real estate on which the suppliers’ facilities are located. These liens and security interests are normally junior to the liens and security interests held by the supplier’s secured lender in that same property. Under these access and security agreements, customers will be obligated to pay for production costs after gaining access to the plant and to pay the financing bank a periodic fee to protect the lender against deterioration of its collateral caused by the customers’ use of it. Other common provisions of access and security agreements include the following:

1. **Customers’ Covenants.** Customers exercising rights of access will normally be obligated (i) to employ reasonable care in the use, custody and preservation of the supplier’s assets; (ii) to insure the assets against damage and loss; (iii) not to interfere with other customers’ access to the troubled supplier’s production assets; and (iv) not to bar access to the plant by the supplier’s representatives or its bank. Customers often agree to use their best efforts to retain the supplier’s employees in producing parts and to pay these employees’ wages during the access period.

2. **Supplier’s Covenants.** In these agreements, the troubled supplier normally agrees that during the access period, the supplier will not (i) sell or otherwise dispose of its operating assets or its real estate; (ii) use its assets in any way that would impair the customers’ access rights; and (iii) terminate any material contracts to which the supplier is a party.
3. **Consent to Injunctive Relief.** The supplier granting access to customers will be requested to acknowledge in the access and security agreement that any breach of the supplier’s obligations under the accommodation agreement and the access and security agreement will cause the customers to suffer irreparable harm and will leave them with no adequate remedy at law. Consequently, the troubled supplier acknowledges that its customers will be entitled to injunctive relief in these circumstances and may be barred from taking in subsequent litigation a contrary position vis-à-vis the customers.

4. **Grant of Nonexclusive License in Intellectual Property.** The supplier usually grants customers exercising their access rights a nonexclusive right and license to use any of the supplier’s intellectual property to manufacture parts during the access period. The customers will also seek the financing bank’s consent to this provision when the bank holds a security interest in the troubled supplier’s intellectual property. Customers may also be permitted to sublicense this intellectual property to third parties in these circumstances. These agreements also typically provide that customers are not obligated to pay any royalties or other charges in return for these licenses and sublicenses. Finally, customers will be obligated to protect this intellectual property against unauthorized use and disclosure by their employees, agents and other third parties.

An access and security agreement approved by the bankruptcy court in *In re Contech U.S., LLC*, Case No. 09-42392 (Bankr. E.D. Mich.) is reprinted below at ¶ 131.54.
131.53 Form—Accommodation Agreement
INTERIM ACCOMMODATION AGREEMENT

This Interim Accommodation Agreement (this "Interim Agreement") is entered into as of April 1, 2016, by and among General Motors LLC (for itself and on behalf of its subsidiaries and affiliates, "GM"), Clark-Cutler-McDermott Company ("Clark-Cutler"), CCM Automotive LLC ("CCM"), AirLoc LLC ("AirLoc"), Duffy's Park LLC ("Duffy's"), CCM Automotive Lafayette LLC ("CCM Lafayette"), CCM Automotive Hildenbran LLC ("CCM Hildenbran") and, collectively, jointly and severally with Clark-Cutler, CCM, AirLoc, Duffy's, and CCM Lafayette, the "Supplier" and, solely with respect to Section 4 hereof, Wells Fargo Bank National Association (together with its successors and assigns, "Lender"). GM, Supplier and Lender may be referred to herein individually as a "Party" and collectively as the "Parties".

RECITALS

A. Pursuant to various purchase orders, supply agreements and/or releases issued by GM to Supplier including GM's general terms and conditions of purchase (collectively, the "Purchase Orders" or individually, a "Purchase Order"), Supplier is obligated to manufacture GM's requirements of certain component parts, service parts or assembled goods (collectively, the "Component Parts" or individually, a "Component Part").

B. Lender and Supplier are parties to various loan and security agreements and related documents (collectively the "Loan Documents") pursuant to which Lender (a) provides certain loans to Supplier and (b) has a lien on substantially all of Supplier's assets and properties.

C. Supplier is in default under the Loan Documents and desires to obtain Lender's agreement to enter into the Forbearance Agreement (as defined below).

D. GM and Supplier are parties to various loan and security agreements (collectively the "Subordinated Loan Documents") pursuant to which GM (a) provided certain loans to Supplier and (b) has a subordinated lien on substantially all of Supplier's assets and properties.

E. Supplier has indicated that it is unable to satisfy its obligations under the Purchase Orders without the agreement by GM to modify certain terms of the Purchase Orders as set forth herein.

F. Subject to the terms and conditions of this Interim Agreement, GM has agreed to provide certain financial accommodations to Supplier as set forth in this Interim Agreement.

BASED UPON THE FOREGOING RECITALS and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

TERMS AND CONDITIONS

1. **Term.** The term of this Interim Agreement (the "Term") will commence on the date hereof execution (the "Effective Date") and continue until the earlier of (a) delivery by GM of written notice to Supplier and Lender of the occurrence of an Event of Default (as defined
below) or (b) April 29, 2016. During the Term, GM and Supplier will negotiate in good faith the terms of a longer term Accommodation Agreement (the "Final Agreement"), which will replace and supersede this Interim Agreement and continue minimally through September 30, 2016 (the "Extended Term"); provided that nothing contained herein shall amend or modify the terms and conditions set forth in the Loan Documents or be construed as a commitment by Lender to make any such modification or amendment at any time in the future.

2. **GM Accommodations.**

A. **Existing Accounts Payable Pullforward.** Within two (2) business days after the Effective Date, GM will pay Lender, for application against the obligations owing by Supplier to Lender in accordance with the Loan Documents and the Forbearance Agreement (defined below), all of its confirmed and undisputed unpaid accounts payable existing as of the Effective Date on account of Component Parts received by GM prior to the Effective Date without setoff or recoupment of any kind other than any Allowed Setoffs (defined below). Based on the amount of outstanding accounts payable reflected in GM’s payment system as of March 30, 2016, as set forth in a schedule to be provided by GM to Lender and subject to any potential Allowed Setoffs, the amount of such payment shall not be less than $3.5 million.

B. **Expedited Payments.** For all accounts payable arising from shipments of Component Parts from Supplier that are received by GM at the applicable GM plant during the Term, GM will expedite payment of its accounts payable to Supplier to terms of “net immediate”. For purposes of this Interim Agreement “net immediate” means that payments shall be made by GM on or before Tuesday of each week for all of the prior week’s Component Part shipments by Supplier that were received at the applicable GM plant on or before the Friday prior to the date on which such payment is due. It is intended that the expedited payments provided under this Section 2.B would continue during the Extended Term.

C. **Limitation on Resourcing.** Notwithstanding anything in the Purchase Orders to the contrary, and so long as no Event of Default has occurred, GM will not resource production of any Component Parts to an alternative supplier during the Term. Notwithstanding the foregoing, GM may (i) take any action that GM deems necessary or useful, in its sole discretion, to prepare for a resourcing, which includes, without limitation: (A) discussing, negotiating, and executing agreements with an alternative supplier(s) relating to Component Parts and (B) purchasing sample or prototype Component Parts from an alternative supplier(s); and (ii) resource production of any Component Parts that Supplier agrees in writing may be resourced, whether pursuant to this Interim Agreement or otherwise, including under Section 3.1 below. This limitation does not prohibit GM from reducing or ceasing orders under Purchase Orders temporarily or permanently because of: (y) ordinary course normal business fluctuations, including, without limitation, reductions in consumer demand; and (z) ordinary course product, engineering, or program changes, cancellations or modifications. This Section 2.C is not a commitment by GM to retain any of its business with Supplier after the Term.
D. Setoff Limitation. For Lender’s benefit only, GM will not setoff, recoup, or deduct against its accounts payable to Supplier that are generated on account of Component Parts received by GM during the Term, except for Tooling Setoffs and Allowed Setoffs (each as defined below). It is intended that the setoff limitations provided under this Section 2.D will continue during the Extended Term.

i. “Tooling Setoffs” means payments made to any third party vendor with respect to Tooling used by Supplier in connection with the manufacture, assembly, or transportation of Component Parts that: (a) is not provided for, or is in excess of the forecasted tooling vendor disbursements for the period in question set forth in, the Budget and (b) GM provides Lender and Supplier with prior written notice of such payment in reasonable detail and GM may only assert Tooling Setoffs against accounts payable arising at least three days after providing such notice. GM may only exercise Tooling Setoffs against accounts payable relating to Tooling.

ii. “Allowed Setoffs” means setoffs, recoupments, or deductions for any and all defective or nonconforming products; quality problems; unordered or unreleased parts that GM returns to Supplier; short shipments; misshipments; premium freight charges necessary to avoid production interruption (and not caused by GM); improper invoices; mispricing; and duplicate payments or billing errors; payments made by GM to third-party vendors to purchase materials, services, or components to be used by Supplier in connection with the production of Component Parts; the price of materials, services, or components supplied to Supplier by GM to be used by Supplier in connection with the production of Component Parts; and GM’s professional fees relating to Supplier. Allowed Setoffs for any specific invoice or group of invoices may not exceed five (5%) percent of the aggregate face value of an invoice or group of invoices (the “Allowed Setoff Cap”). GM may deduct the amount of the Allowed Setoffs that exceed the Allowed Setoff Cap against any subsequent invoices or group of invoices; provided, however, GM may in no event exceed the Allowed Setoff Cap with respect to any invoice or group of invoices.

iii. GM reserves and does not waive any rights and interests it may have or would have against Supplier but for this Interim Agreement, including the right to assert affirmative claims against Supplier and to assert any of its rights of setoff and recoupment for defensive purposes. For the avoidance of doubt, the foregoing is not intended to modify otherwise affect the limitation on setoffs provided by GM in favor of Lender under this Section 2.D.

E. Price Adjustment.

i. GM will pay to Supplier an aggregate price surcharge (the “Price Surcharge”) equal to 50% of the Budget Shortfall (defined below), to be funded on a weekly basis in the manner provided under Section 2.F below. The Price Surcharge will be funded separately from the payment of GM’s accounts payable to Supplier arising from the shipment of Component Parts. Notwithstanding the
foresaid, GM shall have no obligation to provide (or continue to provide) the Price Surcharge from and after the occurrence of an Event of Default. The Price Surcharge does not constitute a volume guaranty or commitment of any kind from GM. The proceeds of the Price Surcharge will be fully available to Supplier for use in accordance with the Budget.

ii. During the Term of this Interim Agreement, GM and Supplier will: (i) work cooperatively to conduct a cost and price analysis with respect to the Component Parts and the price increases requested by Supplier identified on Annex A hereto, which analysis shall be completed by April 15, 2016, and (ii) negotiate in good faith regarding any permanent price increases for the Component Parts identified on Annex A hereto, which would become applicable during the Extended Term (“Price Increases”).

F. Second Lien Term Loan. GM will provide Supplier with a loan in an aggregate amount equal to 50% of the Budget Shortfall (the “GM Loan”), to be advanced by GM on a weekly basis in accordance with the Budget (defined below) as follows: (i) on or before 12:00 pm (prevailing Eastern time) on Thursday of each week, Supplier shall make a draw request for the upcoming week in accordance with the Budget; (ii) provided that the draw request is made in compliance with the foregoing, GM will fund the applicable portion of the GM Loan and/or Price Surcharge on Friday of each week during the Term of this Interim Agreement. The proceeds of the GM Loan will be fully available to Supplier for use in accordance with the Budget. The GM Loan will be funded under the Subordinated Loan Documents, subject to the terms of an intercreditor and subordination agreement acceptable to GM and Lender (the “Intercreditor Agreement”).

3. Supplier Obligations.

A. Continue to Manufacture. Supplier will continue to manufacture and deliver Component Parts in accordance with the Purchase Orders and related releases. Upon expiration of the Term, in the event the parties have not completed negotiations regarding the Final Agreement and/or Price Increases, so long as GM continues to pay for Component Parts as provided in Section 2.F and fund the Budget Shortfall as provided in Sections 2.E and 2.F, Supplier will continue to manufacture and deliver Component Parts in accordance with the Purchase Orders and related releases during the Extended Term.

B. Budget. Supplier will conduct its operations and business in accordance with the budget to be prepared by Supplier, approved by Supplier’s financial consultants, and approved by GM and Lender and their respective consultants, which shall incorporate the GM Accommodations under Section 2, Lender Accommodations under Section 4, and Other Customer Accommodations under Section 3.G, subject to a reasonable variance allowance agreeable to the parties (the “Budget”). The “Budget Shortfall” will mean the remaining operating cash need pursuant to the Budget after taking into account the Lender Accommodations and Other Customer Accommodations referenced above, as well as the GM Accommodations under Sections 2.A, 2.B, and 2.D.
C. **Accounts Receivable Reporting.** Supplier will provide Lender and GM with a weekly roll-forward report of all accounts receivable arising from the sale of the Component Parts during the Term on the Tuesday of each week during the Term, which roll-forward report shall reflect, among other things, the amount of all setoffs, deductions and recoupments made by GM against any accounts receivable of the Supplier for the immediately prior week’s collections from GM.

D. **Operational Plan.** By April 15, 2016, Supplier will provide GM with a cost reduction and operational improvement plan (the “Operational Plan”), which must be reasonably acceptable in form and substance to GM, and which would be implemented during the Extended Term. The Operational Plan must include, among other things: (i) a plan to remedy any operational inefficiencies; (ii) a description of which GM parts are being produced, and intended to be produced, at each of Supplier’s facilities; and (iii) a determination as to the future of Supplier’s joint venture in Mexico. For the avoidance of doubt, the Operational Plan shall not modify or otherwise affect the Loan Documents or the Forbearance Agreement or any of Lender’s rights or obligations with respect to Supplier.

E. **Business Plan.** By April 15, 2016, Supplier will provide GM with a business plan, including short-term and long-term business and financial forecasts (the “Business Plan”), which must be reasonably acceptable in form and substance to GM, and which would be implemented during the Extended Term. For the avoidance of doubt, the Business Plan shall not modify or otherwise affect the Loan Documents or the Forbearance Agreement or any of Lender’s rights or obligations with respect to Supplier.

F. **Contract Cancellation and Resourcing.** Notwithstanding the limitations contained in Section 2.C, GM is permitted, but is not obligated, upon written notice to Supplier, to immediately resource production of the D2UC, D2UG, D2XX, C1XX, E2LB and/or G2KXXZ Component Parts to an alternative supplier and cancel any or all related Purchase Orders, without any liability or cancellation costs or any other payment or obligations to Supplier with respect thereto Supplier will fully cooperate with GM’s resourcing of such Component Parts and any related GM Tooling and any Customer Inventory, Dedicated Equipment and/or Supplier Tooling purchased by GM pursuant to the terms of this Interim Agreement in connection with such resourcing, including by providing all assistance required under Section 3.1 below. Supplier will use reasonable efforts to cause its affiliate CCM Acoustics S.A.P.I. to comply with all Supplier obligations under this Agreement, including with respect to the permitted resourcing under this Section 3.F and Section 3.1 below.

G. **Other Customer Accommodations.** Supplier will use commercially reasonable efforts to obtain substantially similar price and payment term accommodations as those being provided by GM to Supplier pursuant to this Interim Agreement from those customers constituting at least 5% of Supplier’s annual sales by no later than April 15, 2016.

H. **Inventory Bank.** At GM’s request, and subject to Supplier’s reasonable internal capacity limitations, Supplier will build an inventory bank of Component Parts
("Inventory Bank Parts") for GM or GM's designee. Supplier will ship Inventory Bank Parts as directed by GM as they are produced, but not until GM approves the incremental Bank Costs (defined below) associated with such shipment. GM will, subject to any then current Price Increases, (i) timely pay for Inventory Bank Parts and (ii) reimburse Supplier for the incremental costs that Supplier reasonably incurs in connection with building and shipping the Inventory Bank Parts, including, without limitation, all special packaging and handling costs (the "Incremental Bank Costs"). GM must approve all Incremental Bank Costs in advance and in writing. It is intended that the inventory bank commitment provided under this Section 3.1 would continue during the Extended Term.

I. Cooperation with Resourcing. If a Trigger Event occurs, and GM elects to immediately resource some or all of its business from Supplier, Supplier will fully cooperate in GM's immediate resourcing of production of any one or more Component Parts to alternative suppliers, including providing GM and its agents, representatives and successor suppliers with immediate access to Supplier’s facilities and allowing GM to utilize Supplier's employees as is necessary to complete the resourcing. It is intended that the resourcing cooperation provided under this Section 3.1 would continue during the Extended Term.

J. Equipment and Tooling Option. Supplier will grant GM an irrevocable and exclusive option (the "Equipment Option") to purchase (i) any or all machinery and equipment and/or (ii) any returnable containers or dunnage (along with any related accessions, attachments, parts, accessories, substitutions, replacements, documents, software, and appurtenances, as applicable) used in the production of Component Parts for GM (collectively, "Dedicated Equipment"). In addition to the Equipment Option, Supplier will grant GM an irrevocable and exclusive option (the "Tooling Option") to purchase any Supplier Tooling (defined below) and any rights to Supplier Tooling. The Equipment Option and the Tooling Option may be referred to herein individually as the "Option" and collectively as the "Options". Each Option is exercisable by GM in its sole discretion. It is intended that the each Option would continue during the Extended Term.

i. The Equipment Option purchase price shall be the current fair market value of such Dedicated Equipment as determined by an appraiser mutually agreeable to GM, Supplier and Lender. The Tooling Option purchase price shall be the net book value of such Supplier Tooling. The purchase price under each Option will be paid by GM to Lender without setoff or recoupment of any kind.

ii. Supplier warrants that all Dedicated Equipment and Supplier Tooling GM purchases using the Options will be sold to GM free and clear of all liens, claims, encumbrances, and security interests. GM and Supplier agree that any sale under this Section 3.1 is commercially reasonable in all respects, including method, pricing, time, place, and terms.

iii. If GM exercises any Option, Supplier will grant GM and its assignee(s) or designee(s) (for no additional consideration) a royalty-free, irrevocable, and fully transferrable world-wide license or sublicense (as applicable and to the extent Supplier has a right to convey such license and/or sublicense, and provided that
GM pays any applicable third-party royalty or licensing fees) to use: (A) all Intellectual Property (as defined below) that is necessary to use the Dedicated Equipment and/or Supplier Tooling, as applicable, for the purpose of producing Component Parts, and any documents or software related to such Intellectual Property; and (B) Supplier’s processes and methods used in the production of Component Parts. This Section 3.J.iii is intended to expand, and does not limit any of, GM’s rights under the Purchase Orders.

iv. GM may exercise each Option at any time within the thirty (30)-day period beginning on the date of a Trigger Event (provided that resourcing by GM of less than all of its business will be a Trigger Event only as to Dedicated Equipment and Supplier Tooling related to the resourced Component Parts).

v. If, at the time of the exercise by GM of any Option, the accounts payable owing by GM to Supplier and reflected in GM’s payment system exceed $500,000, GM will pay to Lender prior to the removal of the Dedicated Equipment and/or Supplier Tooling subject to such Option a portion of such accounts payable to bring the current balance of such accounts payable to an amount equal to or less than $500,000.

vi. Supplier’s obligations under this Section 3.J will survive the expiration or termination of this Interim Agreement and continue for a thirty (30)-day period following a Trigger Event.

vii. “Trigger Event” means the earlier of: (i) the termination or expiration of the Term unless this Interim Agreement is replaced with a Final Agreement; or (ii) subject to Section 2.C above, GM resourcing some or all of its Component Part production from Supplier (provided that resourcing by GM of less than all of its business will be a Trigger Event only as to Customer Inventory, Dedicated Equipment, Supplier Tooling and/or License, as applicable, related to the resourced Component Parts).

K. IP License. Supplier grants GM (i) a world-wide, perpetual, non-exclusive, irrevocable, sub-licensable, fully paid, royalty-free license to the Intellectual Property owned by Supplier and used in connection with the manufacture of the Component Parts, including all of Supplier’s processes, methods, documents, and software related to such Intellectual Property or used in the production of Component Parts; and (ii) a sublicense to the Intellectual Property licensed to Supplier and necessary for the manufacture of the Component Parts (subject to the terms of any applicable existing licenses and to any licensor’s consent to assignment of such license, if applicable, and provided that GM pays any applicable third-party royalty or licensing fees), to make, have made, use, have used, modify, improve, reproduce, prepare derivative works of, distribute, display, offer to sell, sell, import and do all other things and exercise all other rights in the licensed or sublicensed Intellectual Property that is helpful or necessary to manufacture, assemble or transport the Component Parts for GM (the “License”). The License shall extend to Component Parts supplied or to be supplied under the Purchase Orders (including in the production of new vehicles by GM and service obligations for past-model and used GM
vehicles). The License shall also apply to any (A) new model year changes with respect
to the Component Parts, (B) mid-cycle enhancements with respect to the Component
Parts or (C) refreshes with respect to the Component Parts incorporating the Intellectual
Property. Nothing in this License is intended to limit any rights granted to GM under the
Purchase Orders, including rights concerning licensing and other Intellectual Property,
but is intended to expand those rights. Moreover, nothing in this License may be
construed as an admission by GM of the validity of a Supplier's claimed rights to
Intellectual Property, including an admission that a license is required by GM to make,
have made, sell, offer for sale and/or import the Component Parts. GM will, and will
cause its sublicensees to, treat and preserve the Intellectual Property in accordance with
the same practices employed by GM to safeguard its own intellectual property against
unauthorized use and disclosure. The License will be granted and irrevocable as of the
Effective Date but will only be exercisable by GM upon the earlier of the date of a
Trigger Event (provided that resourcing by GM of less than all of its business will be a
Trigger Event only as to the License related to the resourced Component Parts).
Supplier's obligations under this Section 3.K will survive the expiration or termination of
this Interim Agreement.

i. The term "Intellectual Property" means (A) all registered and applied-for
intellectual property owned by Supplier (including, without limitation, all patents,
patent applications, trademark registrations, trademark applications, copyright
registrations, and copyright applications), used in or related to the manufacture,
assembly or transport of the Component Parts (B) all agreements for Intellectual
property licensed to Supplier used in or related to the manufacture, assembly or
transport of the Component Parts, and (C) any other intellectual property used in
or to produce Component Parts (whether or not the intellectual property is
identified, including, without limitation, unregistered copyrights, inventions,
discoveries, trade secrets and designs, and regardless of whether those items are
registrable or patentable in the future, and all related documents and software),
which Supplier directly or indirectly sells to GM.

L. Inventory Purchase Option. Supplier will grant GM an irrevocable and exclusive
option (the "Inventory Option") to purchase all of Supplier's Component Parts, raw-
materials (including purchased components) and finished goods inventory related
exclusively to the Component Parts (collectively, "Customer Inventory"). The Inventory
Option is exercisable by GM in its sole discretion. It is intended that the Inventory
Option will continue during the Extended Term.

i. The Inventory Option purchase price shall be: (i) for raw materials – one
hundred (100%) percent of Supplier's actual and documented cost and delivery of
the raw materials and (ii) for finished Component Parts – one hundred (100%)
percent of the existing Purchase Order price in effect on the date of purchase of
the Customer Inventory giving effect to any price adjustment agreed to in Section
2.G above. The Customer Inventory purchase price will be paid by GM to Lender
without setoff or recoupment of any kind.
ii. Supplier warrants that all Customer Inventory GM purchases using the Inventory Option will be sold to GM free and clear of all liens, claims, encumbrances, and security interests. GM and Supplier agree that any sale under this Section 3.L is commercially reasonable in all respects, including method, pricing, time, place, and terms.

iii. To the fullest extent permitted under applicable law, any warranties related to the Customer Inventory that are received by Supplier from its suppliers will be deemed to pass to GM upon GM purchasing the Customer Inventory.

iv. Notwithstanding anything in this Section 3.L to the contrary, GM agrees that solely with respect to finished Component Parts shipped by Supplier to GM prior to the expiration or termination of the Term or the Extended Term, the Inventory Option shall be a mandatory purchase obligation, otherwise subject to the same terms and conditions as set forth in this Section 3.L.

M. Tooling Acknowledgement. Supplier acknowledges and agrees that, exclusive of Supplier Tooling and Unpaid Tooling (each as defined below), all Tooling that is now being utilized to manufacture the Component Parts by Supplier for GM, whether under direct agreements between Supplier and GM or agreements between Supplier and third parties ("GM Tooling"), is subject to the terms of this Interim Agreement and is (i) owned by GM (or affiliates of GM, or another supplier to GM); and (ii) is being held by Supplier and, to the extent that Supplier has transferred the GM Tooling to third parties, by such third parties, as bailees-at-will.

i. "Tooling" means collectively all tooling, dies, test and assembly fixtures, gauges, jigs, patterns, casting patterns, cavities, molds, and documentation including engineering specifications and test reports used by Supplier in connection with its manufacture of Component Parts for GM.

ii. "Unpaid Tooling" means Tooling manufactured for GM for which GM has not made full payment under the applicable purchase order agreement with Supplier.

iii. "Supplier Tooling" means Tooling which Supplier asserts is not owned by GM and which is not subject to a purchase order issued by GM.

iv. Within thirty (30) days from the Effective Date, Supplier will provide GM and Lender with a list of all Supplier Tooling and Unpaid Tooling relating to GM's Component Parts ("Tooling List"). If, and to the extent that, Supplier does not include any item of Tooling on the Tooling List or fails to provide the Tooling List, then all Tooling not listed shall be deemed GM Tooling.

v. GM reserves the right to notify Supplier of a dispute regarding the Tooling List for up to thirty (30) days following GM's receipt of such list. To the extent GM does not timely assert a dispute with respect to an item on such list, GM shall be deemed to agree with Supplier’s designation of such item. If a dispute regarding the listing of any Tooling as Supplier Tooling or Unpaid Tooling cannot
be resolved by Supplier and GM within thirty (30) days of the date the dispute arises, the matter shall be jointly submitted to a third party to be selected by Supplier and GM for expedited resolution, with costs to be shared equally by Supplier and GM.

vi. Upon payment of the applicable purchase order price for any item of Unpaid Tooling, a portion of which purchase order price may be satisfied by the assumption and timely payment by GM of any unsatisfied obligations of Supplier to the applicable tooling vendor relating to the Unpaid Tooling, such item will thereafter be included in the definition of GM Tooling under this Interim Agreement. Supplier agrees to assign to GM or its designee any agreements with its vendors relating to Unpaid Tooling at GM’s request. Other than as provided herein, nothing in this Interim Agreement modifies GM’s obligations to Supplier on account of Unpaid Tooling.

vii. Neither Supplier nor any other person or entity other than GM (or its affiliates) will have any right, title or interest in Tooling determined to be GM Tooling other than Supplier’s rights, subject to GM’s discretion, to utilize the GM Tooling in the manufacture of the Component Parts. Subject to the terms contained in this Interim Agreement, GM and its affiliates have the right to take immediate possession of GM Tooling at any time without payment of any kind to Supplier, should GM elect to exercise such right, and Supplier hereby agrees to cooperate with GM in its taking possession of the GM Tooling including by preparing such GM Tooling for pick up by GM at Supplier’s dock. Without further notice or court hearings, which rights, if any, are hereby waived, GM will have the right to enter immediately the premises of Supplier and take possession of any and all GM Tooling, and Supplier agrees to provide GM or its nominee(s) with such access; provided, however, GM will not unreasonably interfere with Supplier’s ongoing manufacturing operations and will utilize reasonable care when removing GM Tooling.

viii. If there is a dispute over whether any Tooling is GM Tooling, Unpaid Tooling, or Supplier Tooling, the Tooling subject to the dispute (the “Disputed Tooling”) will be treated as GM Tooling until the parties resolve the dispute, GM will have the right to take possession of Disputed Tooling pending resolution of the dispute if GM escrows all amounts alleged to be due in connection with such Disputed Tooling on terms and conditions satisfactory to Supplier and Lender, and Supplier will cooperate fully with GM in GM’s taking possession of Disputed Tooling. Disputed Tooling transferred to GM will remain subject to any valid lien or claim held by Supplier for the disputed amounts, notwithstanding the fact that Supplier has relinquished possession.

ix. GM shall have the right, at its sole election, to make payments directly to any third party vendors that have not been paid in full related to Unpaid Tooling or GM Tooling, and to exercise a corresponding Tooling Setoff pursuant to Section 2.D above.
N. **Access.** GM will have full and complete access to Supplier’s facilities, employees, operations, books, records (including, but not limited to, tool prints, tool and engineering drawings, processing sheets, PPAP packages, bills of materials (including vendor contact information), and tool line-ups, CAD data/drawings, vehicle-integration algorithms, lists of returnable containers, and all other general validation and test data) during regular business hours (upon reasonable advance notice), or outside of regular business hours upon reasonable request, to monitor compliance with the terms of this Interim Agreement and any other agreements between GM and Supplier; provided, however, such access shall not interfere with Supplier’s ability to conduct business in the regular and usual manner. Supplier will provide the foregoing information to GM as soon as possible following any request by GM. To the extent GM exercises its rights to purchase and remove Dedicated Equipment and Tooling and/or occupy and use Supplier’s premises, assets, and employees, Lender shall have the right to contemporaneously access the premises to exercise its rights against any of Lender’s collateral not purchased by GM pursuant to the terms of this Interim Agreement.

O. **Financial Reporting.** Supplier will provide GM (and its designated advisors) with financial statements and reports on an on-going basis as and when requested by GM, including all reports and information provided to Lender.

P. **Engagement of Investment Banker.** Within 21 days after the Effective Date, Supplier will engage an investment banking firm to analyze and potentially conduct a sale process for Supplier’s business during the Extended Term. During the Term of this Interim Agreement and as part of the Final Agreement, Supplier and GM will negotiate the time frame and other terms and conditions for a sale process; provided that Supplier will not commence a formal sale process until such time as a Final Agreement is executed.

4. **Lender Accommodations.**

A. **Forbearance Agreement.** Lender and Supplier will enter into a Forbearance Agreement, in form and substance acceptable to Lender and GM in their respective discretion (the “Forbearance Agreement”). During the Forbearance Period (as defined in the Forbearance Agreement), subject to the terms and conditions of the Forbearance Agreement and the Credit Agreement (as defined in the Forbearance Agreement), as amended, Borrower shall be permitted to draw, and Lender may make revolving loans at the advance rates and on terms and conditions set forth in the Credit Agreement and the other Loan Documents (as defined in the Credit Agreement), including, without limitation, that (i) the advance rate for Eligible Accounts (as defined in the Credit Agreement, as amended by the Forbearance Agreement) owed by GM during the Term of this Interim Agreement shall be 85%, and (ii) without limiting Lender’s rights under the Credit Agreement and the other Loan Documents with respect to availability reserves, Lender shall have the right to impose a reserve against its revolving line of credit to Supplier in the amount of $50,000 per week in each of the initial four weeks following the Effective Date, for an aggregate reserve amount of $200,000.

B. **Second Lien Term Loan.** Subject to the terms of the Forbearance Agreement and
the Intercreditor Agreement, Lender consents to the GM Loan to Supplier and to the loans made by GM to Supplier pursuant to the Subordinated Loan Documents, as in effect on the Effective Date, secured by a second priority lien in and to all assets that currently secure Supplier’s obligations to Lender. The proceeds of the GM Loan will be fully available to Supplier for use in accordance with the Budget, provided that: (i) GM provides Lender’s Agent (as defined below) with one business day prior written notice of, and sends a wire transfer of funds to Lender’s Agent containing only the amount of, any proceeds of the GM Loan made by GM for the benefit of Supplier pursuant to this Interim Agreement; and (ii) GM has not received from Lender’s Agent prior to the wire transfer of such funds a written notice of the occurrence of an event of default under the Credit Agreement (other than with respect to the events of default that are subject to the Forbearance Agreement).

C. Consent. Subject to the terms of the Forbearance Agreement and the Intercreditor Agreement, Lender consents to the Supplier entry into and performance under the terms of this Interim Agreement, including the GM Loan, Tooling Acknowledgement, Tooling Option, Equipment Option and License, and the use of the full proceeds of the GM Loan and Price Surcharge by Supplier in accordance with the Budget during the Term of this Interim Agreement, provided that: (i) GM provides Lender’s Agent (as defined below) with one business day prior written notice of, and sends a wire transfer of funds to Lender’s Agent containing only the amount of, any loans and/or advances made by GM for the benefit of Supplier pursuant to this Interim Agreement; and (ii) GM has not received from Lender’s Agent prior to the wire transfer of such funds a written notice of the occurrence of an event of default under the Credit Agreement (other than with respect to the events of default that are subject to the Forbearance Agreement).

5. Events of Default. The occurrence of any one or more of the following will be an “Event of Default” under this Interim Agreement, unless either: (i) a waiver or deferral is agreed to in writing by GM; or (ii) such Event of Default is cured by Supplier within 5 days of written notice being provided by GM; provided, however, if any Event of Default results in a substantial likelihood—in GM’s sole discretion—that GM’s production will be imminently interrupted at one or more of its assembly facilities worldwide, any such Event of Default will be deemed to immediately occur and will not be subject to a cure period:

A. Supplier repudiates or materially breaches its obligations, or refuses to materially perform its obligations under this Interim Agreement;

B. Supplier repudiates or materially breaches its obligations, or refuses to materially perform its obligations under the Purchase Orders (as modified by this Interim Agreement), including, without limitation, Supplier’s obligations in respect of GM’s standard performance requirements, including GM’s quality, service and technology requirements;

C. Supplier fails to provide its operational plan and/or its business plan to GM by April 15, 2016;

D. Supplier fails to use commercially reasonable efforts to obtain similar
accommodations as those being provided by GM from those Supplier's other customers representing at least 5% of annual sales;

E. Any secured or lien creditor commences a foreclosure action of its liens, security interests and/or mortgages in or against a material portion of Supplier's assets;

F. There is an "Event of Default" under the Credit Agreement other than a "Specified Default" (each as defined in the Forbearance Agreement) after the Effective Date and Lender does not agree to forbear from exercising its rights against Supplier on account of such Event of Default and Lender accelerates the obligations owing under the Loan Documents in respect of such Event of Default or fails to cease to provide financing to Supplier consistent with the Forbearance Agreement; or

G. Supplier (i) commences any case, proceeding or other action under Title 11 of the United States Code or any other liquidation, bankruptcy, assignment for the benefit of creditors, conservatorship, moratorium, receivership, insolvency, reorganization or similar debtor relief laws of the US or other applicable jurisdictions in effect from time to time, seeking (a) to have an order for relief entered with respect to it, (b) to adjudicate it as bankrupt or insolvent, (c) reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other related with respect to it or its debts, or (d) appointment of a receiver, trustee, custodian, conservator or other similar official for it or for all or any substantial part of its assets, or (ii) makes a general assignment for the benefit of its creditors.

Upon the occurrence of an Event of Default, GM may, in its discretion, exercise any remedies available to it under this Interim Agreement; provided, however, Supplier will be required continue to satisfy its obligations to GM under this Interim Agreement and GM's Purchase Orders.

6. **Purchase Orders Continue.** Except as specifically provided in this Interim Agreement, this Interim Agreement is not intended to modify the terms and conditions of the Purchase Orders, including GM's general terms and conditions of purchase, which terms and conditions remain in full force and effect. Except as specifically provided in this Interim Agreement, this Interim Agreement does not and will not modify or affect the rights, obligations or guarantees contained in the Purchase Orders or any other existing agreements between GM and Supplier. To the extent of any conflict between this Interim Agreement and any Purchase Order or other agreement between GM and Supplier, this Interim Agreement shall govern.

7. **Confidentiality.** The Parties each agree to keep and maintain the existence and terms of this Interim Agreement strictly confidential, and the Parties shall not disclose the existence or terms thereof to any person or entity who is not a party without the prior written consent of the other Parties, except to the extent that such agreements or terms (a) are already known by, become available to, or are in the possession of the third party recipient at the time of disclosure, provided the source of such information was not known by such recipient to be bound by a legal or contractual obligation of confidentiality, (b) are or become publicly available (other than through a breach of this Section 7), (c) are in good faith determined by the disclosing Party to be necessary or appropriate to disclose in connection with a legal, regulatory, or administrative case
or proceeding (including, without limitation, such an action to enforce the terms and provisions of this Interim Agreement or the Forbearance Agreement), (d) are in good faith determined by the disclosing Party required to be disclosed by law, court order, subpoena, or other judicial, governmental or regulatory process or request, or (e) are in good faith determined by the disclosing party required to comply with requests of bank regulators, examiners, auditors and other similar oversight and compliance entities.

8. **Notice.** Any notice or other instrument to be given hereunder must be in writing and, except as otherwise provided in this Interim Agreement, will be deemed to be duly given (a) if mailed, three (3) days following the date of mailing, (b) if sent by facsimile or hand delivery, at the time of service on the day on which it was so delivered or (c) if sent by electronic mail to the addresses below with a PDF attachment, at the time of sending the electronic mail. Until changed by notice in the manner described above, the addresses of the Parties for the purpose of notice will be:

**If to Supplier:**

Clark-Cutler-McDermott Company  
Five Fisher Street  
Franklin, MA 02038  
Attention: Shawn Souza  
Email: ssouza@ccmcd.com

**With a copy to:**

K&L Gates LLP  
State Street Financial Center  
One Lincoln Street  
Boston, MA 02111-2950  
Attention: Charles A. Dale III  
Email: chad.dale@klgates.com

**and to:**

Goodwin Procter LLP  
52 State Street  
Boston, MA 02109  
Attention: Mark D. Smith  
Email: marksmith@goodwinprocter.com

**If to GM:**

General Motors LLC  
Global Purchasing and Supply Chain  
Vehicle Engineering Center  
30001 Van Dyke Avenue  
M/C 480-210-880  
Warren, MI 48090-9020  
Attention: Mark W. Fischer  
Email: mark.w.fischer@gm.com

**With a copy to:**

Honigman Miller Schwartz and Cohn LLP  
660 Woodward Avenue  
2290 First National Building  
Detroit, Michigan 48226
9. General Terms.

A. This Interim Agreement, together with the other documents referenced herein or executed in connection herewith, constitutes the entire understanding of the Parties in connection with the subject matter hereof and supersedes any prior understandings or agreements concerning the subject matter hereof. This Interim Agreement may not be modified, altered or amended except by an agreement in writing signed by the Parties. This Interim Agreement has been mutually drafted by counsel and has been reviewed by the Parties’ counsel. Therefore, any ambiguity in this Interim Agreement will not be construed against any particular Party as the drafter.

B. This Interim Agreement shall terminate and be of no further force and effect on such date that either (i) the Parties have agreed in writing to terminate this Interim Agreement, or (ii) the Term has ended; provided, however, that notwithstanding any such termination, Sections 3.1 – 3.4, 4.3, and 6 – 11 of this Interim Agreement shall be deemed to survive the termination or expiration of this Interim Agreement.

C. The individuals executing this Interim Agreement warrant that they have the power and authority to execute this Interim Agreement on behalf of the Party they represent and that their signatures bind their respective Parties to the terms of this Interim Agreement.

D. Supplier may not assign or transfer, directly or indirectly, any of its rights under this Interim Agreement without the prior written consent of GM. Any purported assignment in violation of this section will be null and void. This Interim Agreement is not intended for the benefit of any third party including, without limitation, any purchasers of any Supplier’s assets or other customers of Supplier (other than affiliates and subsidiaries of GM).

E. No delay or failure of Lender, Supplier or GM to exercise any right, power or privilege hereunder will affect such right, power or privilege, nor will any single or
partial exercise thereof preclude any further exercise thereof, nor the exercise of any other right, power or privilege.

F. The headings in this Interim Agreement are inserted for convenience and identification only, and are in no way intended to describe, interpret, define or limit the scope, extent, or intent of this Interim Agreement.

G. Any agreement, instrument, statute, law, regulation or rule defined or referred to herein shall be deemed to mean such agreement, instrument, statute, law, regulation or rule as from time to time amended, modified or supplemented, and includes, in the case of agreements and instruments, references to all attachments thereto and instruments incorporated therein. References to “Sections,” “Exhibits,” and “Schedules” are to sections, exhibits, and schedules herein and attached hereto unless otherwise indicated. “Hereof,” “herein” and “hereunder” refer to this Interim Agreement as a whole. “Including” is not limiting and should be followed by the word “without limitation” and “Or” is not necessarily exclusive. Any agreements, covenants, promises, or obligations appearing in the Recitals at the beginning of this Interim Agreement are included in the body of this Interim Agreement as if fully stated herein.

H. Should any provision of this Interim Agreement be held invalid or unenforceable, the remainder of this Interim Agreement will not be affected thereby.

I. Supplier agrees that it will not enter into any other arrangements or agreements that would in any way materially impair GM’s rights under this Interim Agreement.

J. Supplier is not, and nothing in this Interim Agreement will be interpreted to constitute Supplier as, GM’s agent for any purpose.

K. This Interim Agreement may be executed in any number of duplicate originals or counterparts, each of such duplicate originals or counterparts will be deemed to be an original and taken together will constitute one and the same instrument. The Parties agree that their respective signatures may be delivered by facsimile or other electronic mail and that facsimile or PDF signatures will be treated as originals for all purposes.

L. This Interim Agreement is made in the State of Michigan and will be governed by, and construed and enforced in accordance with, the laws of the State of Michigan without regard to conflicts of law principles.

M. The Parties agree, and Supplier irrevocably consents that, the United States District Court for the Eastern District of Michigan, Southern Division, and the Oakland County Circuit Court in the State of Michigan, United States of America, have personal jurisdiction over the Parties and that the exclusive jurisdiction and venue for any dispute arising from or under this Interim Agreement shall be in the United States District Court for the Eastern District of Michigan, Southern Division, or the Oakland County Circuit Court in the State of Michigan, United States of America, and Supplier waives any right to assert, at any time in any proceeding judicial or otherwise relating to this Interim Agreement that jurisdiction and venue are not proper in those courts.
10. **CONSULTATION WITH COUNSEL.** THE PARTIES ACKNOWLEDGE THAT THEY HAVE BEEN GIVEN THE OPPORTUNITY TO CONSULT WITH COUNSEL OF THEIR CHOICE BEFORE ExecutING THIS INTERIM AGREEMENT AND ARE DOING SO WITHOUT DURESS, INTIMIDATION, OR COERCION AND WITHOUT RELIANCE UPON ANY REPRESENTATIONS, WARRANTIES OR COMMITMENTS OTHER THAN THOSE REPRESENTATIONS, WARRANTIES OR COMMITMENTS SET FORTH IN THIS INTERIM AGREEMENT.

11. **JURY TRIAL WAIVER.** THE PARTIES ACKNOWLEDGE THAT THE RIGHT TO TRIAL BY JURY IS A CONSTITUTIONAL RIGHT, BUT THAT THIS RIGHT MAY BE WAIVED. THE PARTIES EACH KNOWINGLY, VOLUNTARILY, AND WITHOUT DURESS, INTIMIDATION, OR COERCION, WAIVE ALL RIGHTS TO A TRIAL BY JURY OF ALL DISPUTES ARISING OUT OF OR IN RELATION TO THIS INTERIM AGREEMENT OR ANY OTHER AGREEMENTS BETWEEN THE PARTIES EXECUTED IN CONNECTION WITH THIS INTERIM AGREEMENT. NO PARTY WILL BE DEEMED TO HAVE RELINQUISHED THE BENEFIT OF THIS JURY TRIAL WAIVER UNLESS THE RELINQUISHMENT IS IN A WRITTEN INSTRUMENT SIGNED BY THE PARTY TO WHICH THE RELINQUISHMENT WILL BE CHARGED.
The Parties have caused this Interim Accommodation Agreement to be executed by their authorized representatives as of the date first set forth above.

GENERAL MOTORS LLC

By: ____________________________
Name: Mark W. Fischer
Title: Director, Supply Risk Management
[Signature Page to Interim Accommodation Agreement]
WELLS FARGO BANK, NATIONAL ASSOCIATION,
as to Section 4 only

By: ____________________________
Name: Maynard Marie
Title: Vice President

[Signature Page to Interim Accommodation Agreement]
Access and Security Agreement

Delphi Automotive Systems LLC, Automotive Components Holdings, LLC, Ford Motor Company, BMW Manufacturing Co., LLC, and Linamar Corporation (individually a "Customer" and collectively "Participating Customers") and MAG Contech, LLC, Contech, LLC, and Contech U.S., LLC (collectively "Supplier") (collectively, with the Participating Customers, the "Parties"), enter into this Access and Security Agreement (this "Access Agreement") on February __________, 2009.

RECITALS:

A. Pursuant to various purchase orders, supply contracts and/or releases issued by the Participating Customers and accepted and agreed to by Supplier, including without limitation, purchase orders, supply contracts and/or releases issued in the ordinary course by Participating Customers during the term of this Access Agreement (collectively, the "Purchase Orders" and each individually, a "Purchase Order"), Supplier manufactures and provides the Participating Customers and/or their respective customers with component parts as set forth in the Purchase Orders (the "Component Parts").

B. Marathon Special Opportunity Fund, L.P., The CIT Group/Business Credit, Inc., in its capacity as both a first lien lender and as Administrative Agent for itself and the other first lien lenders under the Loan Documents (defined below), Citicorp USA, Inc., and SPV Capital Funding (collectively, "Lenders"), provide substantially all of the working capital and term financing to Supplier pursuant to various loan and security agreements and related documents between Supplier and Lenders (the "Loan Documents"). Lenders have a first priority lien on substantially all of Supplier’s assets.

C. Supplier has advised the Participating Customers and Lenders that it faces certain financial and operational problems that impact Supplier’s financial viability which will impact the supply of Component Parts. Supplier acknowledges that any material failure to timely deliver conforming Component Parts under the Purchase Orders would cause significant and irreparable harm to the Participating Customers.

D. Supplier has requested that, in connection with Supplier’s filing for relief under Title 11 of Chapter 11 of the United States Bankruptcy Code on January 30, 2009, the Participating Customers and Lenders provide certain accommodations to Supplier under the terms of that certain Accommodation Agreement ("Accommodation Agreement") executed concurrently with this Agreement.

E. In consideration for the Participating Customers providing certain accommodations under the Accommodation Agreement, Supplier has agreed to enter into this Access Agreement. Contemporaneously with execution of this Access Agreement, Lenders have agreed to execute the Acknowledgment in substantially the form attached hereto as Exhibit "A."

BASED ON THE FOREGOING RECITALS, which are incorporated as
representations and warranties of the parties, and other good and valuable consideration, the receipt and sufficiency of which are acknowledged, the parties hereby agree as follows:

**TERMS AND CONDITIONS**

1. **Defined Terms.** In addition to those terms defined elsewhere in this Access Agreement, the following terms have the indicated meanings, unless the context otherwise requires:

   (a) “Default” shall mean a Resourcing Trigger Event (as defined in the Accommodation Agreement).

   (b) “Intellectual Property” means all now existing or hereafter acquired patents, trademarks, copyrights, inventions, licenses, discoveries, processes, know-how, techniques, trade secrets, designs, specifications and the like (regardless of whether such items are now patented or registered, or registerable, or patentable in the future), and all technical, engineering, or other information and knowledge, production data and drawings, which are used in the manufacture, production or assembly of the Component Parts; including without limitation, all items, rights and property defined as intellectual property under 11 U.S.C. Section 101, as amended from time to time which are used in the manufacture, production or assembly of the Component Parts.

   (c) “Obligations” means the obligation of Supplier to provide the Right of Access (as defined below) to the Participating Customers or their designee(s).

   (d) “Operating Assets” means all assets necessary or helpful for production of Component Parts, wherever located, including equipment, contract rights, software and general intangibles (other than accounts, documents, instruments, chattel paper, deposit accounts, insurance refunds, tax refunds, tax refund claims and related cash equivalents and proceeds of the same).

   (e) “Real Estate” means all real property listed on Exhibit B. Each manufacturing facility located on the Real Estate is referred to herein as a “Facility” and collectively as the “Facilities”.

   (f) “Software” means to the extent used by Supplier in the manufacture, production or assembly of the Component Parts, all (i) computer programs and supporting information provided in connection with a transaction relating to the program, and (ii) computer programs embedded in goods and any supporting information provided in connection with a transaction relating to the program whether or not the program is associated with the goods in such a manner that it customarily is considered part of the goods, and whether or not, by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods, and whether or not the program is embedded in goods that consist solely of the medium in which the program is embedded.

2. **Grant of Liens and Security Interests.** As collateral security for the Obligations, Supplier hereby grants to the Participating Customers a continuing
security interest in the Operating Assets and the Real Estate, whether now owned or hereafter acquired by Supplier, or in which Supplier now has or at any time in the future may acquire any right, title or interest (the "Collateral"). Further, Supplier hereby grants the Participating Customers permission to file on its behalf any financing statements or other documentation deemed necessary by the Participating Customers to perfect their security interests granted hereby. The security interests granted to the Participating Customers pursuant to this Access Agreement to secure the Obligations shall be junior and subordinate at all times and in all respects to claims, liens and security interests granted to the Lenders. Supplier shall not grant any other party a similar right of access except on terms acceptable to Customers and Lenders. Lenders may take any necessary action to protect their rights in the Collateral, including but not limited to preparing for a sale and selling, transferring, or liquidating any asset not included as Operating Assets or Real Estate, or to list the Operating Assets and/or Real Estate for sale provided any closing would occur no sooner than the end of the Occupancy Period (defined below), and preparing all of the Collateral for liquidation (including the Operating Assets and Real Estate so long as such preparation shall not interfere with the manufacture of Component Parts by any of the Participating Customers.

3. Right of Access. Supplier hereby grants Participating Customers or their designee(s) the right, but not the obligation, to use and occupy the Operating Assets and the Real Estate to manufacture Component Parts ("Right of Access") for a period of up to 120 days (the "Occupancy Period") commencing upon the exercise and allowance of the Right of Access. Any Customer (each an "Exercising Customer" and collectively the "Exercising Customers") may exercise the Right of Access with respect to any one or more of the Facilities by delivering written notice at least twenty-four (24) hours in advance to each of Supplier, the other Participating Customers, and Lenders indicating the intention to exercise the Right of Access as to one or more Facilities or any other of Supplier's owned or leased locations at which the Operating Assets may be located on the date the Participating Customer exercises the Right of Access, if a Participating Customer exercises its Right of Access with respect to fewer than all of the Facilities, that Participating Customer and the other Participating Customers must exercise the Right of Access with respect to any of the remaining Facilities within ten (10) business days after the first exercise of the Right of Access or the Right of Access as to such remaining Facilities will expire. The Occupancy Period with respect to all Participating Customers will expire no later than 120 days after the earliest date on which any Participating Customer first exercises its Right of Access. Participating Customers shall have no right to foreclose upon, sell, transfer, or dispose of any of the Operating Assets or the Real Estate as part of the Right of Access or as the holder of a security interest in the Operating Assets. An Exercising Customer's Right of Access throughout the Occupancy Period shall be conditioned upon such Exercising Customer's compliance with Section 3(b) below.

(a) Participating Customer Obligations Upon Exercising Right of Access. If a Participating Customer exercises the Right of Access, such Participating Customer exercising the Right of Access will:

(i) use reasonable care in the custody and preservation of Supplier's assets, and indemnify, defend and hold Lenders and Supplier and their respective officers and directors, harmless from any costs, expenses (including reasonable attorney fees),
losses, damages and liability relating to damage to property (including the Operating Assets and the Real Estate) or injury suffered by third parties, Lenders or Supplier, caused directly or indirectly by the Exercising Customer’s or its designee’s use of the Operating Assets and the Real Estate, provided, however, that the foregoing indemnity obligations shall not apply to claims arising out of or related to conditions which existed or events that occurred prior to the Occupancy Period. The obligation to indemnify Lender and its respective officers, directors and employees shall not be subject to any setoff or recoupment of any kind that Participating Customers may have against Supplier and which obligations shall survive termination of the Right of Access, the expiration of the Occupancy Agreement and termination of this Agreement;

(ii) insure and maintain the Operating Assets and the Real Estate in the same condition as existed upon delivery of the Access Notice by the exercising Participating Customer(s), ordinary wear and tear excepted, naming the Lenders as the lender loss payee and additional insured on all insurance policies obtained with respect to the Operating Assets and/or the Real Estate;

(iii) for any Facilities accessed during and after the Occupancy Period, in lieu of the Purchase Order price for Component Parts produced during the Occupancy Period, pay the verified actual costs and expenses incurred in connection with the manufacturing of the Component Parts (and any other Other Customer’s component parts manufactured pursuant to Section 3(a)(v) below) during the Occupancy Period, including, without limitation, inventory, gross wages (including overtime, and benefits), utilities and other overhead expenses, prorated property taxes and assessments attributable to the Operating Assets and the Real Estate, and any payments due on account of any of the Operating Assets and Real Estate which are leased from third parties, provided, however, that the Exercising Customer shall not be obligated to pay any amount on account of the Supplier’s above costs unless such costs are actually incurred during the Occupancy Period, irrespective of when any invoice for such costs is received; for the avoidance of doubt and by way of example, if Supplier typically pays certain costs (such as insurance premiums) annually, even if the annual payment falls due during the Occupancy Period the Exercising Customer shall only be responsible for paying the pro rated amount of the annual payment that relates directly to manufacturing activities during the Occupancy Period;

(iv) subject to the Exercising Customers’ right to use and occupy the Operating Assets and the Real Estate during the Occupancy Period, afford Supplier’s and Lender’s respective representatives reasonable access to inspect the Operating Assets and the Real Estate;

(v) subject to Supplier’s other customers (“Other Customers” or individually “Other Customer”), which shall include any customer other than the Exercising Customer(s), agreeing to: (a) make payment to the Exercising Customer(s) or their designee(s) on account of such Other Customers’ allocable share of overhead and related expenses and all direct expenses related to such Other Customers’ production and (b) Supplier making the necessary tangible personal property available for use during the Occupancy Period, the Exercising Customer(s) agree, for themselves and their designee(s), to produce Component Parts for such Other
Customers during the Occupancy Period, if requested in writing by such Other Customer(s). If such Other Customers do not agree as aforesaid, the Exercising Customer(s) agree to provide such Other Customers access, to the applicable facilities of the Supplier to remove the Other Customers’ tooling, provided the Exercising Customer(s) have access and the Other Customers do not interfere with the production of the Component Parts;

(vi) purchase the “Inventory” as defined in, and according to the terms of, the Accommodation Agreement;

(vii) on the first day of the Occupancy Period, and on the first day of each month thereafter, in advance, during the Occupancy Period, pay to Lenders an access fee for each Facility in which the Right of Access is exercised, as set forth on Exhibit C (with such amounts pro-rated for any partial months); and

(viii) If more than one Participating Customer exercises its Right of Access, the Exercising Customers will be jointly and severally liable vis-à-vis obligations running in favor of Lenders.

The Exercising Customer(s) obligations under this Section (3)(a) shall not be subject to setoff, recoupment or deduction of any kind and as to obligations owed to Lenders shall be paid and enforced even if Supplier does not comply with this Agreement or any other Agreement with the Exercising Customer(s).

(b) if one or more of the Participating Customers exercise their Right of Access, Supplier shall comply with the following:

(i) at the Exercising Customers’ election in their sole discretion, Supplier shall use its commercially reasonable best efforts to continue to employ those of its employees which the Exercising Customer(s) determine are necessary to maintain production of Component Parts (the “Retained Employees”) and, in turn, lease the Retained Employees to the Exercising Customer(s) or their designee(s), and the Exercising Customer(s) or their designee(s) shall reimburse Supplier for all costs and expenses as and when due relating to Supplier’s employment of the Retained Employees incurred during the Occupancy Period. Without limiting the generality of the foregoing, the Exercising Customer(s) and/or their designee(s) shall reimburse Supplier all amounts incurred by Supplier to meet its regular payroll obligations, including salaries, wages, payroll taxes, workers’ compensation, unemployment insurance, disability insurance, welfare, pension and other payments and contributions required to be made by Supplier with respect to the Retained Employees, which are incurred during the Occupancy Period, but in no event will the Participating Customers be liable for any costs for unfunded pension liability or other obligations relating to service prior to the time the Participating Customer(s) exercised the Right of Access;

(ii) during the Occupancy Period, Supplier shall not increase compensation or benefits of the Retained Employees without the consent of the exercising Participating Customer(s) except as may be required by applicable law or pre-existing contract;

(iii) Supplier shall indemnify, defend and hold the Exercising Customers, their
designee(s) and their respective employees and agents harmless from any and all costs, expenses (including reasonable attorneys’ fees), losses, damages, liabilities or injury arising from claims or liabilities arising or accruing prior to the date of the Exercising Customers’ exercise of the Right of Access, regardless of when such claims are asserted, but subject to any applicable statutes of limitations;

(iv) during the Occupancy Period, Supplier agrees that the Exercising Customers and their designee(s) and respective agents and representatives shall have reasonable access to Supplier’s books and records for the purposes of confirming and calculating the amounts due, if any, from the Exercising Customers under this Access Agreement; and

(v) during the Occupancy Period, Supplier will not relocate, sell or otherwise dispose of the Operating Assets or the Real Estate, or take any other action that would result in the Operating Assets or the Real Estate being unavailable to the Exercising Customer(s) during the Occupancy Period.

(c) Right to Terminate. The Exercising Customer(s) shall have the absolute right to terminate the its respective Right of Access with respect to any one or more of the Facilities upon fifteen (15) days written notice to Supplier, Lenders and the other Exercising Customers. The last Exercising Customer(s) as to any Facility subject to that Exercising Customer’s Right of Access will ensure that the Facility, and the Operating Assets contained in that Facility, are left in a secure and safe state and surrendered to Supplier or Lenders, as the case may be, in the condition they were received, subject to ordinary wear and tear; provided, however, that notwithstanding anything to the contrary, the Facility shall be left in broom swept condition. Exercising Customer’s right to terminate and its cessation of use and occupancy of the Operating Assets and the Real Estate, shall cause no further obligations or liabilities to Supplier or Lender on account of the Right of Access.

(d) SPECIFIC PERFORMANCE. IN CONNECTION WITH ANY ACTION OR PROCEEDING TO ENFORCE THE RIGHT OF ACCESS, SUPPLIER ACKNOWLEDGES THAT THE PARTICIPATING CUSTOMERS WILL NOT HAVE AN ADEQUATE REMEDY AT LAW, THAT THE OPERATING ASSETS AND THE REAL ESTATE ARE UNIQUE AND THAT, THE PARTICIPATING CUSTOMERS SHALL BE ENTITLED TO SPECIFIC PERFORMANCE OF SUPPLIER’S OBLIGATIONS TO AFFORD THE PARTICIPATING CUSTOMERS THEIR RIGHT OF ACCESS UNDER THIS ACCESS AGREEMENT.

(c) Appointment of Receiver. In addition to any rights and remedies the Participating Customers may have under the terms of this or any other agreement between the Participating Customers, Supplier and Lenders, each Participating Customer shall have the right to the appointment of a receiver to effectuate the Right of Access. In connection with any hearing on the appointment of a receiver, Supplier agrees that at least forty-eight (48) hours actual notice of any request for a hearing on such appointment shall be adequate notice and that the only issue to be litigated at the hearing will be whether or not a Default has occurred.

(f) IRREPARABLE HARM; LIMITATION OF NOTICE. SUPPLIER ACKNOWLEDGES THAT THE PARTICIPATING CUSTOMERS WILL SUFFER
IRREPARABLE HARM IF ONE OR MORE OF THE PARTICIPATING CUSTOMERS EXERCISE THE RIGHT OF ACCESS AND SUPPLIER FAILS TO COOPERATE WITH THE PARTICIPATING CUSTOMERS IN ALLOWING THEM TO EXERCISE THE RIGHT OF ACCESS UNDER THIS ACCESS AGREEMENT. ACCORDINGLY, PROVIDED THAT SUPPLIER RECEIVES AT LEAST FORTY-EIGHT (48) HOURS’ ACTUAL NOTICE OF ANY REQUEST FOR A HEARING IN CONNECTION WITH PROCEEDINGS INSTITUTED BY THE PARTICIPATING CUSTOMERS, SUPPLIER WAIVES, TO THE FULLEST EXTENT POSSIBLE UNDER APPLICABLE LAW, THE RIGHT TO NOTICE IN EXCESS OF 48 HOURS IN CONNECTION WITH ANY JUDICIAL PROCEEDINGS INSTITUTED BY ANY ONE OR MORE OF THE PARTICIPATING CUSTOMERS TO ENFORCE THE RIGHT OF ACCESS.

4. License. Supplier, to the extent that it has the right, hereby grants to each Participating Customer during the Occupancy Period for so long as the Right of Access has not been terminated, a non-exclusive worldwide, irrevocable, and fully-paid right and license to use any Intellectual Property to develop and manufacture the Component Parts for such Participating Customer’s use and/or use by third parties (the “License”). The Participating Customers’ right to use the License shall include the right to sublicense third parties for the manufacture of Component Parts, provided, however, that any sublicensee must satisfy the terms of this Access Agreement and sublicensing will have no effect on the Participating Customers’ obligations under this Access Agreement. This Section 4 is not intended to modify any rights granted to the Participating Customers in the Purchase Orders but is intended to expand those rights as set forth in this paragraph.

(a) Right to Use License. Although the License is being granted to the Participating Customers as of the date set forth above, the Participating Customers agree that neither they nor their sublicensees will utilize the License unless:

(i) a Default occurs; and

(ii) the Participating Customer exercises the Right to Access (and then it will only use the License during the Occupancy Period).

(b) No Royalty. For all purposes, Supplier has been fully paid for the License and other rights granted to the Participating Customers under this Access Agreement and no royalties, fees, payments, charges or other consideration shall be due from the Participating Customers on account of the License or this Access Agreement or the Participating Customers’ (or sublicensee’s) use of the License or other rights granted pursuant to this Access Agreement.

(c) Protection of Ownership. The Participating Customers shall treat and preserve the Intellectual Property in accordance with the same practices employed by the Participating Customers to safeguard their own intellectual property against unauthorized use and disclosure and will only use such intellectual Property during the Occupancy Period and only in connection with Component Parts. The foregoing obligations of the Participating Customers shall not be applicable to information which is now or becomes hereafter available to the public through no
action, conduct, omission or fault of the Participating Customers. The provisions of this Section shall survive the termination of this Access Agreement.

5. **Protection of Production.** Upon the exercise of a Right of Access, each Exercising Customer shall have the unlimited right to, among other things, enter into discussions, negotiations and agreements regarding the production of the Component Parts by any potential alternative supplier(s).

6. **Limitations on Participating Customers’ Obligations.** Unless one or more Participating Customers exercises the Right of Access, in which case such Exercising Customer(s) shall have the obligations set forth in this Access Agreement, the Participating Customers who do not exercise the Right of Access shall not have any obligation or liability by reason of or arising out of this Access Agreement, nor shall the Participating Customers who do not exercise the Right of Access be required or obligated in any manner to perform or fulfill any of the obligations of Supplier. The Participating Customers agree they will act reasonably and in good faith if one or more of them exercise their rights under this Access Agreement. If one Participating Customer exercises its rights under this Access Agreement and the other Participating Customers do not need to exercise such rights (i.e., but not by way of limitation, the non-exercising Participating Customers no longer need production from Supplier or do not need production from the involved facility(ies) and will not request the Exercising Customer to produce parts for the non-exercising Participating Customers), the Participating Customer exercising its Right of Access will be liable for all costs associated with this Access Agreement, subject to the obligations of Other Customers as set forth herein. If more than one Participating Customer exercises its rights under this Access Agreement, the Participating Customers exercising their rights will choose a designee to run Supplier’s facility(ies) on their collective behalf. Further, the Participating Customers exercising their Right of Access or continuing to receive Component Parts from the involved facility(ies) will share proportionately, based upon the percentage of Supplier’s sales relative to one another, all costs associated with exercising such Right of Access.

7. **Remedies.** Upon a Default and subject to the terms of Section 2 above, each Participating Customer shall have all rights and remedies provided in this Access Agreement and in any other agreements with Supplier including, but not limited to, the Accommodation Agreement and the Purchase Orders. Further, in connection with the Participating Customers’ rights and remedies under this Access Agreement, all of the Participating Customers’ rights and remedies under this Access Agreement are cumulative and not exclusive of any rights and remedies under any other agreement or under applicable law.

8. **Secured Party and Lessor Acknowledgments.**

(a) In accordance with Recital E above, Lenders will execute and deliver to the Participating Customers and Supplier their Acknowledgment, in form attached as Exhibit A, concurrently with the execution of this Agreement by the Supplier and the Participating Customers.

(b) Supplier will use commercially reasonable efforts to provide to the Participating Customers as promptly as practicable acknowledgments of any lessor(s) of the
Real Estate (to the extent leased) to the Participating Customers’ rights hereunder, in a form substantially similar to Exhibit “B” attached hereto.

9. Injunctive Relief. Given that the Participating Customers will incur significant damages if Supplier and/or Lenders fail to timely satisfy their obligations to the Participating Customers and the Participating Customers’ manufacturing and/or assembly plant operations will be negatively impacted, and because the Participating Customers do not have adequate remedies at law and would be irreparably harmed by such events, Supplier agrees that each Participating Customer shall be entitled to injunctive relief (both prohibitive and mandatory) in connection with any violations by Supplier or Lenders of any terms or conditions of this Access Agreement.

10. Representations and Warranties. Supplier represents and warrants to the Participating Customers that:

(a) Addresses. Supplier’s chief executive office and the location of the Collateral are set forth in Exhibit “D” and shall not be changed without prior written notice to the Participating Customers. Supplier must advise the Participating Customers in writing of any change in its name, trade name, address, or form of organization within fifteen (15) days after such change.

(b) Accuracy of Information. To the best of Supplier’s knowledge, all information, certificates, or statements given to the Participating Customers in connection with this Access Agreement shall be true and complete in all material respects, when given.

11. Description of Real Estate. To the best of Supplier’s knowledge, the legal description of the Real Estate attached as Exhibit “E” is a complete and accurate description of the Real Estate and includes all property on which all buildings and other facilities of Supplier necessary for or useful in the production of the Component Parts are located.

12. Covenants. Supplier covenants and agrees with the Participating Customers that from and after the date of this Access Agreement and until the Obligations are satisfied:

(a) Further Documentation. At any time, upon the written request of any Participating Customer, and at Supplier’s sole expense, Supplier will promptly and duly execute and deliver any and all such further instruments and documents and take such further action as such Participating Customer(s) may reasonably request for the purpose of obtaining all of the benefits of this Access Agreement and of the rights and powers herein granted.

(b) Payment of Obligations. Prior to an exercise of the Right of Access by the Participating Customers, if any, except as may be limited by the terms of the Accommodation Agreement and the Loan Documents, Supplier will pay promptly when due all taxes, assessments and governmental charges or levies imposed upon the Operating Assets and Real Estate or in respect of Supplier’s income or profits, as well as all claims of any kind (including, without limitation, claims for
labor, materials or supplies) against or with respect to the Operating Assets and Real Estate.

(c) Sales or Dispositions of Assets; Certain Uses Prohibited. Except as may be set forth in the Accommodation Agreement, Supplier will not sell or otherwise dispose of any Operating Assets or the Real Estate except in the ordinary course of business. During the Occupancy Period, Supplier will not sell or otherwise dispose of or encumber (other than in favor of Lenders) the Operating Assets or the Real Estate without the written consent of the Participating Customers, which consent will not be unreasonably withheld and the consent of the Lenders. Further, Supplier will not use any of the Operating Assets or the Real Estate in any way which would materially adversely affect the Participating Customers' Right of Access or the Participating Customers' other rights and remedies under this Access Agreement. Supplier acknowledges and agrees that it will be reasonable for the Participating Customers to withhold consent if the proposed sale or encumbrance impairs, or may substantially impair, the Participating Customers' rights under this Access Agreement or any other agreement between a Participating Customer and Supplier.

(d) Limitations on Modifications of Agreements, etc. Supplier will not, other than in the ordinary course of business: (i) amend, modify, terminate, or waive any provision of any contract, or enter into any contract, which would materially and adversely affect the Participating Customers' Right of Access; or (ii) fail to exercise promptly and diligently each and every right which it may have under each contract in any manner which would materially and adversely affect the Participating Customers' Right of Access or the Participating Customers' other rights or remedies under this Access Agreement.

(e) Maintenance of Insurance. Prior to the exercise of the Right of Access by the Participating Customers, Supplier must, at its expense, keep and maintain the Operating Assets and Real Estate insured against all risk of loss or damage from fire, theft, malicious mischief, explosion, sprinklers, and all other hazards or risks of physical damage included within the meaning of the term “extended coverage.” For the benefit of Lenders, Participating Customers and Supplier each agree that any and all proceeds of insurance, including any Proceeds, shall be paid to Lenders.

(f) Right of Inspection; Cooperation. In addition to any rights the Participating Customers may have under the Purchase Orders and/or Accommodation Agreement, each Participating Customer and its representatives shall, upon reasonable request and at reasonable times, have the right to enter into and upon any premises where any of the Operating Assets are located for the purpose of inspecting the Operating Assets, observing their use or otherwise protecting the Participating Customers' interests therein. The Participating Customers will take reasonable steps to maintain the confidentiality of information obtained by the Participating Customers, except as required by law.

(g) Notice of Default. Supplier will provide immediate notice to the Participating Customers, by way of facsimile or email transmission and overnight express mail service, of its or its attorney’s or agent’s receipt of any notice of default under
Supplier’s agreements with Lenders or any other secured creditor including, but not limited to, taxing authorities. Supplier hereby grants to the Participating Customers the option, but not the obligation, to exercise whatever rights to cure defaults that Supplier has under such agreements or by law.

Term. The rights granted to the Participating Customers under this Access Agreement shall continue until May 15, 2009, unless prior to such date any Participating Customer has, following the occurrence of a Default, exercised the Right of Access in which case this Agreement shall expire and Participating Customers shall promptly release the lien and security interest granted in paragraph 2 above, upon the earlier of (i) the expiration of the Occupancy Period, or (ii) when Exercising Customers’ requirements under the Purchase Orders are satisfied in all material respects or all of the Component Parts are resourced.

Notwithstanding the occurrence of a Termination Event and the termination of this Access Agreement and all parties respective obligations hereunder thereby, the following obligations shall survive the termination of this Access Agreement: (a) Supplier’s obligations to indemnify the Participating Customers as set forth in Section 3(b)(iii); (b) Participating Customers’ obligations to indemnify Lenders and Supplier as set forth in Section 3(a)(i); and (c) Participating Customers’ payment obligations under Section 3(a).

13. Confidential Information and Data. Without limiting the Participating Customers’ or Supplier’s rights under this Access Agreement, to the extent the Operating Assets include or the Participating Customers or their designee(s) otherwise come into possession of or become aware of, Supplier’s trade secrets or proprietary information during the Participating Customers’ exercise of the Right of Access or otherwise, the Participating Customers and their designee(s) must (a) keep the information, data, and trade secrets confidential; and (b) only use the Information, data, and trade secrets during the Occupancy Period to the extent necessary to produce Component Parts. The provisions of this Section shall survive the termination of this Access Agreement.

14. Authorization. The parties executing this Access Agreement as representatives warrant that they have the power and authority to execute this Access Agreement on behalf of the entity that they represent and that their signatures bind said entity to the terms of this Access Agreement.

15. Section Headings. The Section headings used in this Access Agreement are for convenience of reference only and are not to affect the construction hereof or be taken into consideration in the interpretation of this Access Agreement. All references to Sections, Schedules, and Exhibits are to Sections, Schedules, and Exhibits in or to this Access Agreement unless otherwise specified.

16. No Waiver: Cumulative Remedies; Unenforceability. No party to this Access Agreement shall by any act, delay, indulgence, omission, or otherwise be deemed to have waived any right or remedy under this Access Agreement or of any breach of the terms and conditions of this Access Agreement. A waiver by any party of any right or remedy under this Access Agreement on any one occasion shall not be construed as a bar to any right or remedy which that party would otherwise
have had on a subsequent occasion. No failure to exercise, nor any delay in exercising, any right, power, or privilege under this Access Agreement, by any party shall operate as a waiver, nor shall any single or partial exercise of any right, power or privilege under this Access Agreement preclude any other or future exercise thereof or the exercise of any other right, power or privilege. The rights and remedies under this Access Agreement are cumulative, may be exercised singly or concurrently, and are not exclusive of any rights and remedies provided by any other agreements or applicable law. Should any provision of this Access Agreement be held invalid or unenforceable, the remainder of this Access Agreement will not be affected thereby.

17. **Waivers and Amendments; Successors and Assigns.** No term or provision of this Access Agreement may be waived, altered, modified, or amended except by a written instrument, duly executed by the parties hereto. This Access Agreement and all of the Parties' obligations are binding upon their respective successors and assigns, and together with the rights and remedies of the Parties under this Access Agreement, inure to the benefit of the Parties and their respective successors and assigns. Supplier may not assign or transfer any right or obligation under this Access Agreement without the prior written consent of all of the Participating Customers and Lenders.

18. **Governing Law and Forum.** This Access Agreement is made in the State of Michigan and shall be governed by, and construed and enforced in accordance with, the laws of the State of Michigan. The parties agree that the federal and state courts sitting in the State of Michigan, in which a proceeding by or against Supplier may be pending, have personal jurisdiction over the parties and that proper jurisdiction and venue for any dispute arising from or under this Agreement shall be in the federal or state courts sitting in the Eastern District of Michigan.

19. **Notices.** All notices, requests, and other communications that are required or may be given under this Access Agreement must be given in accordance with the Accommodation Agreement.

20. **No Third Party Beneficiaries.** The rights and interests of the Parties under this Access Agreement are intended to benefit solely the parties to this Access Agreement, except as expressly set forth in this Access Agreement, and not for the benefit any third Party, including any purchaser of the assets.

21. **Counterparts; Facsimile Signatures.** This Access Agreement may be executed in any number of counterparts and by each Party hereto on separate counterparts, each of which when so executed and delivered shall be an original, but all of which together shall constitute one and the same document, and it shall not be necessary in making proof of this Access Agreement to produce or account for more than one such counterpart. For purposes of this Access Agreement, facsimile signatures and signatures sent by electronic mail in PDF format will also constitute originals.

(a) **Entire Agreement; Conflicts; Ambiguous Language.** This Access Agreement, together with any other agreements and schedules referenced to herein or executed in connection with this Access Agreement, including the Accommodation Agreement and the agreements referenced in the Accommodation Agreement,
constitutes the entire understanding of the parties in connection with the subject matter hereof. Except as expressly set forth in this Access Agreement, neither Supplier nor the Participating Customers are waiving, modifying or limiting any rights they have under the Purchase Orders, which terms and conditions shall otherwise remain in full force and effect. To the extent any term or condition of this Access Agreement is inconsistent or in conflict with the terms of any other agreements (including, without limitation, any accommodation agreement) between the Supplier and any and all of the Participating Customer(s), the terms of this Access Agreement shall govern and control. This Access Agreement is being entered into among competent persons who are experienced in business and represented by counsel, and has been reviewed by the Parties and their respective counsel. Therefore, any ambiguous language in this Access Agreement will not necessarily be construed against any particular party as the drafter of such language.

22. CONSULTATION WITH COUNSEL. THE PARTIES HERETO ACKNOWLEDGE THAT THEY HAVE BEEN GIVEN THE OPPORTUNITY TO CONSULT WITH COUNSEL BEFORE EXECUTING THIS ACCESS AGREEMENT AND ARE EXECUTING THIS ACCESS AGREEMENT WITHOUT DURESS OR COERCION AND WITHOUT RELIANCE ON ANY REPRESENTATIONS, WARRANTIES OR COMMITMENTS OTHER THAN THOSE REPRESENTATIONS, WARRANTIES AND COMMITMENTS SET FORTH IN THIS ACCESS AGREEMENT.

23. WAIVER OF JURY TRIAL. THE PARTIES HERETO ACKNOWLEDGE THAT THE RIGHT TO TRIAL BY JURY IS A CONSTITUTIONAL RIGHT, BUT THAT THIS RIGHT MAY BE WAIVED. THE PARTIES EACH HEREBY KNOWINGLY, VOLUNTARILY AND WITHOUT COERCION, WAIVE ALL RIGHTS TO A TRIAL BY JURY OF ALL DISPUTES ARISING OUT OF OR IN RELATION TO THIS AGREEMENT, THE PURCHASE ORDERS, OR ANY OTHER AGREEMENTS BETWEEN THE PARTIES RELATED TO SUPPLIER. NO PARTY SHALL BE DEEMED TO HAVE RELINQUISHED THE BENEFIT OF THIS WAIVER OF JURY TRIAL UNLESS SUCH RELINQUISHMENT IS IN A WRITTEN INSTRUMENT SIGNED BY THE PARTY TO WHOM SUCH RELINQUISHMENT WILL BE CHARGED.

[SPACE IS LEFT INTENTIONALLY BLANK; SIGNATURES ON FOLLOWING PAGES]

DELPHI AUTOMOTIVE SYSTEMS LLC

By: ___________

Print Name: ___________

Title: ___________

AUTOMOTIVE COMPONENTS HOLDINGS, LLC

By: ___________
FORD MOTOR COMPANY
By: ____________
Print Name: ____________
Title: ____________

BMW MANUFACTURING CO., LLC
By: ____________
Print Name: ____________
Title: ____________

LINAMAR CORPORATION
By: ____________
Print Name: ____________
Title: ____________

MAG CONTECH, LLC
By: ____________
Print Name: ____________
Title: ____________

Contech LLC
By: ____________
Print Name: ____________
Title: ____________

Contech U.S., LLC
By: ____________
Print Name: ____________
Title: ____________
EXHIBIT A ACKNOWLEDGMENT AND CONSENT

While not a party to the attached Access and Security Agreement (the “Access Agreement”), Lenders have first priority liens on substantially all of Supplier’s assets. In such capacity, Lenders acknowledge, consent to, and agree that the exercise by Lenders of the rights and remedies with respect to Lender’s liens and security interests in the Operating Assets (as defined in the Access Agreement) and the Real Estate (as defined in the Access Agreement) is subject to and conditioned upon all applicable terms of the Access Agreement provided that the Exercising Customer(s) (as defined in the Access Agreement) comply with the obligations set forth in Section 3(a). By execution of the Access Agreement, Customers acknowledge that (i) the fact that Lenders are executing this Acknowledgement and Consent in no way makes Lenders a guarantor or surety for Supplier’s performance under the Access Agreement, (ii) except as provided in the Access Agreement and the Accommodation Agreement, Lenders reserve all of their rights against Supplier under its agreements with Supplier or applicable law, and (iii) Lenders are a third party beneficiary to the Access Agreement.

MARATHON SPECIAL OPPORTUNITY FUND, L.P.
By: ___________
Print Name: ___________
Title: ___________

THE CIT GROUP/BUSINESS CREDIT, INC.
By: ___________
Print Name: ___________
Title: ___________

CITICORP
By: ___________
Print Name: ___________
Title: ___________

D.E.SHAW LAMINAR
By: ___________
Print Name: ___________
Title: ___________

EXHIBIT B LESSOR’S ACKNOWLEDGMENT AND CONSENT

While not a party to the Access and Security Agreement made between Delphi Automotive Systems LLC, Automotive Components Holdings, LLC, Ford Motor Company, BMW Manufacturing Co., LLC, and Linamar Corporation (collectively, the “Participating Customers”), and MAG Contech, LLC (“Supplier”), dated as of February ___________, 2009, the undersigned leases certain real estate and/or equipment to Supplier, and, in such capacity, the undersigned acknowledges, consents to, and agrees with, and agrees to be bound by, the terms and conditions of the foregoing Access and Security Agreement, including the Participating Customers’ right to use the Operating Assets and the Real Estate during any Occupancy Period.

By: ___________
Print Name: ___________
Title: ___________

EXHIBIT C ACCESS FEE
<table>
<thead>
<tr>
<th>EQUIPMENT LOCATED AT:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1) SPX Contech 1200 Power Drive, Auburn, Indiana Casting</td>
<td>$34</td>
</tr>
<tr>
<td>2) SPX Contech 5, Arnolt Drive, Pierceton, Indiana Casting</td>
<td>$70</td>
</tr>
<tr>
<td>3) SPX Contech 205 N. Grover Avenue, Alma, Michigan Casting</td>
<td>$25</td>
</tr>
<tr>
<td>4) SPX Contech 51241 Hwy M-51, Dowagiac, Michigan Casting</td>
<td>$35</td>
</tr>
<tr>
<td>5) SPX Contech, Ryken Tube, 3160 Dallavo Ct, Walled Lake, Michigan SPG</td>
<td>$28</td>
</tr>
<tr>
<td>6) SPX Contech, Metal Forge, 1600 Woodhurst Lane, Albemarle, North Carolina SPG</td>
<td>$25</td>
</tr>
<tr>
<td>7) SPX Contech, Production Coatings Division, 1301 Marby Drive, Albemarle, North Carolina SPG</td>
<td></td>
</tr>
<tr>
<td>8) SPX Contech, 901 Alfred Thun Road, Clarksville, Tennessee Casting</td>
<td>$108</td>
</tr>
</tbody>
</table>

**Sub-Total US Only**

$325
Auto Industry Bankruptcy Concepts
Auto Industry – Important Factors

- **Just in Time Inventory Systems**
  - Reduces cost to hold inventory, improves working capital
  - Efficient floor management at assembly plants
  - Creates risk when suppliers can’t deliver on time
  - Supply chains are global and require significant logistical management

- **Dedicated Tooling and Capacity**
  - Most parts of a car require OEM specific tooling
  - Tooling is expensive and requires extensive testing and validation
  - OEM’s are often single sourced on a part – cannot build a vehicle if even one part is missing
  - Suppliers can be negatively impacted by product launch risks (more in 2019 – 2020 than ever before) and by over-capacity situations due to high fixed cost nature

- **Costs of a Plant Shut Down**
  - Through out the supply chain, OEM, Tier 1’s, Tier 2’s …. Tier N, a shut down at any facility is expensive
  - Assembly facility shut down can cost millions of dollars per hour

- **Structural Change**
  - Shift to electrical, autonomous, and SUV’s / trucks causing plant shutdowns and supplier disruptions short and long term
  - Increase in capital outlay for R&D and Tooling
ACCOMMODATION AGREEMENT & ACCESS AGREEMENT

Used either with customer group or by a single customer to document “accommodations” being provided to a distressed supplier:

Accommodation Agreement
- Details the accommodations being made by customer(s), the obligations of the supplier, and the accommodations and/or obligations of others (lender and/or owner)

Access Agreement
- Grants the customer(s) a security interest in the assets of supplier to secure the ability to access supplier’s facilities to continue production, if needed
ACCOMMODATION PROTOCOLS

- Understand the end game
  - Rehabilitate/reorganize
  - Facilitate sale
  - Support until production resourced
- Ensure continued production from supplier and/or long-term viability of supplier
- How much will it cost to:
  - Rehabilitate supplier
  - Sustain operations through a sale or resourcing
  - Cost to resource
  - Wind-down the supplier
- Potential sources of funding to support supplier through distress
  - Supplier with operational improvements
  - Lender
  - Owner
  - Customers
ACCOMMODATION AGREEMENT: KEY PROVISIONS

**Customer Obligations:**
- Financial obligations
- Expedited payment terms
- Non-resource period
- Inventory purchase
- Price increases
- Suspension of setoff rights
- Pay “access costs”

**Lender Obligations:**
- Quid Pro Quo: Lender will forbear from any existing defaults
- Continue to lend
- Consent to customer liens
- Consent to access rights

**Supplier Obligations:**
- Continued production
- Inventory bank build
- Operate within approved budget and restructuring plan
- Obtain and receive similar accommodations from other customers
- Tooling acknowledgement
- Secured lender consent (may be party to agreement or execute separate acknowledgement)
- Supplier may grant to customer the following:
  - Lien on supplier operating assets
  - Option to purchase tooling and equipment
  - License to use IP
ACCOMMODATION AGREEMENT: KEY PROVISIONS cont’d

- **Other Provisions**
  - Execution of Access Agreement
    - Right of access
    - Use of supplier employees
  - Events of Default (which lead to ability to resource) include:
    - Material breach of agreement
    - Bankruptcy filing
    - Lender enforces its lien rights
    - Additional supplier request for financial accommodations
    - Material adverse change in financial condition
  - In event of bankruptcy, supplier required to seek early court approval
  - Sale milestones and customer input
**BANKRUPTCY PROCEEDINGS**

- **Initial Concerns**
  - Confirm which entities are included in bankruptcy filing
  - Confirm the entities with which customer conducts business
  - Confirm that supplier plans to continue performing pursuant to the contracts in place
  - Understand setoff limitations (may not setoff post-petition receivables with prepetition claim amounts)
  - Understand the impact of the automatic stay

- **Other Key Concerns**
  - Assumption/rejection of contracts
    - Adequate assurance of future performance
    - Cure (liability for past and/or unknown warranty claims)
  - Treatment of warranty and other obligations under the debtor’s plan
  - Confidentiality/filing documents under seal
  - Proof of Claim
    - Determine amounts due (e.g. warranty claims) to customer as of the petition date
    - Include any future, unknown warranty claims
  - Critical Vendors (Customer pay agreements)
CUSTOMER GROUPS

- **Purpose:** A group of customers working to minimize costs while protecting their respective production for a set period of time

- **Participating Customers:** Generally any customer that represents at least 5% of the distressed supplier’s total sales, but those customers which do not require production are not usually expected to participate

- **Benefits of a Customer Group:**
  - All customers in the customer group are in it together for a set period of time (no resourcing unless an event of default)
  - One customer is not subsidizing the production of another customer
  - Accommodation Agreement is executed by the supplier and all participating customers, setting forth specific terms and conditions agreed to by all
Distressed Supplier Timeline

Lorraine S. McGowen
October 2019
Executive Summary

An overview of potential restructuring options is outlined below:

- **Consensual Debt Restructuring**
  - Prepack or Pre-Arranged bankruptcy

- **Sale/Equity Infusion**
  - Debtor initiates RFP process for 3rd party investor/purchaser
  - Negotiations with OEMs on terms of Restructuring/Sale

- **Non-Consensual**
  - Company Exclusivity Period

- **Contested bankruptcy process**

- **Debt Restructuring**
  - Costly Process / Transition Issues

- **Asset Sale**
  - Potential Depressed Recovery Values

- **Confirmation of a Debtor Plan over OEM objections (through cram-down)**
## Consensual Restructuring Options

### Prepackaged Bankruptcy vs. Pre-negotiated Bankruptcy

<table>
<thead>
<tr>
<th>Type of Bankruptcy</th>
<th>Timing</th>
<th>Pros</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-Packaged Bankruptcy</strong></td>
<td>▪ Before commencing chapter 11 bankruptcy case, debtor automaker/supplier has negotiated the terms of the restructuring and solicited the necessary votes for approval of the plan (66 2/3 rd in amount/greater than 50% in number)</td>
<td>▪ Fastest process: can generally be accomplished significantly faster than a non-consensual or pre-arranged bankruptcy (45 to 90 days)</td>
<td>▪ A prepackaged bankruptcy presents the least risk and permits OEMs and other creditors to exercise maximum control over the bankruptcy process</td>
</tr>
<tr>
<td></td>
<td>▪ Before soliciting acceptances of the plan, debtor automaker/supplier will obtain &quot;lock-up&quot; (&quot;plan support agreement&quot;) from major creditors (i.e., OEMs, lenders, bondholders) of the terms of the proposed plan and support for the pre-packaged plan</td>
<td>▪ Binding on all parties, including non-consenting and non-voting creditors</td>
<td>▪ Conflicting stakeholder goals, delays in negotiating documents</td>
</tr>
<tr>
<td></td>
<td>▪ Fastest process: can generally be accomplished significantly faster than a non-consensual or pre-arranged bankruptcy (45 to 90 days)</td>
<td>▪ More certainty</td>
<td>▪ Execution risk of automaker/supplier being able to obtain votes from the major stakeholders, including OEMs, lenders and bondholders</td>
</tr>
</tbody>
</table>

### Pre-Negotiated/ "Arranged” Bankruptcy

<table>
<thead>
<tr>
<th>Timing</th>
<th>Pros</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Before commencing chapter 11, debtor automaker/supplier obtains a &quot;lock-up&quot; with major creditors (i.e., OEMs, lenders, bondholders)</td>
<td>▪ Can generally be accomplished faster than a non-consensual bankruptcy (9 months to 1 year)</td>
<td>▪ Restructuring terms negotiated prior to bankruptcy are not binding on non-consenting creditors because the requisite thresholds of approvals have not yet been obtained</td>
</tr>
<tr>
<td>▪ Debtor automaker/supplier does not solicit votes before filing for bankruptcy. The vote solicitation occurs after bankruptcy, if and when the debtor automaker/supplier obtains support from additional creditors that is sufficient to confirm a plan</td>
<td>▪ Reduced costs</td>
<td>▪ The debtor does not have sufficient approvals to confirm a plan immediately upon filing the bankruptcy petition. As a result, additional time (usually several months) and expense is required to obtain additional approvals sufficient to confirm a plan</td>
</tr>
<tr>
<td></td>
<td>▪ Debtor automaker/supplier does not solicit votes before filing for bankruptcy.</td>
<td>▪ Inter-customer, shareholder, other stakeholder negotiations</td>
</tr>
<tr>
<td></td>
<td>▪ Debtor automaker/supplier does not solicit votes before filing for bankruptcy.</td>
<td>▪ Automatic stay precludes enforcement of remedies unless lifted by the bankruptcy court</td>
</tr>
</tbody>
</table>

### Type of Bankruptcy

- **Pre-packaged Bankruptcy**
  - Before commencing chapter 11 bankruptcy case, debtor automaker/supplier has negotiated the terms of the restructuring and solicited the necessary votes for approval of the plan (66 2/3 rd in amount/greater than 50% in number)
  - Before soliciting acceptances of the plan, debtor automaker/supplier will obtain “lock-up” ("plan support agreement") from major creditors (i.e., OEMs, lenders, bondholders) of the terms of the proposed plan and support for the pre-packaged plan

- **Pre-negotiated/ "Arranged” Bankruptcy**
  - Before commencing chapter 11, debtor automaker/supplier obtains a "lock-up" with major creditors (i.e., OEMs, lenders, bondholders)
  - Debtor automaker/supplier does not solicit votes before filing for bankruptcy. The vote solicitation occurs after bankruptcy, if and when the debtor automaker/supplier obtains support from additional creditors that is sufficient to confirm a plan
# Non-Consensual/Contested Restructuring Options

## Non-consensual Bankruptcy

<table>
<thead>
<tr>
<th>Type of Bankruptcy</th>
<th>Timing</th>
<th>Pros</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional Plan (Non-consensual/Contested Plan)</td>
<td>Before commencing chapter 11 bankruptcy case, debtor automaker/supplier begins negotiating framework for a plan with major creditors (i.e., OEMs, lenders, bondholders)</td>
<td>Generally, traditional/non-consensual plan creates most risk; less control of the process, substantial time delays and most expensive</td>
<td>Generally longest; Generally most expensive; Less control of the bankruptcy process; more uncertainty.</td>
</tr>
<tr>
<td></td>
<td>No agreement is reached with creditors before bankruptcy; no “lock up”</td>
<td></td>
<td>Inter-customer, shareholder, creditor(s), regulatory negotiations; Liquidity concerns</td>
</tr>
<tr>
<td></td>
<td>Debtor automaker/supplier does not solicit acceptances before bankruptcy</td>
<td></td>
<td>Automatic stay bars enforcement of remedies unless lifted by the bankruptcy court</td>
</tr>
<tr>
<td></td>
<td>1 to 2 or more years is the norm</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The automakers/suppliers commence a work-out process to preserve supply chain and provide greatest likelihood of maximizing recoveries. Further, by adhering to a consensual bankruptcy process, the automakers will be able to initiate an exit transaction 9 to 12 months earlier than as compared to a non-consensual process.

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### Executive Summary

| Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun |
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
|     |     |     |     |     |     |     |     |     |     |     |     |     |     |     |     |

#### Consensual Process
- **Pre-work-out Negotiations**
- Commencement of Bankruptcy Proceeding/Buyer Due Diligence
- Documentation & Closing (Sale or Restructuring)

#### Non-Consensual Process
- Bankruptcy Proceeding/Litigation
- Bankruptcy Auction (363 Sale)
- Documentation/Closing/Court Approval
Typical Workout Process and Considerations
Workout Negotiations with OEMs, Suppliers, Lenders: Negotiations begin with request for accommodations

### Typical Accommodations from Customers
- Expedited payment terms for parts
- Expedited/progress payments for tooling
- Inventory buy-back provisions/agreement
- Limitation of A/R setoff rights
- Temporary price increase
- Payment direct to Tier II for materials & tooling
- "Comfort Letters"/guarantees to Tier II
- Pay-as-you-go for engineering costs instead of piece price amortization
- No-resourcing agreement (limited term)
- Immediate payment terms for parts bank production

### Typical Accommodations from Vendors/Tier I Supplier(s)
- Commitment to produce production parts
- Commitment to produce parts bank; OEM gets bargain purchase option on M&E
- Information access/periodic reporting requirements
- Tooling acknowledgment/IP license
- Access agreement (OEM right to run plant if production stops)

### Typical Accommodations from Banks
- Forbearance agreement for same duration as no re-sourcing agreement
- Commitment to fund business operating budget
- Increased A/R (90% or higher) and inventory advance rates (60% or higher)
- PIK interest and abatement of principal payments
- Access agreement (OEM right to run plant if production stops) and OEM purchase option on equipment in event of default
Sample Chapter 11 Timeline

1. Petition Filed (Automatic Stay Imposed)
2. Executory Contracts/Leases Assumed/Rejected
3. Claims Filed/Objections
4. Motion to Appoint Trustee or Examiner
5. The Plan Process Begins

- Cash Collateral/DIP Financing Orders Obtained (within 45 days)
- Committees Form and Counsel and Other Professionals Retained (within 45 days)
- Sale of Assets (throughout the bankruptcy case)
- Avoidance Power Litigation Commences (Fraudulent Conveyances/Preferences, etc.) (within two years of the entry of the order of the order for relief or appointment of trustee)
1. Shortly after commencing its bankruptcy case, if not on the date of the bankruptcy case debtor will request the bankruptcy court for emergency approval of a DIP facility, accommodation agreement, access & security agreement). A final hearing on the debtor's application will be held typically within the first 45 days of the bankruptcy case.

2. A committee is generally formed within the first month of the commencement of the bankruptcy case at a meeting of the 20 largest unsecured creditors.

3. The debtor has until confirmation of the plan of reorganization to assume or reject unexpired leases of personal property or executory contracts unless the bankruptcy court shortens such time period at the request of the non-bankrupt contract party; OEMs will want their terms & conditions to be assumed, including warranty claims.

4. In a Chapter 11 case there is no statutory deadline in most jurisdictions for filing of proofs of claim against the debtor; typically, the debtor will file a motion to establish a deadline for filing of claims against it as it begins the plan confirmation process. A debtor, however, is required shortly after the commencement of the bankruptcy case to file schedules identifying its known assets and known liabilities.

5. Both creditors and other parties in interest may seek to have the bankruptcy court to appoint a trustee or examiner. A motion for appointment of a trustee or examiner may be brought at any time, although such a motion is not likely to be granted if filed relatively early in the case and is rarely granted. Whether a trustee or examiner is appointed depends upon what is in the best interest of creditors and the debtor's bankruptcy estate.

6. The Bankruptcy Code grants the debtor various rights including the exclusive right to propose a plan of reorganization during the first 120 days of the chapter 11 case and the exclusive right to solicit acceptances of plan during the first 180 days of the case. The bankruptcy court, however, may lengthen or shorten such periods for cause shown. Extensions are routinely granted in a large and complex case unless creditors present a strong case in opposition. The time period from the commencement of such a bankruptcy petition until confirmation of a bankruptcy plan could range about 90 to 120 days for a pre-negotiated bankruptcy case, from three to four years or longer for contested bankruptcy cases, with an average bankruptcy case taking about 18 months to two years.
## Consensual Deal Scenarios:
### OEMs negotiate Accommodation Agreement, Access & Security Agreement, Inter-customer Agreement

<table>
<thead>
<tr>
<th>Stand Alone Plan</th>
<th>Bankruptcy – Company “Walk Away” Sale of Assets to 3rd Party Sponsor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overview</strong></td>
<td>• Court supervised restructuring in a “pre-packaged” or “pre-negotiated” restructuring</td>
</tr>
<tr>
<td></td>
<td>• OEMs provide most generous form of accommodations</td>
</tr>
<tr>
<td></td>
<td>• Sponsor becomes new equity owner</td>
</tr>
<tr>
<td></td>
<td>• Liabilities addressed as part of a plan of reorganization (liabilities to be assumed subject of negotiation)</td>
</tr>
<tr>
<td><strong>Benefits</strong></td>
<td>• Retain future upside and control</td>
</tr>
<tr>
<td></td>
<td>• Retain consistency in operations</td>
</tr>
<tr>
<td></td>
<td>• Preserve business/supply chain</td>
</tr>
<tr>
<td></td>
<td>• Coordinated effort to select sponsor</td>
</tr>
<tr>
<td><strong>Risks</strong></td>
<td>• Significant write down of debt (likely opposed by lenders/bondholders)</td>
</tr>
<tr>
<td></td>
<td>• Selection of sponsor primary concern for OEMs—supply chain risk (OEMs may not support sponsor)</td>
</tr>
<tr>
<td></td>
<td>• Long-term viability of business a concern</td>
</tr>
<tr>
<td></td>
<td>• Selling at an inopportune time; discount</td>
</tr>
<tr>
<td><strong>Cost/Process</strong></td>
<td>• Lengthy process depending on Company support</td>
</tr>
<tr>
<td></td>
<td>• Expensive process if Company/shareholders/ object</td>
</tr>
<tr>
<td></td>
<td>• Sponsor will seek to fund business with OEM accommodations, some of which will be monetary</td>
</tr>
</tbody>
</table>

- **Overview**
  - OEMs required to provide accommodations
  - Debt restructured in amount TBD
  - Opportunity for existing shareholders/mgmt. to retain a portion of equity
- **Benefits**
  - Retain some upside potential
  - Retain consistency in operations
  - Preserve business/supply chain
  - OEMs able to influence a management change
- **Risks**
  - Less control for OEMs
  - OEMs need to fund liquidity needs/provide accommodations
  - Potential objections/negotiations from significant trade creditors, lenders/bondholders, regulators, other stakeholders
- **Cost/Process**
  - Avoids long process
  - Low cost path
  - Partnering with Company (shareholder/mgmt) results in less than full control

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*[Page 361 of 1015]*
# Non-Consensual Deal Scenarios

## Overview

<table>
<thead>
<tr>
<th>Bankruptcy – Asset Sale</th>
<th>Bankruptcy – Debt Restructuring</th>
<th>Orderly Wind-down/Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• OEMs required to provide accommodations</td>
<td>• Amortizable bank debt</td>
<td>• Management is replaced with team acceptable to OEMs (chief restructuring officer; trustee may be appointed to supervise wind-down of business)</td>
</tr>
<tr>
<td>• Debt restructured in amount TBD</td>
<td>• 100% equity to lenders/bondholders</td>
<td>• Proceeds from asset sales will fund the wind-down process (limiting amount of payments from OEMs)</td>
</tr>
<tr>
<td>• Sale to 3rd party at discount</td>
<td>• Existing equity extinguished</td>
<td></td>
</tr>
<tr>
<td>• OEMs required to provide some accommodations</td>
<td>• OEMs required to provide some accommodations</td>
<td></td>
</tr>
</tbody>
</table>

## Benefits

<table>
<thead>
<tr>
<th>Bankruptcy – Asset Sale</th>
<th>Bankruptcy – Debt Restructuring</th>
<th>Orderly Wind-down/Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Retain some upside potential</td>
<td>• Retain upside potential and control</td>
<td></td>
</tr>
<tr>
<td>• Potential regulatory relief for lenders</td>
<td>• Potential regulatory relief for lenders</td>
<td></td>
</tr>
<tr>
<td>• Supply chain concerns</td>
<td>• Supply chain concerns</td>
<td></td>
</tr>
<tr>
<td>• Long-term viability of business concern</td>
<td>• Long-term viability of business concern</td>
<td></td>
</tr>
</tbody>
</table>
## Non-Consensual Deal Scenarios (cont’d)

<table>
<thead>
<tr>
<th>Bankruptcy – Asset Sale</th>
<th>Bankruptcy – Debt Restructuring</th>
<th>Orderly Wind-down/Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Less control for OEMs</td>
<td>• Significant write-down of debt</td>
<td>• No go-forward business</td>
</tr>
<tr>
<td>• OEMs need to fund liquidity needs/provide accommodations</td>
<td>• Valuation fight likely and unpredictable</td>
<td>• write down of debt</td>
</tr>
<tr>
<td>• Potential objections/negotiations from significant trade creditors, lenders/bondholders, regulators, other stakeholders</td>
<td>• OEMs need to provide accommodations</td>
<td>• OEMs will seek to resource elsewhere in an expedited manner; significant supply chain risk</td>
</tr>
<tr>
<td>• Selection of sponsor primary concern for OEMs—supply chain risk (OEMs may not support sponsor)</td>
<td>• Potential objections/negotiations from significant trade creditors other stakeholders</td>
<td>• Lack of coordination among OEMs</td>
</tr>
<tr>
<td>• Long-term viability of business a concern</td>
<td>• Long-term viability of business a concern</td>
<td></td>
</tr>
<tr>
<td>• Selling at an inopportune time; discount</td>
<td>• Selling at an inopportune time; discount</td>
<td></td>
</tr>
<tr>
<td><strong>Cost/Process</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Lengthy, expensive process</td>
<td>• Lengthy, expensive process</td>
<td>• Extremely expensive to implement wind-down and re-tool alternative suppliers</td>
</tr>
<tr>
<td>• Requires 2/3 vote ($); majority in number</td>
<td>• Requires 2/3 vote ($); majority in number</td>
<td>• Oversight of bankruptcy court</td>
</tr>
<tr>
<td>• Potential complex negotiations among stakeholders including OEMs, lenders/bondholders, other stakeholders</td>
<td>• Potential complex negotiations among stakeholders including OEMs, lenders/bondholders, other stakeholders</td>
<td></td>
</tr>
</tbody>
</table>
GM 10 YEARS LATER:
SOME MUSINGS ON WHO THE
BANKRUPTCY SYSTEM’S
SUPPOSED TO HELP—AND WHAT
BANKRUPTCY JUDGES CAN
PROPERLY DO TO HELP THEM

Hon. Robert E. Gerber (Ret.)
Joseph Hage Aaronson LLC
New York, NY

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On June 1, 2009, General Motors Corp. ("Old GM") filed its chapter 11 case, and on July 5 of that year, I issued my decision approving its 363 sale to a newly formed company that would thereafter be called General Motors LLC, or "New GM." About a month earlier, now-retired Bankruptcy Judge Arthur Gonzalez issued a similar decision approving a 363 sale in Chrysler. The decisions in each were affirmed, and each sale went through.

Each case has just celebrated its 10th birthday. It’s a good time for reflection.

The two 363 sales enabled each of Chrysler and GM to survive. And each sale also facilitated the survival of many of the entities that supplied Chrysler and GM with the parts and subassemblies that you’d find in any Chrysler or GM vehicle. In GM, I learned that at least the majority—and perhaps the great bulk—of the value of a GM vehicle would have come from the Supplier Chain. And I well knew that the GM and Chrysler 363 sales would be important to many Supply Chain entities’ survival, just as they would be to GM and Chrysler themselves.

In fact, saving the Supply Chain was a huge element of the GM case, in the minds of the Auto Task Force, GM’s management and advisors, and its Creditors’ Committee.

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3 See In re Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) ("Chrysler") (Gonzalez, J.), aff’d for substantially the reasons stated in the opinions below, No. 09–2311–bk (2d Cir. June 5, 2009), and opinion and judgment issued affirming bankruptcy court decision, 576 F.3d 108 (2d Cir. Aug. 5, 2009) ("Chrysler–Circuit"), stay granted, 129 S. Ct. 2275 (2009), temporary stay vacated and further stay denied, 556 U.S. 960 (2009), petition for cert granted, judgment vacated, and remanded to circuit court with instructions to dismiss appeal as moot, 558 U.S. 1087 (Dec. 14, 2009), appeal dismissed as moot, 592 F.3d 370 (2d Cir. 2010).
alike. In deciding whether to approve the then-proposed 363 sale, I made a host of factual findings in that regard. Among other things, I stated:

- As the nation’s largest automobile manufacturer, GM uses the services of thousands of suppliers—resulting in approximately $50 billion in annual supplier payments. In North America alone, GM uses a network of approximately 11,500 suppliers. In addition, there are over 600 suppliers whose sales to GM represent over 30% of their annual revenues. Thus hundreds, if not thousands, of automotive parts suppliers depend, either in whole or in part, on GM for survival.\footnote{GM Sale Opinion, 407 B.R. at 476 (emphasis added).}

- And the failure of any of the Big Three (or worse, more than one of them) might well bring grievous ruin on the thousands of suppliers to the Big Three (many of whom have already filed their own bankruptcy cases, in this District, Delaware, Michigan and elsewhere); other businesses in the communities where the Big Three operate; dealers throughout the country; and the states and municipalities who looked to the Big Three, their suppliers and their employees for tax revenues.\footnote{Id. at 477 (emphasis added).}

- The U.S. Government’s fear—a fear this Court shares, if GM cannot be saved as a going concern—was of a systemic failure throughout the domestic automotive industry and the significant harm to the overall U.S. economy that would result from the loss of hundreds of thousands of jobs and the sequential shutdown of hundreds of ancillary businesses if GM had to cease operations.\footnote{Id. (emphasis added) (and continuing, at 477 n.6, that “[m]ore than 500,000 workers are employed by companies in the U.S. that manufacture parts and components used by automakers.”).}

- Thus in response to the troubles plaguing the American automotive industry, the U.S. Government, through the U.S. Treasury and its Presidential Task Force on the Auto Industry (the “\textit{Auto Task Force}”), implemented various programs to support and stabilize the domestic automotive industry \ldots \footnote{Id. (emphasis added). It will be noted that I said the “domestic auto industry,” and not just GM.}.

- Only the U.S. and Canadian Governmental authorities were prepared to invest in GM—and then not so much by reason of the economic merit of the purchase, \textit{but rather to address the underlying societal interests in preserving jobs and the North American auto industry, the thousands of}
suppliers to that industry, and the health of the communities, in the U.S. and Canada, in which GM operates.8

• This is hardly the first time that this Court has seen creditors risk doomsday consequences to increase their incremental recoveries, and this Court—which is focused on preserving and maximizing value, allowing suppliers to survive, and helping employees keep their jobs—is not of a mind to jeopardize all of those goals.9

But should saving the Supplier Chain, in that case, have been a concern of mine? The issue arises, in a case like GM, as to whether a bankruptcy judge should be looking out for anyone other than the debtor and its creditors. How much should the bankruptcy judge be taking into account the good of others—or, for that matter, the public good? In the case of an OEM, could I—or should I—try to do right by the Supplier Chain as well? Even at the expense of bondholders, who, after all, were creditors in the most classic sense? And relatedly, could I—or should I—be looking out for communities and others who, while not creditors in any sense in which “creditors” normally is understood, would have a huge interest in the outcome of the case?

Now that the story can be told—10 years after the sale—I’ll admit that I fudged it. In my findings of fact, I spoke at substantial length of the importance of saving the Supplier Chain, along with GM itself—as the many quotes from the GM Sale Opinion, appearing above, make clear. But in my legal analysis, rightly or wrongly, I considered the good of the Supplier Chain only to the limited extent that I was confident that it was relevant under the then-existing caselaw. I considered it in the context of the “good business reason” for the 363 sale that was a requirement for approval of a 363 sale, under

8 Id. at 480.
9 Id. at 493.
the *Lionel*\(^{10}\) standard\(^{11}\) that’s employed in the Second Circuit (and many others); for the Government’s good faith as a purchaser pursuant to its credit bid;\(^{12}\) and for rejecting contentions that the Government should be equitably subordinated as a creditor, by reason of asserted lack of good faith.\(^{13}\) But partly to “protect the record,” and partly because I wasn’t confident that I should, I did not base my approval of the GM 363 sale on the facts that I’d found that the sale was in the interest of the Supplier Chain—or, for that matter, that it was for the public good.

Though it never mattered in *GM* (because the case for the 363 sale was so overwhelming anyway), I’ve always wondered whether I should have considered the “public interest” or “public good”\(^{14}\)—including, but not limited to, the welfare of the Supply Chain—as such. (In this case, the welfare of the Supply Chain was plainly for the public good, and the public good was advanced by GM’s 363 sale in many other respects as well.) Was I too cautious in addressing those public interest concerns? Or, conversely, does a bankruptcy judge owe his or her duty to the debtor and its creditors alone?\(^{15}\)

\(^{10}\) *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983) (“*Lionel*”).

\(^{11}\) *Id.* at 1071 (“The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application.”).


\(^{13}\) *See id.* at 499 (“[T]he Court finds that none of the U.S. Treasury, the Government of Canada, the Government of Ontario, or EDC acted inequitably in any way. They advanced funds to help thousands of creditors, citizens, employees of GM, and employees of suppliers and others. Their efforts to ensure that they were not throwing their money away in a useless exercise, and were expecting GM to slim down so it could survive without governmental assistance, are hardly inequitable; they were common sense.”).

\(^{14}\) I use the two expressions effectively synonymously.

\(^{15}\) Of course, many (and perhaps the great bulk) of GM’s Supply Chain vendors were parties to executory contracts. And when those executory contracts were assumed and assigned, defaults would need to be cured, and those vendors were paid in full. Though I never heard evidence of such, I suspect this was a key factor in saving the Supply Chain, and I wouldn’t be surprised to hear this was an element of the industry survival strategy crafted by the Auto Task Force.
For the next case that comes down the road, I’d suggest to the Bench and Bar that there’s room for the public interest to be considered—at least in the context of 363 sales, where such sales are an alternative to other options, such as awaiting the confirmation of a plan, or, perish the thought, liquidation. Sales under section 363 of the Code are subject to what I call the “Common Law of Bankruptcy”—which I very much believe to exist. 16

And where, as here, there’s nothing in the Code commanding otherwise, the fact that many bankruptcy court decisions are governed solely by the Common Law of Bankruptcy increases the extent to which a bankruptcy judge can do good.

We all know what section 363 provides. With exceptions not relevant here, it says, in relevant part:

(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....

And nothing more. So textual analysis is useless in this context. And “plain meaning” analysis is useless as well. In fact, if plain meaning analysis were employed to construe section 363(b), there would be no substantive limits on the use of section 363(b) at all. As I noted in the GM Sale Opinion, section 363 has no carveouts from its grant of authority when applied in cases under chapter 11.17 Section 363 does not provide, in words or substance, that it may not be used in chapter 11 cases for dispositions of property exceeding any particular size, or where the property is of such importance that it should alternatively be disposed of under a plan. Nor does any other provision of the Code so provide.18

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16 See page 7 below.
17 GM Sale Opinion, 407 B.R. at 486.
18 Id.
Yet we know, from cases like *Lionel* and its progeny, that 363 sales can be undertaken before confirmation only for “good business reason.” That’s so even though the Second Circuit observed, in *Lionel*, that section 363(b) “seems on its face to confer upon the bankruptcy judge virtually unfettered discretion” to authorize sales out of the ordinary course.20

So what we have, then, is a requirement that doesn’t appear in the Code, but out of a judge-made law—the Common Law of Bankruptcy.

But that’s not a bad thing. Nobody would suggest, I think, that judge-made law could trump anything as to which the Code is specific.21 But even though the Code’s

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20 *Lionel*, 722 F.2d at 1069.
21 One decision suggests—in fact, quite strongly—that there’s no such thing as a Common Law of Bankruptcy. In *In re Kmart Corp.*, 359 F.3d 866, 871-72 (7th Cir. 2004) (“*Kmart*”), a panel of the Seventh Circuit was critical of judge-made law in the bankruptcy realm—there, in the context of the “Doctrine of Necessity” and orders that are entered pursuant to it, “Critical Vendor Orders.” The *Kmart* court stated:

> Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of “necessity” … today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. [Two cases from the 1800s employing the doctrine of necessity] predate the first general effort at codification, the Bankruptcy Act of 1898. Today the Bankruptcy Code of 1978 supplies the rules. Congress did not in terms scuttle old common-law doctrines, because it did not need to; *the Act curtailed, and then the Code replaced, the entire apparatus. Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text.*

*Id.* at 871 (emphasis added).

But nobody is suggesting that the Common Law of Bankruptcy does, or could, “trump the Code’s text.” At least in the respects discussed here, judge-made law is employed to address matters where the Code is silent—and where that judge-made law advances bankruptcy policy.

The *Kmart* court failed to consider (or at least note) the many examples of judge-made law, several of which appear below, that are employed to advance bankruptcy needs and concerns. And *Kmart* preceded the Supreme Court’s later decision in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017) (“*Jevic*”). Citing *Kmart*, in fact, the *Jevic* court noted; seemingly approved;
considerably more specific in the requirements it lays out than the now-superseded Bankruptcy Act ever was (even after the latter’s 1938 Chandler Act amendments), the modern Code still has a lot of holes—requiring bankruptcy judges to create and apply bankruptcy law interstitially. And relief must from time to time be fashioned, or denied, to better achieve the overall purposes of the Code, even when the Code is silent. Beyond the Lionel Rule, other examples of the Common Law of Bankruptcy—crafting rules or devices to better effectuate bankruptcy policy on matters where the Code is silent—are easy to find. In the Supreme Court, we see:

- Caselaw holding that notwithstanding the seemingly unqualified right to convert a case from chapter 7 to chapter 13, a debtor guilty of bad-faith forfeits his or her right to proceed under chapter 13;22
- Caselaw holding that the absolute priority rule applies not just to the confirmation of reorganization plans (as the Code expressly provides), but also to structured dismissals, under sections 349 and 1112 of the Code.23

and in any event did not disapprove bankruptcy practices that are not mentioned (much less authorized) under the Code. See 137 S. Ct. at 985 (“Courts, for example, have approved ‘first-day’ wage orders that allow payment of employees’ prepetition wages, ‘critical vendor’ orders that allow payment of essential suppliers’ prepetition invoices, and ‘roll-ups’ that allow lenders who continue financing the debtor to be paid first on their prepetition claims. … In doing so, these courts have usually found that the distributions at issue would ‘enable a successful reorganization and make even the disfavored creditors better off.’”).

22 See Marrama v. Citizens Bank of Mass., 549 U.S. 365, 373-74 (2007) (“Bankruptcy courts nevertheless routinely treat dismissal for prepetition bad-faith conduct as implicitly authorized by the words ‘for cause.’” … In practical effect, a ruling that an individual’s Chapter 13 case should be dismissed or converted to Chapter 7 because of prepetition bad-faith conduct, including fraudulent acts committed in an earlier Chapter 7 proceeding, is tantamount to a ruling that the individual does not qualify as a debtor under Chapter 13.”); id. at 376-77 (four justices dissented, believing the majority holding to be inconsistent with “the clear terms of the Bankruptcy Code”: “Nothing in § 706(a) or any other provision of the Code suggests that a bankruptcy judge has the discretion to override a debtor’s exercise of the § 706(a) conversion right on a ground not set out in the Code.”).

23 See Jevic, 137 S. Ct. at 983 (bankruptcy court could not approve a “structured dismissal” providing for distributions that failed to follow ordinary bankruptcy priorities without the affected creditors’ consent).
And in the law of my home circuit and district, and others, we see, among other things:

- the law underlying “first-day” orders, with origins in the “Doctrine of Necessity,” allowing certain pre-petition debt to be paid early in the case, long before the confirmation of a plan;\(^24\)

- the STN Trilogy (allowing a Creditors’ Committee, or even an individual creditor), to carry the sword for the Estate in prosecuting litigation where a debtor in possession is or may be conflicted;\(^25\)

- The *Metromedia* standard—permitting Third Party Releases if, but only if, certain court-made standards are satisfied;\(^26\)

- Standards for settlements which permit distributions in the course of the case, and deviations from the absolute priority rule, but nevertheless provide that the absolute priority rule is “the most important factor for courts to consider when deciding whether to approve a settlement under Rule 9019”;\(^27\)

- Use of section 105(a) of the Code with respect to matters as to which the Code is silent, such as stays of litigation against non-debtors, where necessary to facilitate a reorganization;\(^28\)

- The *Farmland* Factors, employed on applications to approve DIP financing.\(^29\)

\(^24\) See, e.g., Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 n.8 (3rd Cir. 2003); see also Kmart, 359 F.3d at 871-72 (which, after being critical of judge-made law in the bankruptcy realm, would nevertheless permit critical-vendor orders, but only when entered consistent with judicially prescribed standards).

\(^25\) See Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters.), 779 F.2d 901 (2d Cir. 1985); Commodore Int’l Ltd. v. Gould (In re Commodore Int’l Ltd.), 262 F.3d 96 (2d Cir. 2001); and Glinka v. Murad (In re Housecraft Indus. USA, Inc.), 310 F.3d 64 (2d Cir. 2002).

\(^26\) *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.),* 416 F.3d 136, 142 (2d Cir. 2005). Of course, in other circuits, Third Party Releases are not permitted at all.

\(^27\) See Iridium (Potomac) LLC v. Official Committee of Unsecured Creditors and JPMorgan Chase Bank (In re Iridium Operating, LLC), 478 F.3d 452, 463 n.18 (2d Cir. 2007).

\(^28\) *Johns-Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60, 64 (2d Cir. 1986) (section 105(a) powers may be exercised “where there is a basis for concluding that rehabilitation, the very purpose for the bankruptcy proceedings, might be undone by the other action”); see also *Adelphia Comm’ns Corp. v. Am. Channel, LLC (In re Adelphia Comm’ns Corp.)*, 345 B.R. 69, 85 (Bankr. S.D.N.Y. 2006); *Lyondell Chem. Co. v. CenterPoint Energy Gas Servs. Inc.*, 402 B.R. 571, 587 & n.33 (Bankr. S.D.N.Y. 2009)
When one is considering the application of the *Lionel* Rule (which itself is, as I’ve noted, wholly judge-made law, which imposes requirements that are in no way required by the text of the Code), it seems to me that at the least, matter advancing the Public Good should qualify as “Good Business Reason,” or otherwise provide a sound basis for approving a 363 sale. The Supreme Court itself evidenced a sensitivity to the Public Good when it stated, in *NLRB v. Bildisco and Bildisco* 30 (abrogated by statute in other respects but not in this one), that “[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.” 31

So I think I was unduly cautious. With the benefit of reflection, 10 years later, I think that I absolutely could have protected the Supplier Chain as part of a consideration of the public good, even if the decision to approve GM’s 363 sale that I made back in 2009 wasn’t as one-sided as it already was.

If bankruptcy judges are to fully succeed in making the Bankruptcy System work at its best, I’d suggest that they implement the Common Law of Bankruptcy more often, and consider what outcomes are most in the public good.

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31 *Id.* at 528.
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Keeping Fintech Fair: Thinking About Fair Lending and UDAP Risks

By Carol A. Evans, Associate Director, Division of Consumer and Community Affairs, The Board of Governors of the Federal Reserve System

Fintech is the latest wave in the continuing technological evolution of financial services. Fintech has already produced real benefits to consumers, including increased speed, convenience, and new product offerings that make it easier for consumers to manage their financial lives. Fintech may also offer ways to bring banking and new financial products to underserved communities, including products and accounts that help the underbanked manage their finances more easily, budget, and save.

Additionally, many firms are exploring ways to leverage new data and analytic techniques to extend credit to more consumers. It may be possible to extend responsible and fair access to credit to more consumers who do not have a traditional credit history and who would otherwise be denied access to prime credit. The Consumer Financial Protection Bureau (CFPB) has found that approximately 26 million Americans are credit invisible, which means that they do not have a credit record, and another 19.4 million do not have sufficient recent credit data to generate a credit score.

Some in the fintech world see an enormous opportunity to improve access to credit on fair terms but are frustrated that the complexities of consumer compliance laws may thwart progress, especially in the areas of fair lending and unfair or deceptive acts or practices (UDAP). On the other hand, some stakeholders, including consumer advocates, are alarmed that some firms are jumping headfirst into new data and products without adequately evaluating the risks. They believe that some fintech trends may not only be unfair to certain consumers but could serve to exacerbate existing inequities in financial access and result in the digital equivalent of redlining.

The purpose of this article is to offer some general guideposts for evaluating UDAP and fair lending risk related to fintech, with a focus on alternative data. Increasing fluency with fair lending and UDAP concepts can help integrate consumer protection considerations into the early phases of business development, which can ensure effective compliance and save everyone time in the long run. In fact, we often hear consumer compliance professionals express frustration that they are brought into the process late when it is harder to course correct. We encourage business executives to view their compliance colleagues as key partners who can provide valuable advice at every stage of the business development process. Of course, both fair lending and UDAP are broad areas of the law where sound legal analysis depends on the specific facts and circumstances. Thus, the summary that follows is intended to offer general questions to help guide thinking early on in the business development process. It is not a substitute for the careful legal review that should be part of any effective consumer compliance program.

LAYING THE FOUNDATION: FAIR LENDING AND UDAP BASICS

Before delving into the possibilities of fintech, it is helpful to first review the basics of fair lending and UDAP.

Fair Lending: The Equal Credit Opportunity Act and the Fair Housing Act

The Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) are the two key federal fair lending laws. ECOA prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of income from any public assistance program, or because a person has exercised certain legal rights under ECOA and other financial statutes. ECOA applies to both consumer and commercial credit. The FHA applies to credit related to housing and prohibits discrimination on the basis of race or color, national origin, religion, sex, familial status, and handicap.

The fair lending laws broadly prohibit two kinds of discrimination: disparate treatment and disparate impact. In some instances, both theories may apply. Disparate treatment occurs when a lender treats a consumer differently because of a protected characteristic. Disparate treatment ranges from overt discrimination to more subtle differences in treatment that can harm consumers and does not need to be motivated by prejudice or a conscious intent to discriminate. The Federal Reserve has made numerous referrals to the U.S. Department of Justice (DOJ) involving disparate treatment in pricing where bank employees charged higher fees or interest rates on loans to minorities than to comparably qualified nonminority consumers. These referrals have resulted in several DOJ enforcement actions. These cases typically involve situations in which bank employees had broad discretion to set interest rates and fees and could increase their own compensation by charging borrowers more.

Disparate impact occurs when a lender’s policy or practice has a disproportionately negative impact on a prohibited basis, even though the lender may have no intent to discriminate and the practice appears neutral. A policy or practice that has a disparate impact may violate the law, unless the policy or practice meets a legitimate business necessity that cannot reasonably be achieved by a means that has less impact on protected classes. Factors that may be relevant to business necessity could include cost and profitability. For example, the CFPB and DOJ brought a discrimination enforcement action against a wholesale lender in 2015. In that case, the CFPB and DOJ alleged that the lender’s policies with respect to broker fees
and its pricing practices resulted in minorities paying more for loans than nonminority borrowers and that the policies could not be justified by legitimate business necessity. In many cases, it is possible to frame an issue of possible discrimination as either disparate impact or disparate treatment. In fact, many enforcement actions do not indicate which theory was used. So, it is helpful to be familiar with both theories.

As we will explore further, fintech may raise the same types of fair lending risks present in traditional banking, including underwriting discrimination, pricing discrimination, redlining, and steering. Although some fintech trends may decrease certain fair lending risks, other trends could amplify old problems or create new risks.

Unfair or Deceptive Acts or Practices

Section 5 of the Federal Trade Commission Act prohibits unfair or deceptive acts or practices. The Dodd–Frank Wall Street Reform and Consumer Protection Act prohibits unfair, deceptive, or abusive acts or practices. Many states also have their own UDAP laws. Deceptive acts or practices are representations, omissions, or practices that are likely to mislead a consumer acting reasonably under the circumstances and are material (i.e., are likely to affect the consumer’s conduct or decision with respect to a product or service). Unfair acts or practices are those that cause or are likely to cause substantial injury to consumers that consumers cannot reasonably avoid. Additionally, the substantial injury must not be outweighed by countervailing benefits to consumers or competition.

Deception in the financial services industry often involves misrepresenting the terms or costs of financial products or services. For example, in 2015, the Federal Reserve announced a public enforcement action against a provider of financial aid and reimbursement services to colleges and universities and demand deposit account services to students. The Federal Reserve alleged, among other things, that the company failed to provide information about the fees, features, and limitations of its product before requiring students to decide how to receive their financial aid disbursement. Another example is the enforcement action of the Federal Trade Commission (FTC) and the Federal Deposit Insurance Corporation (FDIC) against CompuCredit, which advertised credit cards to consumers with poor credit histories. The FTC alleged that CompuCredit violated the UDAP prohibition when it misrepresented the amount of credit that would be available to consumers when they received the card, failed to disclose upfront fees, failed to disclose that purchases that triggered the company’s risk algorithm could reduce a consumer’s credit limit, and misrepresented a debt collection program as a credit card offer.

The unfairness prohibition is also relevant to financial services. In another FTC case, a website operator gathered extensive personal information from consumers for purported payday loan applications and purchased applications from other websites. Consumers believed that they were applying for loans, but the operator sold their application information, including Social Security numbers and bank account information, to companies that fraudulently debited their bank accounts.
SOME QUESTIONS TO CONSIDER WHEN THINKING ABOUT FINTECH AND ALTERNATIVE DATA

Many fintech firms and banks are exploring new data sources as well as new analytical techniques, an approach sometimes referred to as big data. Big data does not have a uniform definition, but it generally refers to the analysis of large, complex data sets that are collected over time from different sources. These data sets, combined with developments in analytics, such as machine learning, can open up new approaches to data modeling. Instead of formulating a hypothesis and collecting data to test it, data sets can be analyzed to find patterns that may emerge.

Much has been written about the potential positive uses of big data to help businesses better serve consumers and to help policymakers solve social problems, as well as about potential concerns, such as fairness and accuracy. These concerns are not limited to financial services but extend broadly to both commercial and governmental uses of big data. In the criminal justice system, a model used by courts to predict recidivism has been criticized for potentially overpredicting the chance that black defendants would commit another crime. In the world of Internet advertising, researchers found that women were less likely to be shown ads for high-paying jobs. And, when Amazon initially launched same-day delivery, its algorithms excluded many minority neighborhoods from the service.

So much depends on exactly which data are used, whether the data are accurate and representative, and how the data are used. A jarring reminder of the importance of representative data involves photo recognition software. Some photo software misclassified images of African Americans and Asian Americans, presumably because the data used to develop the software did not include sufficient diversity. Data also may reflect past biases. By way of illustration, if a hiring model for engineers is based on historical data, which may consist mostly of men, it may not adequately consider traits associated with successful engineers who are women. Thus, while statistical models have the potential to increase consistency in decision-making and to ensure that results are empirically sound, depending on the data analyzed and underlying assumptions, models also may reflect and perpetuate existing social inequalities. Thus, big data should not be viewed as monolithically good or bad, and the fact that an algorithm is data driven does not ensure that it is fair or objective.

To help evaluate alternative data in fintech, we suggest asking some questions early in the process. Before going further, it is important to underscore that institutions should conduct a thorough analysis to ensure compliance with consumer protection laws before implementing new data and modeling methods. The questions and discussion that follow are not offered to replace that careful analysis but may be helpful for institutions early in the business development process.

What Is the Basis for Considering the Data?

Is there a nexus with creditworthiness?

The first question to ask before using new data is the basis for considering the data. If the data are used in the credit decision-making process, what is the nexus with creditworthiness? Some data have an obvious link to creditworthiness and are logical extensions of current underwriting practices, while others are less obvious. For example, for small business lending, some creditors are developing new underwriting models based on financial and business records. These models consider many of the same types of data used in traditional underwriting methods but in an empirically derived way based on analyzing thousands of transactions. Some models may be expressly developed for certain businesses, such as day cleaners or doctors’ offices. In essence, these models are expanding automated underwriting — long used for mortgages and other consumer lending products — to small business loans. Similarly, for consumer loans, some firms consider more detailed financial information from consumers’ bank accounts — especially for “thin file” consumers who may lack extensive traditional credit histories — to evaluate their creditworthiness.

Using data with an obvious nexus to credit risk — and often data that have long been used but in a less structured way can make good sense for lenders and borrowers. Better calibrated models can help creditors make better decisions at a lower cost, enabling them to expand responsible and fair credit access for consumers. Additionally, these models may decrease fair lending risk by ensuring that all applicants are evaluated by the same standards.

On the other hand, some data may lack an obvious nexus to creditworthiness. These data may be viewed as proxies or signals of potential creditworthiness or future income. Generally, the more speculative the nexus with creditworthiness, the higher the fair lending risk. It is easy to find examples of correlations between variables that are not meaningfully related. Even if the data have some predictive foundation, to the extent the data are correlated with race or other prohibited bases under the fair lending laws, careful analysis is critical. For example, we understand that some lenders consider where an applicant went to school or an applicant’s level of education. These data should be carefully evaluated for legal compliance before being used. This approach is reflected in the CFPB staff’s recent no-action letter to a firm that considers educational data, in addition to traditional factors such as income and credit score, in underwriting and pricing loans. The CFPB recognized that the alternative data may benefit consumers who are credit invisible or lack sufficient credit history but conditioned the no-action letter on extensive fair lending testing and data reporting.

Careful analysis is particularly warranted when data may not only be correlated with race or national origin but may also closely reflect the effects of historical discrimination, such as redlining and segregation. For example, it’s been reported that some lenders consider whether a consumer’s online social network includes people with poor credit histories, which can raise concerns about discrimination against those living in disadvantaged areas. Instead of expanding access to responsible credit, the use of data correlated with race or national origin could serve to entrench or even worsen existing inequities in financial access. Finally, it is important to consider that some data may not appear correlated with race or national origin when used alone but may be highly correlated with prohibited characteristics when evaluated in conjunction with other fields.

Are the data accurate, reliable, and representative of all consumers?

Next, it is important to consider whether the data are accurate, reliable, and representative of a broad range of consumers. Inaccurate data can inappropriately penalize consumers and impair their access to credit. It also prevents banks from making loans available to creditworthy borrowers. In
recent years, for example, concerns have been raised about the accuracy and reliability of medical debt data. Federal Reserve and FTC studies have found widespread errors in public record data on consumers’ credit reports, much of which related to medical debt. Recent CFPB complaint data have underscored continuing concerns from consumers, including credit reports listing medical debt that was already paid, was for the wrong amount, or was not properly verified. As a result of concerns with these data, both FICO and VantageScore modified their scoring models to limit the weight placed on these debts. These changes followed a series of 2015 agreements between the three largest consumer reporting agencies and the attorneys general of over 30 states.

In addition to accuracy and reliability, it is important to consider whether the data are representative of all consumers or only a subset. Although the previous examples involving photo recognition and hiring may seem extreme, it is easy to see that many data sets may not be fully representative of the population for which the resulting model will be used. For example, data used for behavioral modeling — such as browsing and social media data — may be skewed toward certain populations.

While noting this risk, it is worthwhile to pause and emphasize that new research on alternative data may in fact improve data availability and representation for the millions of consumers who are credit invisible. Lenders currently lack good tools to evaluate these consumers’ creditworthiness. Alternative data may result in new data sources that are accurate, representative, and predictive. Such data can increase access to credit for this population and permit lenders to more effectively evaluate their creditworthiness.

Will the predictive relationship be ephemeral or stable over time?

Finally, it is important to consider whether the predictive potential of the data is likely to be stable over time or ephemeral. For example, if a model uses online data from social media sites, such as Yelp or Facebook, what happens to the reliability of those data as consumers’ online habits evolve?

How Are You Using the Data?

Are you using the data for the purpose for which they have been validated?

Are the data being used for marketing, fraud detection, underwriting, pricing, or debt collection? Validating a data field for one use — such as fraud detection — does not mean it is also appropriate for another use, such as underwriting or pricing. Thus, it is important to ask if the data have been
validated and tested for the specific uses. Fair lending risk can arise in many aspects of a credit transaction. Depending on how the data are used, relevant fair lending risks could include steering, underwriting, pricing, or redlining.

**Do consumers know how you are using the data?**

Although consumers generally understand how their financial behavior affects their traditional credit scores, alternative credit scoring methods could raise questions of fairness and transparency. ECOA, as implemented by Regulation B, and the Fair Credit Reporting Act (FCRA) require that consumers who are denied credit must be provided with adverse action notices specifying the top factors used to make that decision. The FCRA and its implementing regulations also require that consumers receive risk-based pricing notices if they are provided credit on worse terms than others. These notices help consumers understand how to improve their credit standing. However, consumers and even lenders may not know what specific information is used by certain alternative credit scoring systems, how the data impact consumers’ scores, and what steps consumers might take to improve their alternative scores. It is, therefore, important that fintech firms, and any banks with which they partner, ensure that the information conveyed in adverse action notices and risk-based pricing notices complies with the legal requirements for these notices.

Certain behavioral data may raise particular concerns about fairness and transparency. For example, in FTC v. CompuCredit, mentioned earlier, the FTC alleged that the lender failed to disclose to consumers that their credit limits could be reduced based on a behavioral scoring model. The model penalized consumers for using their cards for certain types of transactions, such as paying for marriage counseling, therapy, or tire-repair services. Similarly, commenters reported to the FTC that some credit card companies have lowered consumers’ credit limits based on the analysis of the payment history of other consumers that had shopped at the same stores. In addition to UDAP concerns, penalizing consumers based on shopping behavior may negatively affect a lender’s reputation with consumers.

UDAP issues could also arise if a firm misrepresents how consumer data will be used. In a recent FTC action, the FTC alleged that websites asked consumers for personal information under the pretense that the data would be used to match the consumers with lenders offering the best terms. Instead, the FTC claimed that the firm simply sold the consumers’ data.

**Are you using data about consumers to determine what content they are shown?**

Technology can make it easier to use data to target marketing and advertising to consumers most likely to be interested in specific products, but doing so may amplify redlining and steering risks. On the one hand, the ability to use data for marketing and advertising may make it much easier and less expensive to reach consumers, including those who may be currently underserved. On the other hand, it could amplify the risk of steering or digital redlining by enabling fintech firms to curate information for consumers based on detailed data about them, including habits, preferences, financial patterns, and where they live. Thus, without thoughtful monitoring, technology could result in minority consumers or consumers in minority neighborhoods being presented with different information and potentially even different offers of credit than other consumers. For example, a DOJ and CFPB enforcement action involved a lender that excluded consumers with a Spanish-language preference from certain credit card promotions, even if the consumer met the promotion’s qualifications. Several fintech and big data reports have highlighted these risks. Some relate directly to credit, and others illustrate the broader risks of discrimination through big data.

- It was recently revealed that Facebook categorizes its users by, among many other factors, racial affinities. A news organization was able to purchase an ad about housing and exclude minority racial affinities from its audience. This type of racial exclusion from housing advertisements violates the Fair Housing Act.
- A newspaper reported that a bank used predictive analytics to determine which credit card offer to show consumers who visited its site: a card for those with “average” credit or a card for those with better credit. The concern here is that a consumer might be shown a subprime product based on behavioral analytics, even though the consumer could qualify for a prime product.
- In another instance, a media investigation showed that consumers were being offered different online prices on merchandise depending on where they lived. The pricing algorithm appeared to be correlated with distance from a rival store’s physical location, but the result was that consumers in areas with lower average incomes saw higher prices for the same products than consumers in areas with higher average incomes.
- Similarly, another media investigation found that a leading SAT prep course’s geographic pricing scheme meant that Asian Americans were almost twice as likely to be offered a higher price than non-Asian Americans.
- A study at Northeastern University found that both digital steering and digital price discrimination were occurring at nine of 16 retailers. That meant that different users saw either a different set of products as a result of the same search or received different prices on the same products. For some travel products, the differences could translate to hundreds of dollars.

The core concern is that, rather than increasing access to credit, these sophisticated marketing efforts could exacerbate existing inequities in access to financial services. Thus, these efforts should be carefully reviewed. Some well-established best practices to mitigate steering risk could help. For example, lenders can ensure that when a consumer applies for credit, he or she is offered the best terms she qualifies for, regardless of the marketing channel used.

**Which consumers are evaluated with the data?**

Are algorithms using nontraditional data applied to all consumers or only those who lack conventional credit histories? Alternative data fields may offer the potential to expand access to credit to traditionally underserved consumers, but it is possible that some consumers could be negatively impacted. For example, some consumer advocates have expressed concern that the use of utility payment data could unfairly penalize low-income consumers.
and undermine state consumer protections. Particularly in cold weather states, some low-income consumers may fall behind on their utility bills in winter months when costs are highest but catch up during lower-costs months.

Applying alternative algorithms only to those consumers who would otherwise be denied based on traditional criteria could help ensure that the algorithms expand access to credit. While such “second chance” algorithms still must comply with fair lending and other laws, they may raise fewer concerns about unfairly penalizing consumers than algorithms that are applied to all applicants. FICO uses this approach in its FICO XD score that relies on data from sources other than the three largest credit bureaus. This alternative score is applied only to consumers who do not have enough information in their credit files to generate a traditional FICO score to provide a second chance for access to credit.

Finally, the approach of applying alternative algorithms only to consumers who would otherwise be denied credit may receive positive consideration under the Community Reinvestment Act (CRA). Recent interagency CRA guidance includes the use of alternative credit histories as an example of an innovative or flexible lending practice. Specifically, the guidance addresses using alternative credit histories, such as utility or rent payments, to evaluate low- or moderate-income individuals who would otherwise be denied credit under the institution’s traditional underwriting standards because of the lack of conventional credit histories.

ENSURING THAT FINTECH PROMOTES A FAIR AND TRANSPARENT MARKETPLACE

Fintech can bring great benefits to consumers, including convenience and speed. It also may expand responsible and fair access to credit. Yet, fintech is not immune to the consumer protection risks that exist in brick-and-mortar financial services and could potentially amplify certain risks such as redlining and steering. While fast-paced innovation and experimentation may be standard operating procedure in the tech world, when it comes to operating financial services, the stakes are high for the long-term financial health of consumers. Thus, it is up to all of us — regulators, enforcement agencies, industry, and advocates — to ensure that fintech trends and products promote a fair and transparent financial marketplace and that the potential fintech benefits are realized and shared by as many consumers as possible.

Endnotes

1 The author gratefully acknowledges the research assistance of Katrina Blodgett.


3 There are many important consumer protection topics that are outside the scope of this article, including the Fair Credit Reporting Act and data security. For general information on these issues, see Federal Trade Commission, “Big Data: A Tool for Inclusion or Exclusion?” (January 2016), https://www.ftc.gov/system/files/documents/reports/big-data-tool-inclusion-or-exclusion-understanding-issues/160106big-data-rpt.pdf. For example, as noted on page 22 of this report, failure to reasonably secure consumers’ data could be considered an unfair practice under the Federal Trade Commission Act.


5 The Supreme Court recently affirmed the availability of a disparate impact theory under the Fair Housing Act in Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc., 135 S.Ct. 2507 (2015). It ruled that the Fair Housing Act permits liability under a disparate impact theory, and the act prohibits policies that seem to be neutral on their face but have a disparate impact on a protected class.


20 Although social media data may be considered nontraditional data for consumer lending, assessing a firm’s online presence, including visibility and reviews, may be viewed as a logical extension of data used in the manual underwriting of small business loans.


23 The no-action letter states that the CFPB does not currently plan to bring a supervisory or enforcement action against Upstart with respect to ECOA. The firm’s application describes its underwriting model, which considers educational attainment in addition to traditional credit factors, particularly for consumers with little credit history. CFPB staff specified that the no-action letter was issued based on the facts and circumstances of the applicant, and that the no-action letter does not endorse the use of any particular credit variables or credit modeling. CFPB staff conditioned the no-action letter on the firm regularly reporting lending and compliance information to the CFPB to mitigate risk to consumers and to assist the Bureau in understanding the impact of alternative data on lending. CFPB, “CFPB Announces First No-Action Letter to Upstart Network” (September 14, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/.


25 Robert B. Avery et al., “An Overview of Consumer Data and Credit Reporting,” Federal Reserve Bulletin at 68, 71 (February 2003), https://www.federalreserve.gov/pubs/bulletin/2003/0203lead.pdf (noting that there may be errors and inconsistencies in public record reporting, including medical collections lawsuits, for several reasons: Many individuals have multiple public record items that appear to be part of a single episode, there are inconsistencies in public record reporting among geographic areas, and lack of data regarding the type of plaintiff in a public record action, such as a collector of medical debt); id. at 69 (finding that about 52 percent of collection accounts are based on medical debt); Federal Trade Commission “Report to Congress Under Section 319 of the Fair and Accurate Credit Transactions Act of 2003” (Accuracy Study) 50-51 (December 2012), at https://www.ftc.gov/sites/default/files/documents/reports/section-319-fair-and-accurate-credit-transactions-act-2003-fifth-interim-federal-trade-commission/130211factareport.pdf (finding 44 potential and 25 corrected errors relating to public records out of 1,001 study participants); at 3, 50-51 (noting that collection accounts can include medical bills and finding 502 possible errors relating to collection accounts with 267 corrected out of a sample of 1,001 consumers).

26 Illustrating the potential impact of errors, a 2014 CFPB report found that about 19.5 percent of consumers have medical collection tradelines on their consumer reports. Of consumers that have any collection tradelines on their reports, 22 percent have only a medical debt trade line, and 50 percent of those consumers have a credit history with no other major blemishes. CFPB, “Consumer Credit Reports: A Study of Medical and Non-medical
technology/2016/03/facebooks-ad-platform-now-guesses-at-your-race-based-on-your-behavior/.


rates, stricter credit cutoffs, or less debt forgiveness to consumers in Puerto Rico and other U.S. territories and some consumers with Spanish-language


million-settlement.


See, e.g., National Consumer Law Center, “Full Utility Credit Reporting: Risks to Low-Income Consumers” (July 2012), (discussing risks to consumers of utility credit reporting and high rates of delinquency for low-income households in cold weather states); Massachusetts Department of


What Is “Credit”? AfterPay, Earnin’, and ISAs

Adam J. Levitin

*Updated version of blog post on CreditSlips.org, July 16, 2019*

A major issue in consumer finance regulation in mid-20th century was what counted as “credit” and was therefore subject to state usury laws and (after 1968) to the federal Truth in Lending Act. Many states had a time-price differential doctrine that held that when a retailer sold goods for future payment, the differential between the price of a cash sale and that of credit sale was not interest for usury law purposes. State retail installment loan acts began to override the time-price doctrine, however, and the federal Truth in Lending Act and regulations thereunder eventually made clear that for its purposes the difference was a “finance charge” that had to be disclosed in a certain way. *See Mourning v. Family Publications Serv. Inc.*, 411 U.S. 356 (1973).

Today, we seem to be coming back full circle to the question of what constitutes “credit.” We’re seeing this in four different product contexts: buy-now-pay-later products like Afterpay; and payday advance products like Bridgit, Dave, and Earnín; earned income access products, such as DailyPay and PayActiv; and Income-Sharing Agreements or ISAs (used primarily for education financing). Each of these three product types has a business model that is based on it not being subject to some or all “credit” regulation. Whether those business models are well-founded legally is another matter.

**What Is “Credit”?**

Let me briefly recap what is “credit” for different regulatory purposes and then turn to its application to the types of products.

The first thing to know is that “credit” is generally a defined term, but there is not just a single definition of “credit” for federal statutory purposes. (I’m not going to get into the state question.) The overarching federal statute, which gives the Consumer Financial Protection Bureau authority to prohibit unfair, deceptive, and abusive acts and practices in consumer finance, the Consumer Financial Protection Act, defines “credit” as:

> the right granted by a person to a consumer to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment for such purchase.

12 U.S.C. § 5481(7). No definition of “debt” is given in the CFPA. A similar definition of “credit” appears in the Equal Credit Opportunity Act and the Fair Credit Reporting Act (which references ECOA):

> the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor.

15 U.S.C. § 1691a(d). *See also* 15 U.S.C. § 1681a(r)(5). As with the CFPA, ECOA and FCRA do not define “debt.” But whereas the CFPA definition of “credit” does not reference a term “creditor” or “debtor,” the definition in ECOA/FCRA does, and ECOA/FCRA defines “creditor” as:
any person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit.

In other words, ECOA carves out the casual creditor. Thus, if I lend you $10 for lunch, I am not a creditor for ECOA purposes unless I do so regularly.

The Fair Debt Collection Practices Act does not define “credit,” but it has an even broader definition of “creditor” that references debt:

any person who offers or extends credit creating a debt or to whom debt is owed...

15 U.S.C. § 1692a(4). “Debt” is then defined by the FDCPA as:

any obligation or alleged obligation of a consumer to pay money arising out of a transaction in which the money, property, insurance, or services which are the subject of the transaction are primarily for personal, family, or household purposes, whether or not such obligation has been reduced to judgment.

15 U.S.C. § 1692a(5). Truth in Lending’s definition of “credit” is quite similar to CFPA and ECOA/FCRA:

the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.

15 U.S.C. § 1602(f). The TILA definition of “creditor” is quite different, however:

The term ‘creditor’ refers only to a person who both (1) regularly extends, whether in connection with loans, sales of property or services, or otherwise, consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness or, if there is no such evidence of indebtedness, by agreement.

15 U.S.C. § 1602(g). Got that? Credit is generally defined as the right to defer payment of an obligation. But sometimes it has to be granted by a “creditor,” and “creditor” is defined substantially differently by statute. In particular, TILA requires either a possible finance charge or payment in more than four installments.

Buy-Now-Pay-Later Products

This finance charge or four-installments provision is key for buy-now-pay-later products like Afterpay. Afterpay allows the consumer to purchase goods now and pay over 4 equal installment payments. So, it’s within the 4-installment part of the “creditor” definition. And Afterpay does not have a charge if you pay on time. It only has a late fee. Late fees are excluded from the finance charge if it is for “actual, unanticipated late payment.” So, if borrowers are anticipated to pay off the Afterpay advance within the four installments, no problem—no finance charge, and not a “creditor” for TILA, and therefore not subject to TILA disclosure rules, TILA error resolution rules, or TILA unauthorized transaction liability limitation rules. Of course, if most consumers are paying late, then Afterpay’s late fee would be a finance charge, so it would
be a creditor, extending credit and subject to TILA. (I have no reason to believe that this is the case).

Note, however, that even though Afterpay is not subject to TILA, it is still subject to ECOA, FCRA, FDCPA, and the Consumer Financial Protection Act.

**Payday Advance**

A similar story emerges for payday advance products like Brigit, Dave, and Earnin’. Some of these products (e.g., Earnin’) advance the borrower a small sum, payable in, say a month. In order to get the advance, the borrower must demonstrate a repayment source (e.g., employment or government benefits) and give the lender an ACH debit authorization to pull the money from the borrower’s bank account on the due date. The debt is non-recourse, but Earnin’ will not make the consumer future advances if an advance has not been repaid. That means that Earnin’ does not allow for rollovers, unlike a standard payday loan.

Earnin’ doesn’t charge for its service, but does solicit tips. That’s not finance charge, and it’s one installment. Not a TILA creditor. Note, however, that the NY Dep’t of Fin. Services is investigating whether the future advances are contingent upon tipping, which might change the TILA (and state usury law) analysis and also raise deception issues. (Again, I have no reason to believe that this is the case.)

Brigit has a different model—it has a monthly fee for eligibility for advances, but no fee for a specific advance. Again, outside the scope of the finance charge definition and thus from the TILA definition of creditor. So, payday advance products aren’t “credit” for TILA, meaning they do not have to comply with disclosure, error resolution, and unauthorized transaction liability rules, but they certainly are “credit,” for ECOA, FCRA, FDCPA, and the CFPA and therefore subject to those statutes.

**Earned Income Access Products**

“Earned income access” products are similar to payday advance products, but with an important distinction, namely they are integrated directly with the borrower’s employer’s payroll process. Whereas the payday advance products are loans arranged outside of the context of the borrower’s employment and allow the lender to draw on the borrower’s bank account, earned income access programs are arranged in the context of the borrower’s employment and create an automatic diversion of the borrower’s paycheck to the lender. Earned income access is, in essence voluntary, contractualized wage garnishment.

Major earned income access providers are DailyPay, FlexWage, Green Dot, and PayActiv. Some earned wage access programs, such as PayActiv, utilize the flat membership fee approach like Brigit does for payday advances. The cost does not depend on the amount of the advance. Others, such as DailyPay, have a flat fee per advance. The former structure would not be credit under TILA as it is repayable in less than four installments and without a finance charge, but the latter would be credit under TILA because the flat fee per advance is a finance charge.

Earned income access programs claim that they are not lenders. For example, on its FAQ page, PayActiv states that it is not a consumer loan provider, but is instead “a financial technology solutions provider. It is not a credit solution.” Yet later on the same page, PayActiv
notes that “PayActiv fronts the cash to the employees.” While PayActiv might not be a creditor under TILA, it is important to recognize that it might well be a creditor under other federal statutes. California is currently considering legislation, SB 472, that would create a state licensing regime for earned income access products.

Income-Sharing Arrangements

That brings us to Income-Sharing Arrangements or ISAs. These are commonly used for education finance. The basic idea is that the provider (lender?) advances funds to the consumer for tuition/living expenses. The consumer commits to paying the provider a percentage of his or her future income over and above a minimum amount. The total number of payments, payment time and/or amount of payment is often capped. The idea is that the more you earn, the more you pay—if you get a degree and can’t get a job, you will owe nothing, but if you’re making bank, you’ll owe more than if you have a middling job.

ISAs are conceptually quasi-equity financing of education, but emphasis on the quasi—it’s more like participating preferred shares, in that if there’s enough to pay the common equity (the consumer) a dividend, then the preferred shares must be paid a dividend. While we often call preferred shares equity, they’re really a hybrid of equity and debt features.

Whether ISAs are credit is critical to their viability. ISAs are priced differently depending on school and/or major. A computer science major is likely to have to pay a lower percentage than an anthropology major. One might imagine a pricing differential between students at an HBCU or minority-serving institution and at other schools. If ISAs are credit for ECOA purposes, there’s likely, therefore, to be major disparate impact issues.¹

So, are ISAs credit? ISA providers and their lawyers don’t think so.² For CFPA purposes, there are two possible ways it could be. First, for ISAs provided by the school itself (such as Perdue University³), the answer is clearly yes. “Credit” is “the right granted by a person to a consumer to…purchase…services [education] and defer payment for such purchase.” If a school is the ISA provider, it’s definitely credit for the CFPA, which means UDAAP prohibitions apply. I think the answer is also the same if the provider is affiliated with the school, as the CFPA has an anti-evasion provision in its definition of “financial product or service”. 12 U.S.C. § 5481(15)(A)(xi)(I).

Second, for ISAs provided by third-parties, the question is whether the ISA is a “right granted by a person to a consumer to defer payment of a debt” or to “incur debt and defer its payment”. (To be sure, the language about “purchase property or services and defer payment for such purchase does not necessarily refer to a purchase from the person…”).

So, is there a “debt”? There is clearly an obligation to repay an advance of funds if certain conditions obtain. Is a contingent repayment obligation a debt? None of the federal credit

³ https://www.purdue.edu/backaboiler.
statutes, other than the FDCPA, tell us what a “debt” is. FDCPA tells us that a debt is an obligation to pay money and doesn’t have to be reduced to judgment. That indicates that there can be some level of dispute or contingency without affecting the status of “debt.” Now, FDCPA’s definition doesn’t control for CFPA, ECOA/FCRA, or TILA, but it’s instructive. The same too for the Bankruptcy Code, which defines a debt as “liability on a claim,” 11 U.S.C., § 101(12), and “claim” as a:

right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.

11 U.S.C. § 101(5). Thus, ISA obligations would be dischargeable in bankruptcy under the regular student loan discharge standard. The broad bankruptcy definition of “debt,” like that of the FDCPA, gives a pretty strong indication that “debt” ought to include contingent obligations to pay, especially as both statutes could will apply to the same contingent obligation.

So, there’s good reason to think that some, if not all, ISAs involve a debt and are therefore “credit,” for various federal regulatory purposes. The most natural read of the statutes is that ISAs are credit and subject to the full panoply of federal consumer finance regulations. Certainly from a purposivist angle, ISAs are financing, and it’s hard to think that Congress was OK with discriminatory equity financing, but not discriminatory debt financing. It’s not possible to reach a definitive legal conclusion at this point about whether ISAs involve “debt,” but I do not know how ISAs can confidently claim not to be “credit.” I cannot imagine a law firm responsibly issuing an opinion letter that these are not “debt,” but perhaps some might if paid enough.

If ISAs are “debt,” and therefore “credit,” then there are serious compliance issues for ISA providers for TILA, ECOA, and FCRA purposes, and, if any ISA obligations go into collection, for collectors of ISA obligations under FDCPA. This isn’t to say that the industry cannot be viable, but it will have to undertake some substantial changes.

I suspect what is going on is an attempt by the ISA industry to get the camel’s nose under the tent and become too-big-to-fail. If the ISA industry gets large enough before facing the regulatory question, the industry will be able to push back against any regulatory attempts by pointing to potential disruption and reliance of consumers upon the product. Frankly, this is an issue the CFPB should be getting out ahead on. The Bureau should be issuing regulatory guidance on ISAs as part of its regulation of the private student lending market. Alternatively, the Bureau could undertake a rule making defining “debt” under the CFPA.

More generally, the emergence at this moment of three product classes all dancing around the definition of “credit” under federal statutes, suggests that it might be time to reopen the issue both with regulatory guidance and formal rulemaking, as well as possibly legislatively. At the very least, a minimum baseline should be to apply the TILA error resolution provisions and unauthorized transaction liability rules to any product that allows deferred payment.

Licensing Issues

Putting aside the definition of “credit” under various federal statutes, a common regulatory issue for firms on the edge of “credit” provision is the question of whether they must be licensed by states in which they lend. If they are lending without the requisite license, that
raises a range of potential liability issues, including state and federal UDAP/UDAAP liability, and also raises questions about the enforceability of their loans.

The particulars of state licensing statutes vary, but it is worth noting that some state payday lending statutes are drafted in terms of “deferred deposit advances” and read literally require the consumer to post a post-dated check as part of the transaction. While that is the original payday lending model, many payday lenders, as well as payday advance and earned wage access lenders instead use an ACH authorization and eschew paper checks. Whether this distinction is sufficient to bring the lender outside of the parameters of the licensing statute is unclear.
1. Student Loan Refinancing (e.g., SoFi, LendKey, CommonBond, Laurel Road)

A number of FinTech companies have created online lending products for refinancing student loans. How might the refinancing of a student loan impact the non-dischargeability of the loan in a bankruptcy of a borrower?

a. Generally Non-Dischargeable

Section 523(a)(8) of the Bankruptcy Code provides that student loans generally are not dischargeable absent proof that not providing for discharge of the debt would impose an undue hardship on the debtor and the debtor’s dependents. The statute includes within the exception most public and private student loans. Not all student loans, however, fall within the exception of section 523(a)(8). With alternative financing for educational purposes becoming more prevalent, challenging whether the particular product fits within the exception may be fruitful ground for litigation.

Section 523(a)(8) provides as follows:

(a) A discharge . . . does not discharge an individual debtor from any debt --:

* * *

(8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents, for—

(A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

(ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or

(B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual.

Based on the above, aside from the undue hardship issue, the court must determine whether the obligation sought to be discharged fits within the four types of obligations that are excepted from discharge in either subsection (A) or (B). For example, is the debt in dispute an educational benefit overpayment or loan? If so, was it made, insured or guaranteed by a governmental unit? If not, was it made under any program funded at
least in part by a nonprofit institution? Alternatively, is the debt an obligation to repay funds received as an educational benefit, scholarship or stipend, rather than a loan or an overpayment? This kind of obligation may result from the failure of a student to meet certain criteria not to have to repay the benefit, scholarship or stipend, such as by not taking a job in a particular sector upon graduation or not satisfying other conditions to the provision of the funds.

If one of the three possible exceptions in subsection (A) has not been met, did the debt nevertheless arise from a “qualified education loan,” thus satisfying (B)?

Under section 221(d)(1) of the IRC, the term “qualified education loan” means:

any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses—

(A) which are incurred on behalf of the taxpayer, the taxpayer’s spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred,

(B) which are paid or incurred within a reasonable period of time before or after the indebtedness is incurred, and

(C) which are attributable to education furnished during a period during which the recipient was an eligible student.

Such term includes indebtedness used to refinance indebtedness which qualifies as a qualified education loan. The term “qualified education loan” shall not include any indebtedness owed to a person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or to any person by reason of a loan under any qualified employer plan (as defined in section 72(p)(4)) or under any contract referred to in section 72(p)(5).


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1 As a bankruptcy court recently explained, in In re Jean-Baptiste, 584 B.R. 574 (Bankr. E.D.N.Y. 2018) (“[t]he protection accorded educational loans under § 523(a)(8)(A)(i) extends to private loans provided the overall loan program pursuant to which such loans were issued received non-profit funding.” See also In re Pilcher, 149 B.R. 595, 600 (9th Cir. BAP 1993) (§ 523(a)(8) does not require the non-profit institution to fund the loan, only that the overall educational loan program receive non-profit funding).

2 Courts have held that the stated purpose and not the actual use of the loan determines whether a loan is an “educational loan” excepted from discharge under § 523(a)(8). Murphy v. Pa. Higher Educ. Assistance Agency (In re Murphy), 282 F.3d 868 (5th Cir. 2002); Busson-Sokolik v. Milwaukee Sch. of. Eng’g (In re Busson-Sokolik), 635 F.3d 261, 266 (7th Cir. 2011), cert. denied, 564 U.S. 1020 (2011). Presumably, any refinancing of a student loan should make the purpose clear to protect the non-dischargeable character of the loan.
b. Refinancing of Student Loan Debt

A number of online lenders have moved into the business of refinancing student loans. Some examples are SoFi, Earnest, ELFi, LendKey, CommonBond, CitizensOne and Laurel Road. Even some traditional banks and credit union, such as Wells Fargo, Bank of America and PenFed Credit Union, will refinance certain student loans. If a debt qualifies as a non-dischargeable student loan but then is refinanced through one of these lenders, does it maintain its status as a student loan excepted from discharge?

With respect to a “qualified education loan” covered by subsection (B) of section 523(a)(8), the answer lies in the definition of that term in the IRC. “Such term includes indebtedness used to refinance indebtedness which qualifies as a qualified education loan.” 26 U.S.C. § 221(d)(1). So, by definition, the refinancing of such a loan should make that refinance loan also non-dischargeable. However, Treasury Department regulations make clear that the new indebtedness must be incurred solely to refinance a qualified education loan.3

With respect to the types of student loan obligations that are made non-dischargeable by subsection (A) of Section 523(a)(8), nothing expressly states that the refinancing of any of those obligations does not change the character of the debts from non-dischargeable obligations. Presumably, courts would find the IRC language helpful, but not controlling, in the context of an obligation only covered by subsection (A).

Precisely what the refinancing vehicle looks like may also be relevant. Consolidation of prior debts may not actually refinance the debt, but merely add another loan on top of the existing loans. Even in a true refinance of student loan debt, in which the original student loan has been repaid in full through the new loan, the answer is that the refinancing may not alter the non-dischargeability of the debt. The new loan arguably was still a debt incurred for one of the types of debts covered by subsection (A), albeit to repay other debt incurred more closely in time to the incurrence of the educational expenses. No decisions have been identified that have addressed this issue.

2. Other Issues Relating to the Online Nature of New Lending Products

a. Choice of Law

If a lender with operations in only one state offers an online loan to a borrower located in another state and the borrower has no connection with the lender’s state other than having made the loan through the internet, will the lender’s choice of the law of its home state be enforced by a bankruptcy court sitting in the borrower’s state? It depends on the laws of the forum state and the fundamental policies of the states involved. In short, it’s complicated.

3 See 26 C.F.R. § 1.221-1(e)(3)(v) (“Refinanced and consolidated indebtedness—(A) In general. A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.”).

While the choice of law rules must be examined in any particular forum, generally, a choice-of-law provision will be honored “so long as the contract bears a substantial relationship to the chosen state.” See, e.g., Mary Kay Inc. v. Woolf, 146 S.W.3d 813, 816 (Tex. App. 2004) (emphasis added). Using Texas law as an example, a substantial relationship exists when “the contacts between the transaction and the chosen state” are “reasonably related,” and the “contacts themselves are not contrived in order to substantiate the choice of law.” Cook v. Frazier, 765 S.W.2d 546, 549 (Tex. App. 1989); see also Restatement (Second) of Conflict of Laws § 187 cmt. f (substantial relationship will exist except in “unusual situation where [selected law] is wholly fortuitous and bears no real relation either to the contract or to the parties”).

The fact that one of the contracting parties lives in the jurisdiction of the selected law and conducts business there may be enough to establish the requisite relationship. See, e.g., Cardoni v. Prosperity Bank, 805 F.3d 573, 581 (5th Cir. 2015) (“The parties had a reasonable basis for agreeing that Texas law would apply given that Prosperity is headquartered in the state.”).

The Restatement also allows for more than just the location of the parties to provide the basis for the “substantial relationship”—the transaction itself can provide the requisite link. See Restatement (Second) of Conflict of Laws § 187(2)(a) (“substantial relationship to the parties or the transaction”).

If there is a relationship between the transaction or the parties to that transaction and the selected law, the provision likely will be honored unless another state has (i) a materially greater interest and a more significant relationship to the transaction, and (ii) that state has a fundamental public policy that would cause its courts not to honor the choice-of-law provision. Saturn Capital Corp. v. Dorsey, No. 01-04-00626-CV, 2006 WL 1767602, at *8 (Tex. App. June 29, 2006), “[Fundamental] requires more than the mere enactment of a state law on the subject; there must be clear expression by the state’s courts that they “will refuse to enforce an agreement contrary to that law, despite the parties’ original intentions.” DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 680 (Tex. 1990).

Applying the above argument, an online lender’s choice of its home state’s substantive laws to apply to the loan may be enforceable despite the borrower’s lack of other contact with the lender’s state. Examination of the facts and the fundamental policies of the borrower’s state’s laws, however, may be required to determine whether the lender’s choice of law will be enforceable.

b. Participation of Online Lenders in Bankruptcy Cases
Anecdotally, many online lenders are not appearing in bankruptcy court seeking to enforce claims against bankrupt consumer borrowers. The time and expense of filing claims and disputing claim objections simply may not be worth the return to many of these lenders, particularly for low dollar, high-risk loans. In addition, some issuers may not be experienced in collections and recovering debt and may not want to expose their products to close judicial scrutiny. With defaults rising in credit card, automotive and certain other consumer debts, however, the pressure to seek recovery through bankruptcy claims may increase.

3. Marketplace Lending (e.g., Upstart, Lending Club) and Crowdfunding (e.g., Kickstarter, Indiegogo)

a. Impact of Marketplace Lending on Consumer Bankruptcy Filings

Certain FinTech loan products may allow consumers to avoid bankruptcy altogether. While interest rates on some of these products may be higher than traditional bank loans, according to at least one study, the availability of marketplace lending products may actually reduce consumer bankruptcy filings.

In that study, there was an observed reduction in marketplace lending in two states following the decision in *Madden v. Midland Funding LLC*, 786 F.3d 246 (2d Cir. 2015) (finding that nonbank assignees of national bank do not enjoy benefit of National Bank Act “preemption” permitting lenders to charge any interest rate provided it does not exceed rate permitted in bank’s home state).\(^4\) That resulting loss of marketplace lending was found to have an economically and statistically significant impact on consumer bankruptcy filings in those states. Access to marketplace loans may allow higher risk consumers to refinance, for example, credit card debt and medical expenses that those borrowers may seek to discharge through bankruptcy if such alternative credit is not available. See Piotr Danisewicz and Ilaf Elard, “The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy” (July 5, 2018), available at https://ssrn.com/abstract=3208908.

b. Who is the Creditor in Marketplace Lending and Crowdfunding?

While marketplace lending is based on the peer-to-peer lending concept, in some marketplace lending, a bank makes the loan and sells the loan to the investor vehicle that raises the capital through online individual investors. In other marketplace lending, an investment vehicle entity may make the loan directly to the borrower using the investors’ capital. If the borrower files for bankruptcy protection, who is the creditor? Presumably, the creditor is the investor vehicle that makes the loan or obtains title to the loan from the original lender. In this instance, the individual investors may not have the right to pursue collection of the loan in the bankruptcy proceeding.

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\(^4\) See also *In re Rent-Rite Superkegs West, Ltd.*, Case No. 17-21236 TBM, Adv. Pro. No. 18-1099 TBM, 2019 WL 2179688 (Bankr. D. Colo. May 20, 2019) (disagreeing with *Madden* decision, noting difficulties raised by applying usury laws of state of assignee and following the “valid when made” rule for promissory notes).
Do individual investors in marketplace lending products have standing to appear in bankruptcy court? The analysis likely is no different than that applied in the context of a participated or syndicated loan in the commercial context. The governing documents must be reviewed to determine who has enforcement rights. The note may, for example, be payable to an agent for the benefit of the lenders who may from time-to-time own a participation interest in the loan. Alternatively, the note may be payable to the lenders themselves. Standing to sue likely follows the legal title to the note, not the beneficial interests of lenders or investors in the note represented by the investment vehicle or an agent. See, e.g., In re Electroglas, Inc., Case No. 09-12416-PJW, 2009 WL 8503455 (Bank. Del. Sept. 23, 2009) (bankruptcy court denied attempts of both the majority noteholders and the minority noteholders to exercise a credit bid right; credit bid rights could only be exercised by the indenture trustee on behalf of the noteholders); Beal Savings Bank v. Sommer, 8 N.Y.3d 318, 321, 865 N.E.2d 1210 (2007) (individual lender in syndicated loan did not have right to enforce loan).

In situations in which the loan documents do not specify who has the right to exercise certain rights on behalf of a group of lenders, some courts have found that the administrative agent, or the collateral agent if one exists, has the right to act at the direction of the lender participants holding a majority in amount of the loan based on other provisions in the agreement. In re GWLS Holdings, Inc., Case No. 08-12430-PJW, 2009 WL 453110 (Bankr. Del. Feb. 23, 2009); In re Metaldyne Corp., 409 B.R. 671 (Bankr. S.D.N.Y. 2009). These courts have reviewed provisions of the credit agreement to determine whether the participants intended to act by collective action in the event of a default by the borrower, keeping one or more lenders from acting to enforce the collateral rights inconsistent with the desires of others. Whether collective action is required is a fact based determination to be made by reviewing the specific provisions of the credit agreement. See Beal Savings Bank, 865 N.E.2d at 321 (granting defendant’s motion to dismiss lawsuit brought by one syndicated lender seeking to enforce “keep-well” agreement when all other lenders had directed administrative agent to forbear from enforcing agreement).


Due to the relatively small size of each individual backer’s typical investment, the risk of individual backers seeking to enforce crowdfunding obligations of the recipient of the funds, the creator, may be quite small. According to one commentator, class proofs of claim arguably may provide a path for providing relief to numerous individual backers. See Crowdfunding in Bankruptcy Part II.
c. Is a Crowdfunding Obligation a “Claim” in Bankruptcy?

Section 101(5) of the Bankruptcy Code broadly defines a “claim” for bankruptcy purposes to include any “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 right to an equitable remedy for breach of performance if such breach gives rise to a right to payment . . . .”

Thus, a payment due on account of a promissory note or on account of an equity security interest is a claim in bankruptcy. Certain crowdfunding investments, however, might be structured as a pre-order, or a donation with a potential reward, rather than a right to payment that would be a claim in bankruptcy. See Crowdfunding in Bankruptcy Part I.

Backers of claims against a creator who obtains money through Kickstarter, for instance, may be entitled not only to an unsecured claim for any unfulfilled promise made by the creator, but also may be entitled to priority status under section 507(a)(7) of the Bankruptcy Code, up to $2,850, if their claim arises from the pre-petition deposit of money for undelivered goods or services for personal, family or household use. See id. For example, former crowdfunding recipient and motorcycle-helmet developer Skully Inc. scheduled its backers as priority unsecured creditors in its chapter 7 case. See In re Skully Inc., Case No. 16-31113, Dkt. No. 4 (Bankr. N.D. Cal. Oct. 4, 2016). Other crowdfunding sites, however, characterize the backer’s contributions as “pledges” that may not be conditioned on creator promises and thus may not give rise to claims in a creator’s bankruptcy. See Crowdfunding in Bankruptcy Part I.

In addition, the terms of the crowdfunding contract control whether a debt is created that is enforceable by legal action or merely an ethical obligation to attempt to create the product or service contemplated by the crowdfunding. Under some of the crowdfunding programs, creators need only demonstrate that they made a good faith effort to succeed and do not have to provide a refund if they cannot deliver the product. Hylton Levy, “Crowdfunding: The Bankruptcy Loophole,” Jan. 30, 2018, available at https://farbergroup.com/crowdfunding-bankruptcy-loophole/. A backer’s decision to invest is akin to a loan to a distant family member made on the basis of trust. “Such lenders, we all understand, are foolish to assume repayment or project delivery according to the letter of any law. Rather, they should view their contribution through the lens of a fluid (often, exciting, but equally often disappointing) human experience.”

Many of the crowdfunding investments similarly do not qualify as equity investments. Under the American JOBS (Jumpstart Our Business Start-ups) Act, which in 2012 amended provisions of the Securities Act of 1933, 15 U.S.C. § 177a et seq., creating equity interests through crowdfunding is not permitted without complying with certain securities laws. Many of the crowdfunding programs do not seek to create such interests in compliance with the JOBS Act due to the limited size of the crowdfunding investments and the costs of compliance. See id.

4. Merchant Cash Advances (e.g., National Funding, Square Capital, CanCapital, PayPal Capital, OnDeck, Rapid Finance)
a. Structure of MCA Transactions

A merchant cash advance ("MCA") is a variety of financing, structured as a sale of future receivables. In these transactions, the MCA company advances cash as a purchase price, usually to a small retail business and often in a lump sum, in exchange for daily payments to the MCA company consisting of a percentage of the business’s daily credit card and debit card sales. The payments are made directly to the MCA company by the processor that clears and settles the credit card payments for the business until the debt is repaid, usually during a term that lasts no more than 24 months. The MCA companies contend the arrangements are not loans and not subject to usury laws, and at least one New York state court has agreed. See IBIS Capital Group, LLC v Four Paws Orlando LLC, 2017 WL 1065071, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U) (N.Y. Sup. Ct. Mar. 10, 2017).

b. Enforceability of MCA Agreement Provisions in Bankruptcy

If the MCA agreement contains penalty and confession of judgment provisions, are they enforceable in bankruptcy? Will the MCA company continue to receive its share of the credit card receipts in a bankruptcy of its counterparty?

i. Penalty provisions

The Bankruptcy Code does not explicitly disallow claims for penalties provided by contract. Some such provisions may be disallowed as unenforceable under state law. In addition, section 506(b) of the Bankruptcy Code may provide a basis to disallow an enforceable penalty claim as a secured claim in favor of an oversecured creditor, leaving it as a potential unsecured claim. Section 510(c) also may provide a basis to equitably subordinate even an enforceable penalty claim under certain circumstances. While nonpecuniary penalty claims may be disfavored to the extent they would prefer one creditor over another in the pro rata distribution of available assets of a debtor, the allowance of a claim must be considered based on the specific agreement and the facts and circumstances of the case.

A claim is defined in section 101(4) of the Bankruptcy Code as a “right to payment” or a “right to an equitable remedy for breach of performance if such breach gives rise to a right to payment.” Whether a contractual provision providing for liquidated damages is in fact a right to payment or an unenforceable penalty is a question of state law. In re 1141 Realty Owner LLC, 598 B.R. 534, 541-42 (Bankr. S.D.N.Y. 2019), see also In re United Merchs. & Mfrs., Inc., 674 F.2d 134, 141 (2d Cir. 1982); Hassett v. Revlon, Inc. (In re O.P.M. Leasing Servs., Inc.), 23 B.R. 104, 111 (Bankr. S.D.N.Y. 1982).

Generally, liquidated damages are authorized if the amount specified is determined to be reasonable and the amount of damages is difficult to ascertain. See, e.g., Unified School District No. 315 v. DeWerff, 6 Kan.App.2d 77, 626 P.2d 1206, 1208 (1981). A liquidated damages clause is valid under New York law, for example, if: (1) actual damages are difficult to determine, and (2) the sum is not "plainly disproportionate"

A court is required to evaluate the reasonableness of a liquidated damages provision from the viewpoint of the parties at the time of contracting. See, e.g., United Merchs., 674 F.2d at 142. The court must examine the purpose of the prepayment premium provision to ascertain its reasonableness. See id.; Walter E. Heller & Co., 459 F.2d at 898-99.

“The party seeking to avoid the liquidated damages clause bears the burden of proving that it is a penalty and must demonstrate either that the damages flowing from prepayment were readily ascertainable at the time the parties entered into the lending agreement or the prepayment premium is “conspicuously disproportionate” to the lender’s foreseeable losses.” 1141 Realty Owner, 598 B.R. at 542 (quoting JMD Holding Corp. v. Cong. Fin. Corp., 828 N.E.2d 604, 609 (N.Y. 2005)). “This burden must be considered in light of the admonition that the historical distinction between liquidated damages and penalties has become increasingly difficult to justify, and courts should not interfere with the parties’ agreement regarding liquidated damages ‘absent some persuasive justification.’” 1141 Realty Owner, 598 B.R. at 542 (quoting GFI Brokers, LLC v. Santana, No. 06 Civ. 3988 (GEL), 2009 WL 2482130, at *2 (S.D.N.Y. Aug. 13, 2009).

Federal bankruptcy law, and not state law, governs distribution of a debtor’s assets to creditors. American Surety Co. v. Sampsell, 327 U.S. 269, 272, 66 S.Ct. 571, 573, 90 L. Ed. 663 (1946); Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 162-63, 67 S.Ct. 237, 240, 91 L. Ed. 162 (1946). Thus, if the claim is asserted as a secured claim, section 506(b) of the Bankruptcy Code is applicable and the secured creditor would be entitled to collect reasonable charges. If the penalty provision is valid under state law, the court likely would still be required to determine its enforceability under the Bankruptcy Code.

In the context of a secured claim, section 506(b) imposes two requirements for the collection of an additional charge by an oversecured creditor: (1) the charge must be provided for in the agreement, and (2) the charge must be reasonable. See, e.g., Joseph F. Sanson Investment Co. v. 268 Limited (In re 268 Limited), 789 F.2d 674, 676-78 (9th Cir. 1986). If the provision is unreasonable, section 506(b) prohibits its application. Id.

Accordingly, the allowance of a penalty provision in an MCA agreement depends on the facts and circumstances of the particular provision and its reasonableness.

ii. Confession of judgment provisions

Due to the automatic stay, upon the bankruptcy of a party that received funding under an MCA agreement, the MCA company should not be able to enforce a confession of judgment provision. Confessions of judgment typically provide the holder of a
promissory note or other instrument a power of attorney to act for the borrower or obligor in confessing judgment for the obligation. Under section 362(a)(6) of the Bankruptcy Code, the act of confessing judgment undoubtedly would be viewed as an “act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.” In addition, acting on behalf of the estate pursuant to a power of attorney likely also would be a violation of section 362(a)(3), barring any “act . . . to exercise control over property of the estate,” i.e., the debtor’s right to confess judgment.

iii. Continuation of rights of MCA company in credit card receivables

A debtor subject to an MCA agreement might argue that the MCA company’s right to collect a portion of its credit or debit card receivables is cut off by section 552(a) of the Bankruptcy Code. The answer may depend on the proper characterization of the MCA transaction. Did the transaction result in the sale of certain receivables, or was the transaction a disguised loan subjecting a portion of the receivables to a secured interest in favor of the MCA company? If the transaction was a true sale, then the MCA company owns those receivables. If the MCA company only has a lien on a portion of the receivables, section 552 and cash collateral issues will come into play in the debtor’s attempt to use the receivables to fund post-petition operations.

5. Early Wage Access (e.g., PayActiv, ZayZoon, Branch, DailyPay, Earnin, Even Responsible Finance)

a. Structure of Financing

Some employers are finding that assisting their employees with early access to some or all of their net earnings before their typical payday may boost morale and productivity since financial stress may affect employees’ ability to perform their jobs, including missing work to address personal financial issues. As a result, some employers now offer early wage access products in partnership with FinTech companies.

Some programs are structured only to allow payment of previously earned net wages, while other products may actually be advances against wages not yet fully earned. Some programs provide a limited number of free drawdowns or “Instapays,” up to a limited amount, immediately upon the employer’s payroll funding to their payroll provider, but prior to the time a direct deposit of the paycheck would hit the employee’s account. Walmart reportedly has a different program, allowing employees to request, in certain situations, that their employer run a daily payroll to pay them directly what they owe through that day, in advance of the normal payday.

Who is advancing the funds under these programs, the employer or the program provider? It depends on the program. In many, the employer is funding payroll that has been earned, albeit perhaps a bit earlier than otherwise required. In some, the FinTech company may be advancing funds after confirming the amounts the employer is funding into their payroll provider, with repayment to come to the FinTech company out of the
direct deposits when they otherwise would hit the employees’ accounts. There likely are variations on these approaches.

b. Bankruptcy Issues

What if an employee files for bankruptcy while using one of these early wage access products? Does the employer have a setoff right against the bankruptcy employee? Does the automatic stay operate to prohibit exercise of any such setoff right without relief from the automatic stay?

In many cases, there may not be any debt owed to the employer because the funds advanced or paid were fully earned by the employee, just paid earlier than normal. If for some reason funds are owed back to the employer because the employee was not entitled to receive the funds, some of the FinTech firms offer to indemnify the employer against that risk.

If the employer is owed funds from the employee at the time of his or her bankruptcy filing, however, the impact of the automatic stay, as well as the application of state law, must be considered. Section 362(a)(7) of the Bankruptcy Code expressly enjoins “the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.”

Whether setoff or recoupment is at play is critical to the application of the automatic stay. Recoupment is a common law equitable principle that allows the netting of credits and debts that arise from the same transaction. Newbery Corp. v. Fireman’s Fund Ins. Co., 95 F.3d 1392, 1399 (9th Cir. 1996). Setoff, on the other hand, is applicable between two parties with mutual debts, acting in mutual capacities, irrespective of whether the debts arose from the same transaction.

If the debt owed to the employer by a bankruptcy employee arises under an early wage access program it likely arises from the same transaction as any debt owed by the employer to the employee for the balance of the wages owed. Thus, the mutual debts would fall into the principle of recoupment, and the employer should be able to recoup those funds from the employee’s later paycheck, provided that the employee wage access program and any other applicable state law and employment rules and regulations allow it. See In re Williamson, No. 17-1375, 2018 WL 4926430 (B.A.P. 9th Cir. Oct. 10, 2018) (allowing recoupment of overpayment of retirement benefits against monthly benefit payment). Recoupment, however, may be viewed restrictively in certain bankruptcy courts, so careful consideration should be given as to whether the transaction giving rise to the mutual debts will be viewed as one or more transactions. Compare id. at *2-3 (applying “logical relationship” test, examining whether debts arose from the same operative facts) with Westinghouse Credit Corp. v. D’Urso, 278 F.3d 138, 147 (2d Cir. 2002) (applying “single integrated transaction” test, finding recoupment applies only if “both debts arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations”) (citations omitted).
Debts owed to the employer by the employee for matters unrelated to the advance of wages, however, may only give rise to a setoff right, not recoupment, and likely require relief from or termination of the automatic stay before the setoff can occur. See 11 U.S.C. § 362(a)(7).

6. Clean Energy (PACE) and Home Improvement and Solar Contracts (e.g., GreenSky)

a. Structure of Financing

Various methods exist to finance energy efficiency home improvements, such as the installation of solar power and improved HVAC systems. Some financing may be offered through local or state programs (Property Assessed Clean Energy financing, or PACE programs, available in 30+ states), while others may be offered through loans from banks or credit unions, sometimes supported by FinTech companies (e.g., GreenSky, Inc.).

In PACE financing, a special assessment is added to the residential tax bill and paid annually when the owner pays the real estate taxes. Upon receipt of the PACE assessment, the municipality remits the collected funds to the PACE lender. If the homeowner fails to pay the special assessment, the lender may be able enforce the assessment much like a municipality would for unpaid real estate taxes, by selling the real estate to pay the obligation. The PACE loan is typically secured by a lien right in favor of the lender on the real estate but non-recourse to the borrower. See Christopher J. Schreiber and David I. Cisar, “Emerging Issues: Residential PACE Loans and Bankruptcy,” The National Law Review, Feb. 8, 2018, available at https://www.natlawreview.com/article/emerging-issues-residential-pace-loans-and-bankruptcy (hereinafter, “Emerging Issues”).

In typical bank financing, the lender may take a security interest in the improvement made with the funding, such as HVAC or solar equipment. In many cases, such a security interest will be limited in scope of collateral to the improvement purchased with the financing. In some cases, however, the improvements may be made through a junior mortgage lien or deed of trust on the residence, whether through a home equity line of credit or a term loan.

b. Bankruptcy Issues

There has reportedly been a large increase in defaults by homeowners on PACE financing, particularly in California. If a borrower in either a PACE or bank financing of improvements files a chapter 13 bankruptcy case, are any rights or liens acquired by the party financing the improvements subject to modification in chapter 13 cases?

i. “Claims” in bankruptcy

Both the PACE loan debt and the bank-provided home improvement loans would be “claims” in any bankruptcy proceeding of the borrower. Despite the fact that the PACE debt may be non-recourse to the borrower, a non-recourse obligation is still a
claim under section 101(5) of the Bankruptcy Code because it qualifies as “a right to payment, or alternatively, a right to an equitable remedy” against property of the estate.” See Emerging Issues (citing In re LaMont, 740 F.3d 397 (7th Cir. 2014)).

ii. Modifying liens securing the financing

Chapter 13 of the Bankruptcy Code prohibits the modification of certain secured claims. Section 1322(b)(2) provides that “the plan may: (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 . . . .”

Under this provision, a residential PACE loan cannot be modified if there is no other collateral for the loan and the assessment is against real property and that real property is the principal residence of the debtor.

According to the authors of Emerging Issues, “the typical PACE loan involves an agreement among the borrower, PACE lender and municipality (as the taxing authority), which will likely have the characteristics of a “security agreement” creating a “security interest” in favor of the PACE lender. Although the characteristics of PACE loan agreements will vary from state to state, the PACE lender should be entitled to the anti-modification protections of § 1322(b)(2).”

With respect to a lien securing a traditional home improvement loan, even though the improvement may become a fixture and thus part of the real estate itself under some state’s laws, no case has been identified to date in which a court has decided whether a lien on an improvement to a principal residence was not subject to modification due to section 1322(b)(2). Based on the Bankruptcy Code’s definition of “debtor’s principal residence” in section 101(13A), a loan for improvement secured only by the improvement should be subject to modification. Section 101(13A) defines “debtor’s principal residence” to mean “a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to the real property.” The statute likely cannot be stretched to include loans secured by liens on only incidental property and not the residential structure itself. The lien first has to be a lien on real estate, and that real estate has to be the debtor’s principal residence. See In re Ennis, 558 F.3d 343, 345-46 (4th Cir. 2009). The HVAC is not the “residential structure” even if becomes part of the real estate under state law.

7. Issuer Bankruptcy Filings

What unique issues might arise if the issuer of one of these alternative financing products files for bankruptcy protection? There is little precedent for how borrowers and obligors who owe sums to the issuer may react to an issuer bankruptcy filing, in part because banks and savings and loan associations are not eligible to become debtors in bankruptcy cases pursuant to section 109. Will the value of the assets of the issuer diminish considerably upon a filing? Will debt buyers be willing to acquire the assets for fair value?
8. Cryptocurrency issues

FinTech has allowed for the proliferation of cryptocurrencies and for blockchain technology to track the settling of accounts through their use. Bankrupt debtors may file for protection while owning cryptocurrency for use in trades or as speculative investments. What happens when debtors file for protection owning cryptocurrency or have entered into contracts to be settled through cryptocurrency?

a. Ownership by Bankrupt Debtors

Bitcoin and other cryptocurrency owned by debtors in their accounts at the time of bankruptcy filing become property of their bankruptcy estate under section 541 of the Bankruptcy Code. They are an asset of the debtor, characterized most likely as a general intangible. While one of the attractions of many types of cryptocurrency is anonymity for the owner, one commentator has suggested there is no reason to suggest that a debtor will be any more likely to fail to disclose ownership of cryptocurrency than ownership of a gold ring. The penalties for failing to disclose assets of the estate should be sufficient disincentive to secreting estate assets through non-disclosure in the debtor’s bankruptcy schedules. In addition, while the debtor’s ownership of Bitcoin or other cryptocurrency may be anonymous to others, credit card and other account statements should allow a trustee to discover trades and ownership in cryptocurrency. Andrew C. Helman and Carl N. Wedoff, “When Blockchain Meets Article 9 and Bankruptcy,” Law 360, Feb. 9, 2018, available at https://www.law360.com/articles/1011153/print?section=banking.

b. How is Cryptocurrency to be Valued in Bankruptcy?

If a debtor fails to comply with a contractual obligation to pay in Bitcoin, for example, how is that claim amount established? Based on the value at the time of contracting, the time of breach or the time of bankruptcy? Is the claim to be paid in Bitcoin or the equivalent U.S. dollars at the time of distribution?

The court in In re Hashfast Technologies LLC, Adv. No. 14-30725, 2016 WL 8460756 (Bankr. N.D. Cal. Feb. 5, 2016), held that, for the purpose of section 550(a) of the Bankruptcy Code, Bitcoin was not equivalent to US dollars. The case involved a fraudulent transfer claim against a person who had been paid 3,000 Bitcoin in 2013 by the debtor. At the time the payment was made the 3,000 Bitcoin had an approximate value of $360,000, but had since appreciated to a value of $1.2 million. The critical issue was how the Bitcoin should be valued for purposes of recovery upon the transfer being avoided. Section 550(a) of the Bankruptcy Code states that if a transfer is avoided, the trustee is entitled to recover “the property transferred, or, if the court so orders, the value of such property.” The bankruptcy trustee argued that Bitcoin was property and that the estate was entitled to recover either the 3,000 Bitcoin or their current value of $1.2 million. The defendant, on the other hand, argued that Bitcoin was not property but rather the equivalent of U.S. dollars that retained its “face” value as of the date of transfer. Without deciding whether the Bitcoin was money or a commodity, the bankruptcy court decided it was not the equivalent of U.S. dollars and did not retain the
same face value over time. As a result, the court concluded that the value of the Bitcoin should be determined as of the date of the transfer.
ALTERNATIVE LENDING

through the Eyes of “Mom & Pop” Small-Business Owners:

Findings from Online Focus Groups
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Online alternative lenders are reporting rapid growth and recent surveys suggest more small businesses are turning to them as potential sources of credit. These nonbank lenders offer small-dollar credit products including cash advances, lines of credit, and various types of loans. Many provide the funds in days or even hours, expedience made possible with data-driven technologies and new approaches to underwriting, pricing, loan delivery, and servicing. While the industry holds promise for expanding access to credit, it also raises potential risks for small-business borrowers as these products can be considerably more expensive than traditional credit.

Few studies have examined the emergence of online lenders and the impact to the small-business credit environment, especially from the perspective of borrowers. In light of this, the authors set out to gauge small-business owners’ perceptions and understanding of online alternative lenders and the small-dollar credit products these lenders offer. The study was conducted using online focus groups, a method of gathering participants’ perceptions through online discussions—and in this case, an effective way to convene a group of geographically dispersed and busy small-business owners. The online format allowed for the collection of detailed responses as well as insights into the complex decision processes of potential borrowers. As part of the study, participants evaluated mock loan products and visited the websites of actual online lenders and shared their impressions.

The participants recruited for this study operate small businesses (“Mom & Pops”) with two to 20 employees and less than $2 million in annual revenues, from across the US, and in a wide range of industries. In total, 44 small-business owners participated in two separate online focus groups. Given the relatively small sample size, this study was not designed to derive conclusions about a representative sample of borrowers; rather, the intent was to surface key issues that could guide future research, data collection, and policy analysis.
Key Findings

The focus group findings reveal that as small-business owners navigate financial challenges, they turn to a number of sources for financial advice, including their banks. However, they did not necessarily perceive banks as a likely credit source. Some participants cited concerns about their ability to meet banks’ lending criteria, while others were skeptical about their banks’ willingness to lend to businesses of their size. The study also found that some participants did not readily recognize online alternative lenders as a distinct lender category. Rather, they view “online” as a place where they can shop for or obtain credit from both traditional and alternative sources.

While the focus group participants demonstrated an openness to online alternative lenders, their responses suggest areas of concern.

- **Online alternative lender websites are alluring, but trigger concerns about data security and privacy.**

  When asked for their initial top-of-mind impressions of online lenders, a majority of participants relayed negative to neutral reactions. Interestingly, attitudes shifted positively after participants visited actual lender websites. However, the lenders’ collection of businesses’ financial information raised data-security and privacy concerns, recurring themes in the discussions about online lenders.

- **Using information typically provided on online alternative lenders’ websites, small businesses find it difficult to compare credit products.**

  Although participants initially said it was “easy” to evaluate credit products when presented with several options, many expressed uncertainty or answered questions incorrectly when making specific product comparisons, particularly on cost.

- **Virtually all the focus group participants said they want clearly stated product features and costs and an easier way to compare product offerings.**

  Among their suggestions were interest rates expressed as APRs, straightforward explanation of all fees, and required statements about payment policies, including late fees and prepayment penalties.
Online alternative players and products

Small-business lending in 2015 looks very different from the lending environment in the years prior to the Great Recession. Bank lending to small businesses declined considerably in the post-recession period and credit remains tight, especially for small-dollar loans, or those under $250,000. At the same time, alternative online lenders have become increasingly active, although they account for a small share of the total small business credit market.

In this study, online alternative lenders are defined as nonbank credit providers operating online to serve small-business borrowers. The players include merchant cash advance companies that allow businesses to borrow against future sales and repay with a fixed percentage of daily credit card sales receipts. Some online lenders are marketplace lending platforms (also known as peer-to-peer lenders) that do not lend directly, but price the risk of loan applications and connect small-business borrowers with investors who have capital to lend. Other providers lend directly to small businesses and keep the loans on their balance sheets. Still others are payment processing firms that have made forays into the cash advance business by lending to their small-business account holders. Online alternative lenders often pull borrower data electronically, including non-traditional measures of creditworthiness such as customer ratings on social media.

The credit products offered by online alternative lenders go by a variety of names: business loans, peer-to-peer loans, lines of credit, funding programs, capital advances, business cash advances, or simply “funds.” Payment amounts may be fixed installments or based on a percentage of sales, and may be due daily, weekly, bi-monthly, or monthly. They also have varying repayment arrangements, for example, daily swipes of credit card receivables, payment accounts, or automated clearinghouse payments (ACH). Despite the differences, the products generally come in two varieties—loans and cash advances.

Loans: Typically, these are short-term loans underwritten by the online lender. Those with a fixed term usually are originated with an FDIC-insured bank that immediately assigns the loan back to the online lender. These loans are serviced by the online lender, who may package and sell the notes to investors.

Cash advances: Advances allow businesses to convert future credit card or payment account receivables into capital. While the distinction may be unclear to the borrower, these products differ from term loans in that they are the sale of a set percentage of the borrower’s future sales for a specified dollar amount. For example, $50,000 in capital is provided in exchange for $65,000 in future receipts, repaid with daily swipes of 10 percent of credit card sales.

In practice, both of these credit products are unsecured and often carry effective interest rates that exceed those of traditional bank products.

Drivers of online lending to small businesses

Online alternative small-business lending appears to be gaining traction, although the overall size of the industry is unclear due to a lack of independent data. Online alternative lenders are not subject to the same reporting requirements as banks, making it difficult to accurately assess the volume of lending taking place. Estimates come from industry sources and suggest rapid growth in the past several years. Whatever its precise magnitude, the growth appears to be fueled, to some extent, by both small-business borrowers and investors.

Among borrowers, there is evidence of unmet credit demand. For example, a recent small-business survey conducted by several Federal Reserve Banks indicates that 44 percent of credit applicants reported they received none of the funding they were seeking. The survey also suggests that small-business borrowers are increasingly turning to alternatives, with nearly one in five (18%) of those who applied for credit saying they applied to an online lender.
On the supply side, curtailed lending to small businesses by traditional banks may also be a factor driving the growth in alternative lending. Small-business lending has reportedly become less profitable relative to other types of lending, reducing banks’ interest in making small-dollar loans to small business. At the same time, while small businesses’ financial position (collectively) has improved, it is not yet as strong as reported prior to the recession. This makes it all the more challenging for small businesses to meet traditional banks’ credit standards.

Online alternative lenders assert their business models can more effectively meet small businesses’ small-dollar credit needs. Among their innovations are proprietary underwriting algorithms that the lenders say can identify borrowers most likely to repay, despite their inability to meet traditional lender criteria or collateral requirements. Also, online alternative lenders purport to underwrite, originate, and service credit more cheaply than traditional banks. They cite cost savings from not having a branch network (the biggest savings), as well as efficiencies from automated originations and online back office support.

Meanwhile, investors pursuing better returns in the current low-interest-rate environment are actively investing in the alternative lending industry. Interest is reportedly robust from investors looking to purchase the loans originated by the alternative lenders. Securitization activity is rising, and a few recent securitization transactions have earned investment-grade ratings. In addition, venture capital firms are backing many of the new entrants, as well as existing industry players, in developing their underlying platforms and technologies.

To keep pace with investor demand, online alternative lenders are seeking new borrowers to boost their lending volumes. They’ve been active in forming new partnerships with other corporations and non-profit organizations that serve small-business customers, as well as with traditional banks. These partnerships drive new customers to the lending platforms and supplement the flow of customers reached not only through brokers, but also through the online lending industry’s growing investment in marketing. Online alternative lenders have increased their television, radio, internet, and direct-mail advertising markedly in the past two years. Furthermore, some online alternative lenders continue to broaden their customer bases and the menu of products they offer to small-business borrowers. For example, a number of the lenders formerly focused on the consumer market are branching into small-business lending. Similarly, some of those that had offered only cash advances are now extending loans as well.

Implications for potential small-business borrowers

In short, online alternative lending is an emerging industry that its leaders say holds promise for increasing access to credit for small businesses. It is also a rapidly growing, crowded, and potentially confusing marketplace for prospective borrowers. From their perspective, a number of concerns arise. Small-business advocates note the prevalence of subprime lending in the industry as some firms, especially merchant cash advance companies, offer high-cost credit to borrowers with FICO scores in the low 500s. They also have raised concerns about questionable industry practices that result in “stacking” (i.e., the practice of providing cash advances to borrowers who already have outstanding cash advances).

Disclosure is another issue raised by advocates. Credit extended for a business or commercial purpose is not covered by the disclosure requirements of the federal Truth in Lending Act. In practice then, online alternative small-business lenders have had considerable leeway when it comes to the content and format of disclosures about their products’ features and costs. On this issue of disclosure, some online lenders and small-business advocates have proposed a “borrower bill of rights” to clarify the obligations of both borrowers and lenders. Finally, researchers have called for more data collection from industry participants and for statistics on the various loan products and how borrowers fare during and after repayment.
The Federal Reserve has an interest in online alternative lending from several perspectives. For one, small businesses need adequate credit to succeed and grow; otherwise they may underperform, slowing economic growth and employment. For another, these online products and delivery methods are still relatively new and pose opportunities as well as potential risks to borrowers. The smallest businesses (those with 2 to 20 employees) are of particular concern as they lack the financing options of larger businesses and may be less likely to recover from a poor credit decision.

Also, traditional banks may view online alternative lenders as competitors or as partners. As a bank regulator, it is important for the Federal Reserve to understand changes in the competitive landscape for financial institutions. Finally, this study can help set the stage for more in-depth qualitative or quantitative research on the topic of alternative lending. While one study cannot address all the issues noted earlier, this project attempts to further our understanding of how a segment of small-business potential borrowers views this important emerging industry.

Why online focus groups?

For this study, the Federal Reserve Board and the Federal Reserve Bank of Cleveland conducted online focus groups to better understand small businesses’ perceptions of online alternative lenders and the short-term, small-dollar credit products they offer. Typical quantitative surveys of small businesses do not probe respondents’ motivations for considering online lenders or their decision-making processes for evaluating these alternatives. Focus groups provide deeper insights into these topics. Furthermore, the type of focus group employed here, an online bulletin-board focus group, is an especially effective way to convene a group of geographically dispersed and busy “Mom & Pop” small-business participants—a demographic that is particularly hard to reach with a face-to-face focus group.17

The online focus group format proved to be well suited for studying products marketed and delivered online. It also yielded insights that may be useful to policymakers and that can inform the design of follow-up research using other qualitative or quantitative methods. It should be underscored, however, that focus groups, whether online or in-person, are not designed to measure incidence or quantitative trends. Due to their small sample size and the non-random selection of participants, the results of these focus groups should not be interpreted numerically or otherwise generalized to the wider population of small businesses. Key facts about the logistics for the online focus groups are summarized in Figure 1.

Figure 1 Overview of the small-business online focus groups

- Two separate online focus groups were conducted: the first from November 11-14, 2014, and the second from March 23-27, 2015.
- Both focus groups had 22 small-business participants for a total of 44.
- Both focus groups were professionally moderated by the Nielsen Company.
- The online bulletin boards ran day and night; participants responded at their convenience.
- New questions were posted daily for three days. The boards remained opened a fourth day for closing comments and follow-up questions.
- Participants committed to spending 30-45 minutes each day answering questions.
Recruitment of small-business participants

The focus groups convened small businesses likely to be in the pool of potential borrowers for online sources of credit. To qualify for the study, a business was required to have 2 to 20 employees and annual revenues under $2 million (a minimum threshold of $200,000 was set for the second focus group). Participants had to be the financial decision makers, or share that responsibility, for their businesses. Excluded were self-employed individuals, “larger” firms with more than 20 employees, and new businesses—this last category because many online alternative lenders require at least a two-year sales history.

Professional recruiting firms contacted small businesses and screened for these criteria. The recruiters were charged with identifying at least 22 qualified small-business participants for each group that were diverse in geography and industry and with varying levels of knowledge of and experience with online alternative lenders. The Federal Reserve was identified as the sponsor of the study.

Within the established criteria, the 44 small businesses that participated in the focus groups were quite diverse. They were fairly balanced across the ranges for number of employees and annual revenue. While two years was the minimum threshold for participation, many firms had been in business a decade or even two. The businesses came from a wide variety of sectors and services and were located across five US time zones in more than 20 states. Participants were roughly balanced between males and females, and about a quarter self-identified as African-American, Hispanic, or Asian. Their ages ranged from early 30s to late 60s. See Appendices A and B for more detail on the demographics of the focus group participants and the screening process.

The online focus-group discussion

The question set for the focus groups (or “topic guide”) was developed by Federal Reserve System staff in collaboration with the Nielsen Company (Nielsen). Leveraging the flexibility of the online focus-group format, loan-product descriptions and other items were posted on a virtual whiteboard for participants’ consideration. Participants also were asked to visit the websites of online lenders and then return to the focus group discussion to share their impressions. Using these capabilities, the topic guide staged three days of questions, each focused on a different theme.

- **Day 1 topics**: Stresses and joys of running a small business, their biggest financial concerns, where they go for advice.
- **Day 2 topics**: Process for seeking short-term credit, perceptions of online lenders, online “shopping” exercise that prompted participants to visit web pages of online lenders.
- **Day 3 topics**: Evaluation of mock credit products, participant recommendations.

During the online focus group, participants logged onto a secure internet site each day over a period of three days to respond to questions. The site remained accessible a fourth day for participants to review, add final thoughts, or respond to any last follow-up questions. Participants were able to go in and out of the site at their convenience since it did not occur in “real time.” Participants could view questions one at a time and were able to see others’ responses only after posting their own. The groups were professionally moderated by Nielsen, with Federal Reserve staff observing and conferring with the moderator on follow-up questions for participants, when needed.
KeY FINDINGS

The focus groups provided documentation for some existing assumptions about small-business borrowers and also provided fresh insights on these and on new issues. The findings outlined here summarize the common perceptions and notable themes raised by the participants themselves. The detailed observations that support these findings are discussed in the next section of this report.

1. **Online alternative lender websites are alluring, but trigger concerns about data security and privacy.**

   About one-quarter of all participants in the focus groups had direct experience with an online alternative lender. Most of the others reported they were at least vaguely familiar with online lenders or had heard the names of some of the larger firms, though a few indicated they were not at all familiar. All participants were asked for their initial, top-of-mind impressions of the term “online lender.” The overall impressions of those not experienced or unfamiliar with online lenders were quite negative. Conversely, those who had applied to or actually borrowed from an online lender were generally more positive.

   Interestingly, the negative attitudes of participants less familiar with online lenders turned somewhat positive after they visited actual lender websites. Some participants said they were pleasantly surprised by the user-friendliness and professionalism of the websites. However, the websites’ collection of businesses’ information for marketing and underwriting raised data-security and privacy concerns and was a turn-off for participants across the board.

   Participants in the focus group self-identified as a financial decision maker for their businesses. This may have been one of the reasons that, when asked whether it was easy or difficult to compare several mock loan products, participants overwhelmingly answered that it was “easy.” However, during the course of the focus group, many participants said they were “not sure” about the actual costs and specific features of some of the products. Moreover, when asked for recommendations to ensure online loans are safe, stable, and flexible, most said they wanted more information to make products easier to compare.

2. **Using information typically provided on online alternative lenders’ websites, small businesses find it difficult to compare credit products.**

   Although participants initially said it was easy to evaluate loan products, many expressed uncertainty or answered questions incorrectly when making specific product comparisons, particularly on cost.

   The lack of standardization in how online lenders present their products was problematic for many focus group participants. During the product comparison exercises, some noted missing information about specific features and costs, while others did not.

   A majority of participants said they want clearly stated product features and an easier way to compare product offerings. Among their suggestions were using a standard annual percentage rate (APR) and explicitly listing all fees as well as requiring statements about payment policies, including late fees and prepayment penalties. In addition, participants stressed they want assurances about the security of their business data and information to help them determine whether the companies they might borrow from are reputable or not.

3. **Virtually all the focus group participants want clearly stated product features and costs and an easier way to compare product offerings.**
DETAILED OBSERVATIONS

This section both summarizes key elements of the discussion among the focus-group participants and presents their views in their own words. Tracking the flow of the topics covered during the focus group (see Appendix C), the section begins with insights on business owners’ financial challenges as well as their sources of advice and short-term credit. Next, detailed observations are presented on participants’ perceptions of online alternative lenders and their comparisons of mock online credit products. The section closes with participants’ recommendations to ensure online loans are safe, stable, and flexible.

**Business challenges and financial decision making**

At the outset of the focus group, participants were asked about the challenges of running a small business today. They described a wide range of challenges, many of them financial and stemming from uneven cash flow. Were they to consider short-term financing, most said they would proceed cautiously, doing research on the Internet but also seeking out trusted sources of advice, including personal contacts and their banks. However, they did not necessarily view banks as a likely source of funding.

**CHALLENGES MANAGING BUSINESS FINANCES**

The business challenges participants face are as varied as their products, services, and customers. Participants relayed concerns about generating new business, meeting the evolving needs of their clients, and managing employees. The foremost and nearly ubiquitous financial concern they voiced, however, was managing cash flow. This sentiment was expressed directly and also emerged at the top of a priority-ranking exercise on the focus group whiteboard. Uneven cash flow was a source of worry for dealing with matters ranging from the immediate—such as paying creditors or meeting payroll—to the longer-term, including business promotion, expansion, and related challenges they described.

**Cash flow and cash-related problems are what keep many of the participants up at night.**

- Managing cash flow is the hardest thing I face. The second hardest thing, as well as the third, are managing cash flow.
  
  **Part-owner of an engineering firm, Texas**

- Short term: I want to make sure that the lights stay on.
- Long term: I want to make sure that the lights stay on. Seriously though, getting clients to pay what they owe in a timely fashion, and make sure that my employees are properly compensated.

**Part-owner of a professional staffing firm, California**

- The one concern that keeps me up at night in regards to the growth in my business is the ability to have the funds to pay for product on demand. There are times where my client might ask for a substantial amount of inventory, and if I don't have the capital to produce the demand requested [it] will cause my client to lose faith in my company's integrity.

**Owner of a manufacturing business, Illinois**

- My biggest financial headache is the uncertainty of my tax burden combined with fluctuating cash flow.

**Part-owner of a media production company, Utah**

- My biggest concern is keeping a good bank balance so when we are slow in the winter months and do not have very many payments coming in we can keep afloat. So we have to be mindful during our busy season.

**Part-owner of a photography business, Georgia**

If they have sought, or were to seek, advice on options for short-term credit to cover business expenses, participants turned to a variety of sources and approaches. Perhaps not surprisingly, many reported the Internet as a useful resource. In addition, participants said they would turn to business colleagues, family, and friends as important sources of advice. Also, quite a few participants—from businesses as varied as architecture, event planning, and healthcare staffing—said they would consult their bankers for guidance, citing their existing banking relationships and the banks’ familiarity with and interest in their businesses. That said, a number of participants reported they would avoid banks altogether.
Participants would consult a variety of sources, including their banks, for advice on short-term credit.

I would talk to a trusted business person who is a friend and ask their advice. I would seek out short-term funding from the bank institution that is familiar with our cash flow.

**Part-owner of a funeral services business, North Carolina**

I would do my research on the Internet. For advice, I would most likely go to a friend or financial advisor.

**Owner of a remodeling business, North Carolina**

We have a great relationship with our local bank and I would probably go to them first.

**Manager of a law firm, Illinois**

First I would call my local bank [with] whom I have had a long-term relationship. Next I would go online to see what offers are available from online lending sources.

**Manager of a management consulting firm, Virginia**

I would go to my attorney, not a bank. *Probe: Why not a bank?* Banks are very inflexible and limiting. Like the classic Bob Hope line, A bank is a place that will loan you money if you don’t need it.

**Owner of an automotive business, New Jersey**

Some participants did not view banks as a likely source of short-term credit for their businesses.

By the time you need the loan a lot of banks do not want to give it to you. Also, the interest rate and the payment on the loan are so high that it’s not feasible.

**Owner of a home remodeling business, North Carolina**

Securing debt for a forklift is easy. It is operating money that is tough. Most of the time you don’t need it. When you do, there is never enough time to get it.

**Part-owner of an engineering firm, Texas**

Lenders are so much more cautious these days. It has been very difficult to obtain funds simply for cash flow management in a small business. They are more willing to lend for things like capital improvement, but unsecured loans are very hard to get.

**Owner of a medical practice, New Jersey**

Biggest problem I have is lack of collateral to secure a loan with.

**Owner of an office supply business, Georgia**

[The biggest challenge is] the amount of information and records needed to secure a loan. Banks do not seem to want to take a chance on small firms.

**Manager of an environmental consulting business, Maryland**

Interestingly, while banks were a source of advice for some, they were not necessarily viewed by many participants as likely sources of loans for working capital. Quite a few business owners cited concerns about their ability to meet banks’ lending criteria, while others were skeptical about their banks’ willingness to lend to businesses of their size. This is consistent with findings from other small-business surveys and sources in which respondents raise concerns about lending standards, especially credit score and collateral requirements, as obstacles to obtaining a loan from a traditional financial institution.\(^{22}\)

**Perceptions of online alternative lenders**

Probing participants about their business challenges and attitudes toward borrowing and short-term credit set the stage for in-depth discussions about online alternative lending during the next phase of the focus group. Those discussions began with questions about general top-of-mind impressions of online lenders, then moved to virtual shopping in which participants visited the websites of online lenders and reported back on their impressions. As noted in the Key Findings, while many participants shared initial neutral or unfavorable impressions of online lenders, a number of them reported more favorable views after “shopping.”
UNFAVORABLE INITIAL IMPRESSIONS

Top-of-mind impressions from participants who had not heard of online lenders—or had heard of but not used them—were generally unfavorable and skeptical. Some participants were quite wary, particularly about cash advance providers. That said, a number of the skeptics attributed their distrust to their limited knowledge of and experience with online lenders.

Other participants, particularly those who reported experience with online lenders, were a bit more trusting and were more likely to see the lenders in a favorable light.

"SHOPPING" APPEARS TO CHANGE PARTICIPANTS’ IMPRESSIONS

During the course of the focus groups, participants were asked to visit some online lender websites and pretend to shop for a loan. Participants were instructed not to apply or provide any personal information. Although a list of online lenders was provided to participants, no hotlinks to lender websites were included. Rather, participants were encouraged to explore those and other lenders as they wished.

The online shopping experience created excitement and interest especially among those who were not particularly familiar with online alternative lenders. The number and variety of lenders was surprising to many participants. Although most participants reported knowledge of a few online lenders during the screening process, they became aware of many others through the shopping exercise. Some visited as many as a half-dozen websites and reported back in detail on their impressions. A number of participants were wooed by the sites’ positive testimonials, customer-friendly feel, advertised low rates, and quick turnaround for funds deposited in borrowers’ accounts.
What comes to mind when you see or hear the phrase “online lender”? How about “cash advance” company?

“Online lender—I feel a little leery because I don’t know anything about them. Cash advance company—I think shady and high interest rate.”

“Online lender sounds better than cash advance but both make me nervous. I get the feeling of high rates and no personal connection. I feel like there would no working with them if things got tough.”

Following the virtual shopping exercise, these participants shared more favorable views.

Let’s talk about the online lending site(s) that you looked at. What was the most interesting thing that you learned?

“I am really so excited and impressed with the new online ways to get financing, which are based on your business history and not on your credit reports or on your other debt. [These lenders] are really fueling small businesses with micro-loans and banking on the businesses growing and prospering. That’s the kind of people I want to do business with.”

“Some of the websites are user friendly and provided a lot of information, which makes it easier to navigate through what could be a stressful time. I like that [one lender] gives personal stories of borrowers’ success with the lender. I like when I see an ad that [a major business publication] has given them a top rating. That puts me more at ease because I feel that a reputable company has put their name on the lender backing up their practice.”

Asked what they would tell a friend they learned after “shopping,” many participants cited the wide variety of options, quick funding, and reasonable advertised interest rates.

“[Owner of an entertainment business, California]

You’d be surprised how much money you can get and how fast you can get it from some of these online lenders. There’s a ton of competition and it seems like everyone wants your business.

“Manager of an entertainment business, California”

Most of them advertised reasonable rates in the 6-9% range. They also supported loans from $4,000 to $200,000 and seemed to be willing to lend for cash-flow problems.

“Owner of a medical practice, New Jersey”

With banks there’s usually a standard set of loan offerings. While there are a lot of similarities, none of these companies seem to offer exactly the same things as each other.

“Part-owner of a technology business, Tennessee”

All of these companies seem to not only offer a high amount of money (up to $2,000,000), [but also] a short time in which you could get access to the money (most ranging up to 5 days), and being able to show your cash flow as your main support to obtain the money.

“Owner of an accounting firm, Georgia”

There are solutions for almost any problem. To me, the idea of going to my bank and sitting down with a stranger and filling out piles of forms makes me nervous and is really unappealing. I liked how easy the online solution is and all the choices, especially if I could work with a company I trust.

“Owner of a retail business, Massachusetts”

They offer great deals to businesses with not-so-great credit scores. They seem to give small businesses hope. I feel like this would be a great alternative to a traditional bank loan.

“Owner of an event planning business, Pennsylvania”

However, even some of the participants who shared very positive reactions about their shopping experiences expressed apprehension about vague terms and conditions associated with borrowing. Indeed, privacy, security of information, and borrower protection emerged as primary concerns among participants. They were more comfortable with providers with which they have some familiarity, either through name recognition or a business relationship.

[23]
After “shopping,” many would tell a friend about data-security and privacy concerns, high interest rates, and loss of control over their merchant accounts.

Do NOT enter any personal info until you have decided which lender(s) to work with. Check the rate, fees, and terms very carefully as they vary dramatically.

Owner of a vacation rental business, Connecticut

I would steer my people away from these types of lenders. Although their rates were not as high as I thought they would be, they are still too high to consider in a real world situation.

Owner of a technology firm, California

I would have to apply to several to see what the fine print really said. Sounds almost universally like you give up control over your merchant services account.

Part-owner of an engineering firm, Texas

Only one site out of the four I reviewed provided the exact fees you would pay for the loan. The other sites all required that I input my contact info before I could get further info about terms and conditions of the potential loan.

Owner of a real estate company, California

Overall, the fees were much higher than I thought they’d be.

Owner of a financial planning firm, Washington

There are so many more ways to borrow money than I realized. It just isn’t that hard to do. But you have to be so careful because the interest rates provided will kill you if you aren’t ready to pay back the loans on time or ahead of time.

Manager of a management consulting firm, Virginia

Mock product comparisons

As a follow-up to the questions about impressions of online lenders, the focus group discussion turned to credit products. The following scenario was posed to participants: “Suppose you needed $40,000 in funds above and beyond the limit on your personal or business credit cards.” Participants were then shown three mock credit products on the whiteboard (see Figure 2) and asked a series of questions, both general and product-specific.

Note that the features described in the table are based on advertised conditions and terms because, in many ways, this captures the initial filtering process a prospective borrower uses to decide whether to explore, if not pursue, a particular product. In practice, the actual terms and conditions specified in a borrower credit agreement may be similar to, or quite different from, the featured terms and “as low as” rates highlighted on the lender’s website. The terms offered may vary depending on borrower creditworthiness, or may change with the inclusion of additional costs and fees. Furthermore, the frequency of payments specified in a credit agreement—daily, bi-weekly, or monthly—may greatly affect the product’s effective rate.

While not identified to participants, Product A mimics the common features of merchant cash advance products, while Product B is modeled after loan products offered by several online direct lenders (particularly those that rely heavily on automated processes). The third offer, Product C, reflects what a small business borrower might find either impersonal or on the website of a traditional financial institution.

<table>
<thead>
<tr>
<th>Figure 2</th>
<th>Product A</th>
<th>Product B</th>
<th>Product C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount borrowed</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Information you provide</td>
<td>Your sales history and bank account information, tax returns, etc. You send the information directly to the lender through mail or email.</td>
<td>You give permission to have your records pulled electronically for your sales history, bank accounts, inventory, and online reviews of your business.</td>
<td>Your bank account information, tax returns, and three years of financial statements. You send the information directly to the lender through mail or email. You pledge collateral to secure the loan.</td>
</tr>
<tr>
<td>Credit score</td>
<td>You need at least a 500 FICO</td>
<td>You need at least a 650 FICO</td>
<td>You need at least a 700 FICO</td>
</tr>
<tr>
<td>Waiting period for decision</td>
<td>3 to 5 days</td>
<td>2 hours</td>
<td>7 days</td>
</tr>
<tr>
<td>How soon funds arrive in your account</td>
<td>3 to 5 business days after you are approved</td>
<td>The same day you are approved</td>
<td>4 weeks</td>
</tr>
<tr>
<td>Repayment information provided</td>
<td>You owe $52,000. The company takes 10 percent of your debit/credit card sales receipts each day until it is paid off.</td>
<td>You owe the original $40,000 plus 28 cents for every dollar you borrow. The loan is paid off in one year.</td>
<td>You owe monthly payments of $3,440. Your effective APR is 6.0%. The loan is paid off in one year.</td>
</tr>
</tbody>
</table>
For purposes of comparing the three products, a one-year repayment schedule is presented. However, in practice, terms for many online products are shorter than one year. For this reason, follow-up questions were asked to gauge participants’ understanding of the impact of earlier repayment on the total amount owed and on the effective interest rate. Though perhaps imperfect in their representation of “typical” credit products, the mock products do provide insights into participants’ preferences, priorities, and understanding of product features.

**CHALLENGES COMPARING PRODUCTS**

Participants were presented with the mock products and asked to comment on each individually before comparing the three. Overall, Product A was appreciated for its flexible approach to underwriting and Product B was attractive largely due to the ease of application and speedy delivery of funds. Product C was perceived to be the most affordable. The downsides cited by participants were the high costs associated with the first product, the potential data risks for the second product, and the length of time required for approval and funds disbursement for the third.

When comparing the products, participants initially reported the three were easy to compare and that they had all the information needed to make a borrowing decision. However, many participants subsequently found it difficult to answer specific questions about the products. For example, although many cited the importance of knowing an APR, participants often did not note until asked that a specific interest rate was not included in the table. Instead, a number of participants made assumptions based on the information provided. When attempting to answer questions about the total amount owed and interest rates, participants became notably less confident in their ability to make an informed borrowing decision, with many qualifying their answers or indicating they were “not sure.” Interestingly, when asked later for recommendations to ensure online loans are safe and secure, the majority indicated that products should be easier to understand and compare. Their recommendations are described in greater detail later in this section.

**Is there anything in these offers you find confusing?**
- Nothing confusing.
- No, it’s pretty straightforward.

**What additional information would you like to see about these products to help you make a decision?**
- I can’t think of anything more I would need to see, really.
- This is enough info for me to make a decision.

**How easy or difficult is it for you to compare the cost to you or the total amount you would pay for these loan products?**
- It was simply a matter of a little multiplication. Very easy to compare the 3 loans.
- Very easy, just do the math.

When asked specific questions about the interest rate or repayment amount, the first participant qualified answers with “I think…,” “My best guess is…,” and “Maybe…,” and was unable to correctly answer the questions. The second answered somewhat more accurately but made some incorrect assumptions.

**What specific recommendations would you make to ensure that online loans are safe, stable, and flexible to use?**
- Just make the loan descriptions simple and easy to understand for the average person who might not have a CPA license.
- They need to set guidelines for APR, length, and fees that these types of online lenders can charge. This would make what you end up owing much more clear to the average consumer.
CONFUSION ABOUT PRODUCT COSTS

Though the questions were not designed to gauge participants’ financial acumen, their answers to some questions suggest significant gaps in their understanding of the repayment repercussions of some online credit products and the true costs of borrowing.

As previously noted, the information provided was deliberately limited to replicate terms and features as presented by lenders on their websites. Using only this information, calculating a true effective interest rate would not have been possible without making some assumptions. With that proviso, participants were asked about interest rates for the products, initially using a one-year loan duration for simplicity. Participants also were asked about the directional change in their effective interest rates should the credit products be repaid sooner. The wide variation in responses may reflect both differences in their interpretation of product features when these features are not clearly specified as well as differences in participants’ financial savvy.

The graphics that follow present a sampling of participant responses to questions about the interest rate for Product A. It is the product that participants appeared to have the greatest difficulty interpreting, conceptually. Typical of a merchant cash advance, Product A combines the interest payments with other fees in the total repayment amount and, generally speaking, there are no savings associated with early repayment for these types of products. The entire repayment amount is owed, even if paid off the next day. As this repayment obligation usually is not indicated up front in product advertising, it also was not mentioned in the chart. Perhaps not surprisingly, the lack of details about early repayment on this product was a source of confusion for many participants.

Q: What is your “best guess” of the interest rate on product A*?

- 28%
- I’m guessing it’s about 23%
- 5%
- If you pay it back in 12 equal monthly payments, it’s on the high side of 50%
- 30%
- About 30% APR, probably includes origination fees and interest
- 9.8%
- 15%, fees and interest
- 25%
- Not sure, maybe 20%
- A little less than 10%
- I am figuring around 30% for the $40,000 loan, plus the 10% of the sales each day
- It seems that the interest rate would be a whopping 30%, unless it’s a mixture of interest and fees

* Note: In practice, for a credit product structured like Product A, the effective interest rate varies depending on how long it takes a borrower to repay which, in turn, depends on the volume and timing of credit card sales receipts. Simply put, the interest owed on Product A is 30% of the principal value, but assuming consistent monthly sales and daily payments, the effective interest rate is on the order of 60%, and higher if funds are repaid sooner than one year. (Added 9.29.2015)
Q: Suppose sales are brisk and you pay this loan back in four months. How do you think that affects the total amount you pay? How would paying back the loan more quickly affect your interest rate? Is it higher, lower, or the same?

I would assume the rate would be lower.

It would not affect the rate.

The effective interest rate would be higher.

I really don’t know.

The interest rate is irrelevant since I still have to pay $12k on $40k.

Well, it looks like I will owe $52,000 no matter what. That would skyrocket the effective APR, to like 90%.

Owner of a retail electronics business, Indiana

The rate would stay the same but the amount would be less. If paid back in 4 months versus 12 months, it would be 25% of $12,000 or $3,000.

Owner of a training/consulting firm, Washington DC

You would end up paying less if you paid the loan off in 4 months rather than 6 or 8 months because you would not have that extra 10% going out every month. I would not consider this an interest rate hike as much as a fee.

Owner of a technology business, California

There is no information on what happens if this loan is paid early. I assume you would pay less in interest but not necessarily a lower interest rate.

Manager of an environmental consulting business, Maryland

While the quotes here are a sampling of responses to questions about Product A, it should be noted that participants reported confusion in understanding all three products. For example, in response to questions about Product B one noted, “Okay, after looking at a few replies, maybe I am confused. I thought for the first $40K there was no interest, that it was only 28 cents on the dollar for anything borrowed above the $40K?” Another remarked of Product C, “I am not sure what they mean by my ‘effective APR.’”

Participant recommendations

At the conclusion of the focus group, participants were asked about recommendations they would make to ensure online loans are safe, stable, and flexible. Virtually all participants cited the need for consistency, common terminology, and the use of plain English in describing online loan products and details about their features, terms, and costs.

Potential borrowers want information about loan products—especially costs—to be clear.

Everything needs to be spelled out and easy to understand.

Owner of a remodeling business, North Carolina

Give the customer the most information available in the clearest terms possible.

Owner of a retail business, Massachusetts

They should have minimum requirements to clearly spell out the terms, fees, APR, prepayment scenarios, and borrower requirements.

Owner of vacation rental business, Connecticut

APR and total repayment cost need to be easily available and displayed.

Manager of a law firm, Illinois

Furthermore, participants noted the possibility that potential borrowers could be confused or misled by advertised features, and recommended safeguards to reduce the likelihood that they would misunderstand actual product terms.
Potential borrowers don’t want to feel they can be taken advantage of.

Lenders will present these offers [in] as confusing [a way] as possible and provide bright colors and sweet logos and friendly people saying ‘we are here to help,’ but they don’t give you all that you need.

Owner of an automotive business, New Jersey

Requiring certain figures (APR, total cost, etc.) is a really good idea because the American public is generally in the dark about simple math and calculations. It may be too easy for lenders to use that to their advantage and use tricky or unclear wording.

Manager of an education services business, Illinois

The loan business depends on the borrowers paying as much ‘extra’ as possible, I understand that. However, it should be ensured that disclosure is not intentionally deceptive or misleading.

Owner of a retail electronics business, Indiana

During the course of the focus group, participants repeatedly raised data-security and privacy concerns. Many recommended that steps be taken to ensure the protection of borrowers’ personal and business information.

Potential borrowers want ironclad protections for their business data.

Guarantee that personal information is safe by encrypting, and alert all customers of any security breaches.

Owner of an event planning business, Pennsylvania

Make sure all information provided is kept safe.

Owner of a retail business, California

Privacy should be protected when online permission is given to pull electronic records.

Owner of a training/consulting firm, Washington DC

Make sure my information is not sent to a third party.

Part-owner of a real estate business, Alabama

Finally, as potential borrowers, the small-business owners participating in this focus group want assurances that firms they would consider borrowing from are reputable. Several participants recommended some measure of regulatory oversight.

Potential borrowers want to do business with firms they are sure are reputable.

Ensure that the lenders are scrutinized and are honest and reliable. Some of these loans seem very predatory.

Owner of a real estate business, California

Require minimum cash reserves for lenders so they don’t do desperate things to stay in business if borrowers are slow in paying back.

Owner of an entertainment business, California

Regulating who can qualify to play/participate in both roles is crucial to preventing predatory lending [and protecting borrowers, but] don’t over-regulate to a simple model that reduces who can access these loans.

Manager of a construction company, Colorado

Regulate all parts of the industry under Federal law.

Part-owner of an engineering firm, Texas
This study used an online method of, and best practices for, focus-group research to better understand small-business owners’ perceptions of online lenders and credit products. The findings are based on the responses of 44 business owners, and should not be considered representative of the nation’s small business population. That said, the focus groups do provide insights into small-business owners’ approach to financial decisions, as well as their interest in and concerns about online borrowing. This study raises key issues and questions that may help guide policy discussion and inform future research and data collection on small-business borrowing.

Issues for future exploration

How would standardized product disclosures affect small-business owners’ borrowing decisions?

As with any emerging product line, building understanding and educating borrowers are essential for the development of an efficient and equitable marketplace. Participants in the focus groups, for example, had varying levels of financial acumen and degrees of comfort with financial products and decisions. It is notable that even those participants who demonstrated a firm understanding of financial products, similar to those who did not, recommended that lenders be required to disclose specific product terms (i.e., APR, fees, and total cost) in straightforward and consistent language. While a number of participants said they preferred to know the total repayment amount over the effective interest rate, a majority wanted the interest rate or both. Total repayment amount alone, as typically presented by cash advance providers, is generally useful only in the context of assessing the affordability of an individual loan product. The effective interest rate expressed as an APR could make comparing products easier, especially alternative credit products with traditional ones.

For many small firms, borrowing working capital is a relatively high-stakes, complex, and infrequent transaction that can put them at a disadvantage in dealing with lenders. Recently, alternative lending industry leaders have advocated for best practices, concerned that “bad actors” could inflict reputational harm at a time when the online lending business is gaining greater acceptance. Some lenders promote and advocate for their own companies’ approaches to explaining their products, rates, and costs. Therefore, it remains to be seen whether efforts on the part of the industry to gain consensus on and adopt best practices will be successful.

More study is needed to determine the impact that clear and consistent disclosures would have on potential borrowers’ decisions. Would standard disclosures prompt borrowers to comparison shop and lead to better borrowing decisions? Would borrowers expect different disclosures from online alternative lenders versus traditional institutions? If disclosures were required for small-business credit products, what information should be included and in what format, and how should such rules be implemented?

How will concerns about data security and privacy affect both borrowers and the industry?

That participants reacted positively, in general, to their virtual shopping experience suggests that online lenders know their target audiences well and cater to their desire for ease and simplicity. Yet small businesses—like consumers—clearly are concerned about the safety and security of their business information, a theme that recurred throughout the focus groups. This raises an important question about the extent to which privacy concerns are affecting the rate of adoption of online credit products by borrowers.

Automated record pulling and algorithms for underwriting are key features of the online credit industry and have potential to drive down costs for providers, raise returns for investors, and increase access to credit for borrowers. Individual lenders tout their proprietary underwriting models and creative use of electronic data. This study’s findings suggest that, should there be a significant data breach, potential borrowers might well become reluctant to share the type of information many online lenders depend on. An important issue for the industry going forward is how to balance the streamlined, customer-friendly experience they offer with an effective approach to data security. Policymakers may want to weigh in, as well, on how best to protect the interests of both borrowers and industry participants.
How will online alternative lending change the nature of small-business banking?

The value focus-group participants place on their relationships with their banks was highlighted during the discussions about trusted sources of information. It was notable that business owners indicated that they would be likely to turn to the bank where they have their accounts for advice or information, but would not necessarily expect to receive funding there. This finding is important because it speaks to the potential of, and concerns with, partnerships between traditional banks and online alternative lenders.

The rising prevalence of these partnerships increases the connectedness of online lenders to the broader financial industry and raises a number of questions. Do issues of disparate treatment arise if banks refer certain customers to their alternative lending partners, but offer traditional loan products to others? Does the use of automated underwriting raise or address fair lending concerns? If small-business borrowers become increasingly reliant on online alternative lenders, could small firms’ access to credit suffer if the lenders’ business models prove to be unsustainable, especially during an economic downturn?

Lessons for future research

Potential borrowers appear to consider “online” a place, not a category of loan.

In contrast to industry analysts and researchers, potential borrowers do not appear to distinguish between cash advances and loans, nor do they appear to make distinctions among the various types of online lenders providing them. The website of a traditional bank may prompt a potential borrower to view that bank as an online lender much the same as a nonbank online platform, since “online” is the place many go for information about both alternative and traditional lenders and products. This suggests that, in future quantitative and qualitative research, questions about online alternative lenders and their products be carefully phrased to ensure that respondents are truly distinguishing and not answering with other products and services in mind.

Self-reporting of ease or difficulty making judgments about loan products should be paired with more objective measures of comprehension.

The fact that participants in the focus group self-identified as financial decision makers may have led them to respond that it was “easy” to compare the mock loan products. However, when asked specific questions, it became clear that the participants were unsure about the actual costs and features of some of the products. In future quantitative research, it may be useful to pair questions on self-reported perceptions of ease or difficulty with a series of questions developed to measure actual understanding of products and the obligations associated with them.

Perceptions of online lending will likely evolve along with the industry itself, and future research should track these changes.

Online alternative lending is an industry still gaining traction. With greater market penetration will come greater experience among borrowers with online credit products. This experience, along with greater competition among lenders, may raise expectations among prospective borrowers about the features of products that are offered and how well the terms of these products are disclosed. Further study on borrowers’ comprehension of credit products – both new and existing – and research to track changes in their attitudes and expectations will be important to understanding the online alternative lending industry going forward.
Appendix A: ABOUT THE PARTICIPANTS AND THEIR BUSINESSES

A total of 44 participants took part in the two national online focus groups. They were identified and recruited through a detailed screening process (see Appendix B). The pool of participants ranged across revenues, geography, and industry. Twenty-eight had annual revenues of $500,000 or less. Participants came from 20 states across the US and operated in a variety of industries. As seen in the charts below, they were a diverse group reflecting various demographic and business characteristics. (Note: The “Years in business” chart below was modified 9.29.2015 to reflect a category of 2-5 years, rather than 1-5 years.)

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Appendix B: FOCUS GROUP SCREENER QUESTIONS

Besides yourself, how many employees, either full- or part-time, are in the company that you work for?
1. 1–20 employees
2. Greater than 21 [Terminate.]

Which one of the following statements best describes your involvement at your business?
1. I am the sole owner of the business
2. I am part owner of the business
3. I manage the business, but don’t own it
4. Not an owner or manager of the business [Ask to speak to; otherwise, terminate.]

Which of the following best describes your role in financial decision-making for your business?
1. I am a final decision maker in all financial business decisions
2. I share the decision-making in all financial business decisions
3. I have no involvement in financial business decisions [Ask for; otherwise, terminate.]

Does your business fit into any of the following industries? [Rotate list]
1. Non-profit organization [Thank and terminate.]
2. Retail trade
3. Health-care
4. Technology
5. Marketing research [Thank and terminate.]
6. Lending industry, such as a bank, credit union, or loan firm [Thank and terminate.]
7. Other
Please describe your business: ___________________________
[Categorize for purposes of obtaining a mixture of industries.]

How long has your company been in business? [If less than two years, terminate.]

So we can be sure to include a wide range of respondents, which of the following best describes the total annual revenue for your business before taxes? Your best estimate is fine.

1. Less than $200,000 [Thank and terminate.*]  
2. $200,000 to less than $500,000  
3. $500,000 to less than $1,000,000  
4. $1,000,000 to less than $2,000,000  
5. $2,000,000 to less than $5,000,000 [Reserve for possible inclusion.]  
6. $5,000,000 or more, Don’t Know, or Prefer Not to Say [Thank and terminate.]

* For this study, recruiters sought businesses with annual revenues under $2 million (a minimum threshold of $200,000 was set for the second focus group). An upper bound for revenues was set at $5 million in case recruitment proved difficult. In the end, virtually all the participants’ businesses had revenues of approximately $2 million or less.

We are interested in understanding your familiarity and experience with different lending sources and ways of obtaining funds. Have you ever applied to any of the following sources to obtain funds or loans for the purposes of operating or growing your business, debt consolidation, or refinancing? [Yes, applied; No, have not applied.]

- Traditional financial institutions such as a bank or credit union, either in person or online
- Online lenders such as merchant cash advance companies, peer-to-peer lenders, or online direct lenders, other than bank or credit union websites
- Credit cards, either business or personal
- Other [Specify.]

Which of the following online funding sources have you heard of? [Rotate list below.]

1. Lending Club  
2. Prosper  
3. CAN Capital  
4. Rapid Advance  
5. OnDeck  
6. Kabbage  
7. Live Oak Bank  
8. CIT  
9. Amazon Capital  
11. Square Capital  
12. Any other online direct lenders, merchant cash advance companies, or peer-to-peer lenders you have heard of? [Specify.]  
13. None of the above [If answered Yes, applied to Online Lender but can’t name, thank and terminate.]

Did you apply for a loan or other forms of credit at [list each company respondent heard of] for the purpose of operating or growing your business, debt consolidation, or growing your business? [Looking for a mixture of respondents who have applied/have not applied at online lenders.]

What age group do you fall into? _____ [Terminate if less than 18.]

What do you consider to be your ethnic background?

INVITATION FOR BULLETIN BOARD: Based on your responses, we would like to invite you to participate in an online bulletin board-style focus group sponsored by the Federal Reserve to discuss some topics regarding small business lending needs and lending practices. [Participants committed to spending 30-45 minutes each day answering questions and were provided with a $150 incentive upon completion.]
APPENDICES

Appendix C: FOCUS GROUP TOPIC GUIDE

Summary of day 1 questions – introductions, financial challenges, thoughts about short-term credit

Tell us a bit about your business and some interesting things about what you do, e.g.: What your business is all about; how long you’ve been doing this; your role and responsibilities; what you think makes your business special:

- What gives you the greatest satisfaction and joy?
- What’s the toughest part about running your business?
- Imagine a friend was talking with you at a party and asked you, “What is it like running a small business in today’s economic environment?” What would you tell them?

Think about all that’s required to keep your business up and running and able to meet your financial obligations. What’s your business’s biggest short-term financial concern today? What’s the one thing that’s keeping you up at night and making you nervous?

Take a look at this list of some of the short-term financial challenges that your business may have faced or may be facing today. Please prioritize them. If you’ve had a business issue that’s more important than the ones listed here, please write it below.

A. Pay for inventory
B. Meet payroll
C. Pay creditors
D. Marketing and sales
E. Attend a special event like a trade show or sales event
F. Purchase or lease new equipment
G. Make needed repairs
H. Offer a new product or service
I. Smooth out cash flow

Have you ever been faced with an immediate business problem or opportunity where you didn’t have the cash on hand to fund it? What did you do? How did you handle it?

Have you ever taken out a short-term business loan to secure funds for your business?

Let’s assume that you are going to take out a short-term loan or cash advance for your business... Describe how you would shop for such a loan or get access to short-term funds.

- Where would you go to look for the loan or short term funding?
- What specific things would you want to know about the loan?
- What would you want to know about the lender?

Summary of day 2 questions – impressions of online lenders and products

Imagine you need a $40,000 loan to pre-pay for inventory or materials. You intend to repay the loan when you receive payment from your client—say, in about 6 months. You don’t want to expense it over the long term. Who would you go to for advice? Where would you turn for information?

What comes to mind when you see or hear the phrase “online lender”? How about “cash advance” company?

Here are the logos of a number of online lenders.

- What’s your reaction to seeing this list?
- Which of these online lenders had you heard of before this research?
- How familiar are you with what these companies have to offer?
Thinking back, have you seen information or ads from any of these or other online lenders? What do you remember seeing? Where did you see them?

Have you ever been contacted online or by phone by a sales person or broker who wanted to present or talk about an online loan? [Probe, if yes.]

In your opinion, do you feel online lenders and online loans are safe? Are they secure? Why do you feel this way?

Is it important for you to know how online lending sources get their money or how they use your business information?

Have you looked for or applied for a loan with an online lender? [If yes, probe: Which online lenders, steps taken, and if obtained the loan, thoughts about the experience.]

Go online and “pretend to shop” for a loan. You may explore the websites shown on the whiteboard or the sites of other online lenders. PLEASE, don’t apply or provide any personal information.

- What do you notice that you find interesting or attractive?
- Do you see anything that turns you off or makes you nervous or concerned?
- Did you find anything confusing?
- How easy are the products to compare?
- What makes one [lender or product] more attractive than another?

Summary of day 3 questions – mock product evaluations, recommendations

Let’s assume that you needed $40,000 in funds above and beyond the limit on your business or personal credit card and you came across the following online loan. [Participants are presented with one product at a time from Figure 2 of the report, and asked about each product.]

- What do you like most about this loan?
- What concerns, if any, do you have with this loan?
- Is there anything that you find confusing?

What is your best guess of the interest rate on this loan if you pay the loan back in one year?

What do you think the [payment amount presented in chart] in this loan includes?

Suppose sales are brisk and you pay back this loan in four months. How do you think that affects the total amount you pay?

How would paying back the loan more quickly affect your interest rate? Is it higher, lower, or the same? Looking at all three loan options together:

- Which looks like the best business proposition for you and your business? Why?
- Is there any one of these three loan products that you would never take? If so, why?

When it comes to borrowing for the short term, are you more comfortable knowing the interest rate (APR) or total cost of repayment?

Is there anything else you would want to know in order to make a decision on which loan to take?

Based on what you have learned about online loans, what specific recommendations would you make to ensure that online loans are safe, stable, and flexible to use?
Bank lending to small businesses was rising until the Great Recession, then declined significantly. FDIC reporting shows that, in 2015, total small-business loans outstanding are 18% below 2008 levels, in absolute terms. Even with recent recovery in small C&I lending (under $250K), these loans remain almost 9% below 2008 levels. For more on the small-business lending environment, including the various factors contributing to the decline in bank lending, see Federal Reserve Bank of Cleveland Economic Commentary, “Why Small Business Lending Isn’t What It Used to Be,” August 2013; and “Current State of Small Business Lending,” Traci Mach, Board of Governors of the Federal Reserve System, presentation, May 15, 2014.


Industry estimates vary and this may be due to the inclusion of certain online products or lenders and to the specific metric being reported. For example, a Morgan Stanley study, “Global Marketplace Lending” (May 2015), estimates marketplace loans at just over $4 billion in issuance in 2014. Peter Renton, Global Overview of Online Lending, Lend Academy (April 2015), estimates total industry loan volume at $5 billion in 2014, rising to $12 billion by the end of 2015. Karen Mills’ “Alternative Online Lenders Fill Funding Needs for Small Business” in Forbes.com (September 23, 2014) estimates outstanding capital in the market at $10 billion by the end of 2014, excluding merchant cash advances. Lenders often report their own growth rates; for examples, see websites of OnDeck and CAN Capital.

The 2014 Joint Small Business Credit Survey was conducted by the Federal Reserve Banks of New York, Atlanta, Cleveland, and Philadelphia. Other surveys from prior years, while not altogether comparable, have indicated very little activity with online alternative lenders. For example, a 2013 Federal Reserve Bank of New York survey asked small-business owners about their primary source of funding and almost none cited an online lender. For other indications of growth in online borrowing, see recent Pepperdine Private Capital Access Survey results.

Federal Reserve Bank of Cleveland Economic Commentary, August 2013.


The October 2014 Federal Reserve Senior Loan Officer Opinion Survey (SLOOS) asked special questions about small-business-lending standards relative to the midpoint of standards in the previous 10 years; the responses point to relatively tight standards. The July 2015 SLOOS again included the special questions and these responses show that standards have now eased somewhat relative to their midpoint since 2005.

For an example of an industry analysis, see “A Trillion Dollar Market: By the People, For the People,” Foundation Capital, May 2014.


See May 1, 2014 Bloomberg report on subprime online business loan securitization.

For examples, see the following American Banker reports: May 8, 2014 (a bank partnership - OnDeck and BBVA Compass); June 10, 2015 (a nonprofit partnership - Lending Club and Opportunity Fund); and February 3, 2015 (a corporate partnership - Lending Club and Alibabal. See also a corporate partnership example in February 24, 2015 USA Today (Staples and Lendio). For an example of bank involvement with a cash advance and loan company, see April 2, 2015 Market Watch report.


Borrowers, collectively, can be affected by the overall health of the online lending industry and the continued flow of capital. These and other more “macro” issues are covered in a 2014 International Organization of Securities Commissions (IOSCO) working paper.

Note that merchant cash advances involve the sale of future receivables, and, as such, industry proponents have argued that they should not be considered “loans.” For example, see First Data 2012 White Paper, pg. 3: Because a merchant cash advance by a nonbank provider “is structured as a commercial transaction instead of a loan, it is regulated by the Uniform Commercial Code in each state—as opposed to banking laws like the Truth in Lending Act. Thus, the provider is able to avoid many of the regulations and documentation requirements associated with making loans.”

See Responsible Business Lending Coalition Borrowers’ Bill of Rights, August 6, 2015.

An online bulletin board also is known as an “asynchronous” focus group because it does not occur in real time. This method is increasingly used by banks and financial services firms for conducting customer research.

An upper bound for revenues was set at $5 million in case recruitment proved difficult. In the end, virtually all the participants’ businesses had revenues of approximately $2 million or less.

Online focus groups can accommodate two to three times more participants than traditional face-to-face focus groups.

In addition, Nielsen provided independent observation reports on the focus groups, which informed the authors’ own analysis as they identified the key findings.

Verbatim quotes are presented as they were typed into the online focus group bulletin boards by the participants themselves, with only minimal editing for space and clarity, or to remove names of specific lenders.


For example, participants that use PayPal or Square for payments processing reported greater comfort with PayPal Working Capital and Square Capital.

Note that a typical daily remittance rate of 10% of credit card sales receipts was used for Product A. Even some merchant cash advance industry executives have observed that the remittance rate is sometimes mistaken by borrowers as the APR. Online lenders (especially merchant cash advance providers) often express repayment either as the total amount owed or as a factor of the original amount borrowed (say, 1.28). The more straightforward total amount is used here.

For example, see “Bridging the Small Business Capital Gap: Peer-to-Peer Lending,” Sam Hodges, Co-Founder and Managing Director, Funding Circle USA, Testimony to US House of Representatives, Small Business Committee, May 13, 2015. See also, Responsible Business Lending Coalition Borrowers’ Bill of Rights, August 6, 2015.
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Browsing to Borrow: “Mom & Pop” Small Business Perspectives on Online Lenders

June 2018

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Executive Summary

This report discusses findings of a study conducted by the Federal Reserve Board and the Federal Reserve Bank of Cleveland to gauge small business owners’ perceptions of online lenders and their understanding and interpretation of information online lenders use to describe their credit products. The Federal Reserve has an ongoing interest in small businesses and their access to the credit they need to succeed and grow. As the small business credit market evolves, prompting discussion about borrower protections, the perspectives of small business owners are an important consideration.

Nonbank, online lenders are becoming more mainstream alternative providers of financing to small businesses. These nonbank lenders offer small-dollar credit products including cash advances, lines of credit, and various types of loans, typically under $100,000. Borrowers can apply in minutes and receive funds in days or even hours, expedience made possible with data-driven technologies. The industry’s growing reach has the potential to expand access to credit for small firms, but also raises concerns about product costs and features, and the manner in which these are disclosed to prospective borrowers.

The study used online focus groups, a method of gathering participants’ perceptions through online discussions. The online format allowed for the collection of detailed responses, as well as insights into the complex decision processes of potential borrowers. As part of the study, participants evaluated sample loan products, presented in a format mimicking the language used and content provided by online lenders. They also visited the websites of actual online lenders and shared their impressions.

The participants recruited for the study operate small businesses (“Mom & Pops”) with at least one but no more than 20 employees, and less than $2 million in annual revenues, from a wide range of industries, located across the United States. Additionally, all participants had sought credit for their businesses in the prior 12 months. Two separate focus groups were conducted with a total of 42 small business participants. Given the relatively small sample size, this study was not designed to derive conclusions about a representative sample of borrowers; rather, the intent was to surface key issues that could guide future research, data collection, and policy analysis.

Key Findings of the Study

- Participants already are familiar with online lending. Nearly all of the study’s participants were at least somewhat familiar with online lending for small businesses, and most were familiar with at least one or two lenders on a list of the more prominent firms. While some had positive views of online lenders, more had negative initial impressions of the industry. These negative impressions appear to be based, in part, on sales calls from lenders or brokers and frequent email and mail solicitations.
Participants preferred websites with detailed product information. When browsing online lender websites, participants reacted most favorably to sites that they thought offered the most detailed information on products, costs, and borrower qualifications. Participants were most skeptical of sites that provided limited information, especially those that withheld product details until visitors entered their business and contact information.

Participants found sample online products confusing. When presented with three sample online products, participants found the descriptions difficult to understand or lacking detail about costs and features. However, participants responded positively to a sample disclosure table clearly displaying interest rate, payment amount, fees, and other product terms. Importantly, nearly all said this level of detail, even if estimated or presented as a range, should be available to potential borrowers before they apply and turn their businesses’ financial data over to the lenders.

Participants were nearly unanimous in their call for clear disclosure of product costs and terms, and the findings suggest that improved disclosures could benefit both lenders and borrowers. Online lenders could engender trust and grow their customer base. Borrowers could evaluate competing products based, not only on the costs and features offered, but also the degree to which the lender is forthright about product details. Therefore, future policy discussions should focus on how best to inform prospective borrowers so that they can choose the credit products most suitable to help their small businesses thrive and grow.
Overview of Small Business Online Lending

Nonbank Small Business Online Credit

Online lenders are part of the emerging fintech industry that is providing a variety of data-driven financial products and services. Nonbank, online lenders are becoming more mainstream alternative providers of financing to small businesses. According to the annual Small Business Credit Survey (SBSCS) conducted by the 12 Federal Reserve Banks, awareness of online lenders has grown, and business owners increasingly turn to these companies for funding. In 2016, some one-in-five credit applicants (21 percent) sought financing at an online lender, rising to nearly one-in-four (24 percent) in 2017.¹

While no comprehensive and independent data source currently exists, consensus among industry analysts is that the volume of online lending to small businesses is relatively small—perhaps $12 billion last year. However, analysts project that online lenders will continue to grow, expanding their market share of small-dollar loans.² More importantly, while they likely will represent a small share of total small business credit for the foreseeable future, online lenders already have had outsized effects on the credit landscape, especially in the market for small-dollar loans (under $100,000). The simplified application processes and quick turnaround on approval and funding provided by online lenders are raising expectations for fast and convenient service among borrowers and are increasing competitive pressures on traditional banks.³

The industry is comprised of lenders that utilize three types of business models: (1) balance sheet lenders that raise capital and lend directly (for example, OnDeck, Kabbage, RapidAdvance); (2) marketplace platforms that connect small businesses with lenders or investors (for example, Lending Club, Funding Circle); and (3) payment processing firms and retailers that offer working capital to their merchants (for example, Square, Paypal, Amazon). What these online lenders have in common is that borrowers apply, are processed, underwritten, and serviced online. Borrowers can receive funds in a couple of days or even hours.


² The size of the industry and estimates vary significantly depending on which products and lenders are included. S&P Global Market Intelligence estimates that the five prominent lenders (OnDeck, Kabbage, Credibly, Square Capital, and PayPal Working Capital) will grow at a compound annual growth rate of 21.5 percent during the five-year period ending in December 2021 (see https://pages.marketintelligence.spglobal.com/rs/565-BDO-100/images/DigitalLending_Public_Web.pdf). PayNet, Inc., which provides small business credit information to lenders, forecasts that online lending will grow to become “a substantial and established provider” of credit for small businesses over the next 5 years, especially for loans under $250K. See William Phelan, “Financing through Fintech: Online Lending’s Role in Improving Small Business Capital Access” (testimony before the United States House of Representatives, House Committee on Small Business, October 26, 2017), https://smallbusiness.house.gov/uploadedfiles/10-26-17_phelan_testimony.pdf.

The credit products offered by online alternative lenders are known by a variety of names, including merchant cash advances (MCAs), working capital loans, marketplace loans, funding programs, capital advances, or simply, business funding. While the product terms vary significantly across funding types and different lenders, products generally fall into one of two categories:

- **Cash advances:** Advances allow businesses to convert future credit card or payment account receivables into capital. While the distinction may be unclear to the borrower, these products differ from term loans in that advances entail the sale of a set percentage of the borrower’s future receivables for a specified dollar amount. For example, $50,000 in capital is provided in exchange for $65,000 in future receipts, repaid with daily swipes of 10 percent of daily credit card sales. Depending on the speed of repayment, equivalent annual percentage rates (APRs) can exceed 80 percent or even rise to triple digits.

- **Loans and lines of credit:** Loans with fixed terms, usually three to five years, feature set payment schedules, and interest rates in the range of a typical credit card (10 to 30 percent). Shorter duration loans and credit lines share many of the features of cash advances in that they require daily or weekly payments, have higher interest rates, and may lack a fixed term. Equivalent APRs range from 25 percent to 80 percent, and funds are often repaid in six to 18 months.

Note that for purposes of this study, lenders utilizing any of the three business models and offering these types of products are referred to as “online lenders.” Though some online lenders specialize in specific types of financial products that are not structured as loans—such as merchant cash advances or credit lines—it is clear that small business owners view these companies collectively as lenders. To this point, when asked about initial impressions of and interactions with online lenders, focus group participants offered the names of numerous companies, including those that offer MCAs and other specialized products.

Online lenders use both traditional metrics (such as business or personal credit scores) and other business metrics (such as credit card sales and shipping data) in proprietary algorithms to make credit decisions. Low credit scores or minimal credit history generally are not barriers to obtaining funding, as long as the business can demonstrate revenues are sufficient to be tapped by the lender for repayment. Many lenders obtain online access to a prospective borrower’s accounting software, merchant accounts, and payroll data in real time. Moreover, they can monitor these data continuously throughout the life of the loan.

Online lenders have touted their ability to reach underserved borrowers, and data suggest they may be increasing credit access for certain small businesses. For example, an analysis of SBCS data showed that applicants to online lenders are more likely to be smaller (revenues under $1 million), newer (in business less than five years), and minority-owned firms as compared to businesses applying to traditional lenders only. A separate analysis found that online borrowers

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have characteristics similar to the businesses that were denied credit from banks, suggesting that online lenders provide credit to small businesses that likely would be denied financing otherwise. For such borrowers, online credit, albeit more expensive, may reflect their relative risk and provide a much-needed capital source. Such an expansion of credit access may be viewed as a positive development as long as the credit products are suitable, the businesses can handle the debt, and the owners understand the costs and terms of credit.

**Implications for Small Business Potential Borrowers**

While recognizing the promise of online lending, small business advocates have raised a number of concerns from the perspective of borrowers. For one, the 2017 SBCS reveals far-lower satisfaction rates for customers of online lenders, than those of more traditional financial institutions—even when approved. More than half (52 percent) of online lender applicants expressed dissatisfaction with high interest rates, and one-third cited unfavorable repayment terms. That a large share of applicants flag these issues raises the troubling prospect that many borrowers may not fully understand the cost of credit products they are considering.

In general, credit extended for a business or commercial purpose is not covered by the federal Truth in Lending Act (TILA), which requires lenders to clearly disclose lending terms and costs to borrowers. In practice, online lenders use a wide range of descriptive terms and phrases when presenting product information. For example, products may express the cost of money in terms of “interest,” “simple annual interest,” “cents on the dollar,” “fee,” “factor rate,” or as part of a “lump sum repayment.” In addition, products may entail repayment through a variety of methods, including traditional installment payments via direct monthly, weekly, or daily draws by automated clearing house (ACH), or direct draws from merchant accounts or credit card receipts. The lack of consistency across products can make it difficult for business owners to estimate interest rates and costs, and to compare products.

Questions, too, have been raised about some features of online products, such as the automatic diversion of sales receipts for repayment. Some observers have argued that the owner’s loss of control over cash flow puts some small businesses at risk. It is also the case that online lenders

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6 TILA is implemented through Regulation Z, which does impose certain substantive protections applicable to credit card holders, including where the card is issued for business use. Online alternative small business lenders, however, do not typically issue credit cards.


have invested heavily in aggressive marketing campaigns. Some rely on brokers who may steer new small business customers to online products that pay the highest commissions but are not necessarily best for the businesses. Also, some merchant cash advance companies engage in “stacking” (providing a cash advance to a business that already has one) to augment the inflow of borrowers. Small business advocates report some firms that take on added debt loads may not fully recognize the costs involved, and could potentially jeopardize the financial health of their businesses.⁹

⁹ St. Louis and others, *Unaffordable and Unsustainable*, pages 6-7.
About the Study

The Federal Reserve’s interest in online lending stems from several concerns, prompting this study. For one, the Federal Reserve has an interest in ensuring small businesses have the credit they need to operate and thrive. Small businesses are important economic engines in their communities and contribute significantly to national economic growth and employment. For another, the personal and business finances for many small business owners and their families are intertwined. Finally, the smallest businesses are of particular concern as they may lack the financing options of larger businesses and the in-house financial expertise to guide their credit decisions.

The financial technology and algorithms used by online lenders may enable credit to be underwritten and delivered with greater efficiency, convenience, and lower processing costs—a development that certainly can benefit small businesses. At the same time, concerns about small business borrower protections persist. As debate in policy circles intensifies with respect to the need for oversight of fintech lenders, the perspectives of small business owners are an important consideration and are of interest to the Federal Reserve.

The Online Focus Groups

This study aims to gauge small business owners’ perceptions of online lenders and their understanding and interpretation of information online lenders use to describe their credit products. It expands on a 2015 study, Alternative Lending through the Eyes of “Mom & Pop” Small-Business Owners: Findings from Online Focus Groups. In the earlier study, most participants were unfamiliar with online lenders, and many expressed concerns about privacy and security of their business information were they to use these lenders. As part of the study, participants were asked to compare three mock credit products on cost and other features. Although most of the participants initially said it was “easy” to compare products, many of these same participants said they were “not sure” or answered incorrectly when asked specific questions about product costs. Virtually all said they would like to see clearly stated features and costs to make it easier to compare product offerings.

The current study revisits the topic, as the industry has evolved and online lenders have become a more common source of credit over the last three years. Among other updates, this study recruited small business owners that had sought credit for their businesses in the prior 12 months. This ensured that their responses were more grounded in actual experience rather than in a future, unspecified need for credit. Also, while participants were again asked to compare examples of credit products, this study attempted to more closely replicate a credit shopping experience. The products were presented mimicking the language, content, and formatting used by online lenders, making product comparisons more realistic.

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10 The Federal Reserve’s SBCS has found that a majority of small business owners rely on personal credit or collateral to secure financing for their businesses (www.fedsmallbusiness.org/).

11 Lipman and Wiersch, Alternative Lending.
The previous study demonstrated that online focus groups are an especially effective way to convene geographically dispersed owners busy running their small businesses—a notoriously hard-to-reach demographic. Therefore, the online approach was used again for this study. It is important to note that focus groups are designed to gather insights, not to measure incidence. Results should not be interpreted numerically or otherwise generalized to the wider population of small businesses.

For an overview of the focus group methodology, see box 1. Appendixes A, B, and C provide information about participant selection and focus group topics.

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**Box 1. Overview of the Small-Business Online Focus Groups**

**Participants**
- Small businesses with 1 to 20 employees (excluding the owners) and at least $200,000 but less than $2 million in revenues.
- In business at least 2 years (as required by some online lenders).
- Business sought credit within the prior 12 months.

**Process:**
- Two separate focus groups were conducted in November 2017, with a total of 42 participants.
- Both were professionally moderated by Harris Insights & Analytics.*
- The online bulletin boards ran day and night; participants responded at their convenience.
- New questions were posted daily for three days. The boards remained open a fourth day for closing comments and follow-up questions. Participants typically spent 30–45 minutes each day answering questions.

**Topics:**
- Day 1 – financial concerns and recent experiences seeking credit;
- Day 2 – impressions of online lenders and virtual “shopping” exercise; and
- Day 3 – product evaluations and participant recommendations.

* In addition, Harris Insights & Analytics provided an independent observation report on the focus groups, which informed the authors’ own analysis as they identified the key findings.

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12 An online focus group also is known as an asynchronous (or “bulletin board”) focus group because it does not occur in real time. This method is increasingly used by banks and other financial services firms for conducting consumer research.
Themes and Observations

This section summarizes the discussion among the focus group participants and presents their views in their own words.\textsuperscript{13} It tracks the flow of topics covered during the focus group, as described in appendix C.

Cash Flow and Other Top Business Concerns

Asked about the toughest part of running their businesses, most participants cited the challenges of managing their cash flow. Some specifically noted that their ability to make payroll and their customers paying in a timely manner are worries that keep them awake at night. In addition to these concerns, other top challenges included finding and retaining staff and managing those employees, generating new business while continuing to meet client expectations and staying competitive, and dealing with the complexity of taxes and the regulatory environment (cited by some who desired to provide health care benefits). Participants also mentioned the demanding hours required of an owner; keeping pace with technology; finding mentors; and the general pressure, responsibility, and uncertainty of running a business.

Banks Are Still the Go-To Credit Source

Participants were asked to rank in order of importance a list of factors they might consider in making decisions about where to go for business credit. Overall, participants ranked “best price” first, followed by “a lender I know and trust.” The factors “likelihood application will be approved” and “quick/easy application process” were also important to participants.

With respect to where they would turn for funding, participants overwhelmingly prefer traditional financial institutions to online lenders, personal connections, or using their credit cards. As one participant put it, “I would most likely try a traditional bank first. I’m looking for credibility and reliance. Then I’d look online just to see my options.” Among those most likely to consider an online lender, a typical response was, “I feel these types of lenders are more flexible with their approval process.”

Borrowing Experiences Are Mixed

Participants that recently applied for financing at banks were generally pleased with the terms of their products and their interest rates. They did, however, express concerns about the stringent borrower qualifications, time-consuming paperwork, and long wait until approval and funding. That said, several participants that applied at their current bank remarked that their good relationships with their bankers helped to make the process easier.

\textsuperscript{13} Verbatim quotes are presented as they were typed into the online focus group bulletin boards by the participants themselves, with only minimal editing for space and clarity, or to remove names of specific lenders.
Experiences with banks were generally positive.

“Sticking with a proven lender saves time and trouble… Everything was transparent.”
— Traditional-bank applicant and owner of a writing services business in Oregon

“The process was very clear but time consuming. The bank needs a lot of information for the application, which is not always easily accessible.”
— Traditional-bank applicant and owner of an art gallery in Iowa

Some participants were not successful in obtaining credit from their banks, including several who said they were customers in good standing. They reported being frustrated with banks’ requirements (like personal guarantees) and said they believed that banks were “unwilling to take a risk” on small businesses.

Bank customers who were denied financing expressed frustration.

“I learned - once again - that despite many years with our bank, including taking out and paying back several previous loans, that the bank is really only interested in our current financial position.”
— Traditional-bank applicant and video production business owner in New York

“I … started the process by meeting with a local bank that I was doing all my banking with. After turning in P&L’s, reports and statements, the bank would not give me the loan… I then met with a smaller community bank and [was approved]. I switched all of my accounts after this.”
— Traditional-bank applicant and party rental business owner in North Carolina

Participants that recently applied at online lenders remarked favorably on the application process, convenience, and speed of funding. The concerns they expressed were related to unforeseen fees or costs and frequent or high payments.
Online lender applicants were positive about the process, but less so about costs.

“The process was a whole lot less complicated than when I bought my house.”
—Online lender applicant and co-owner of a restaurant in Arizona

“I wish I had been more diligent to look at the fine print on the loan. The fee was astronomical.”
—Online lender applicant and owner of a skin care spa in Utah

Initial Perceptions of Online Lenders Tend to be Negative

About one-quarter of the participants had submitted a full or partial application to an online lender. All participants, regardless of whether they had direct experience with online lenders, were asked, “What comes to mind when you hear the phrase ‘online lender’?”

Some participants shared positive perceptions, and others relayed neutral or uncertain views. A majority of the participants, however, conveyed negative impressions.

“competitive rates because they have less overhead”
“more willing to deal with business loans”
“easy process”
“faster loan approval turnaround”
“easy, quick and painless”

“higher interest rate”
“scam, identity theft”
“barrage of calls and snail mail”
“loan shark”
“business payday loans”
“red flags”
“not trustworthy”
“fly by night”
Participants were asked whether they thought their personal records, including financial information, would be as secure with an online lender as they would with a traditional bank. While some expressed concerns about the security of information with an online lender, most participants appeared to be resigned to what they perceived as vulnerabilities in both online and traditional financial institutions. Some participants suggested that the type of financial entity was less important to data security than the people in charge of the data. Several cited recent high-profile data breaches, and one participant noted, “even credit bureaus are hacked.”

**Bothersome Solicitations through Ads, Calls, and Offers**

All but two participants said they were at least vaguely familiar with one or more online lenders when shown a list of 15 of the most prominent companies. Some said they recognized the names of lenders that offer other services such as payment processing. Several recalled television advertising. Many said they recognized names through solicitations. In fact, more than three quarters of the participants reported receiving some type of contact from online lenders, either in the form of email, mail, phone calls, or offers.14 Most participants expressed strong, unfavorable reactions to the solicitations they have received. They used words like, “annoying,” “junk mail,” “spam,” “deceptive,” and “a scam” to describe email and mail contacts. These communications appear to have been a factor in some participants’ top-of-mind negative perceptions of online lenders.

Participants also used words like “not credible,” “ridiculous,” “unsolicited,” “irresponsible,” and “shady” to describe pre-approved financing offers from both online lenders and credit card issuers. Interestingly, several participants noted that they saved mailers from lenders, filing them away “just in case” they ran into cash flow issues or needed a new funding source.

Importantly, since the study included a number of small business owners who had previously applied for credit at one or more online lenders, many of these participants (and also some who had searched, but not actually applied) found themselves on the call lists of lenders and brokers. They described frequent bothersome—and at times aggressive—calls from brokers selling credit products.

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14 Note, this depiction of market penetration is provided for background on the experiences of the study’s 42 participants. Like other numerical indicators provided throughout the report, these figures should not be viewed as representative of the experiences of a broader population of small businesses. Furthermore, the study includes only business owners who recently searched for credit, increasing the likelihood that they would be familiar with a range of lenders.
Participants often receive calls, email, and mailers from online lenders. While some reported they “know of” certain lenders because of mail and email promotions, they strongly dislike sales calls.

“I get these calls and emails almost every day. The worst part is they almost never take ‘no’ for an answer.”
— Owner of a vehicle equipment wholesale business in Missouri

“I must say … how angry these folks make me taking up my limited valuable time with sales people who cannot take a nice polite ‘no’ for an answer.”
— Owner of a retail business in North Carolina

“I get calls twice a week and emails all the time. You just want to shut it off and not be bothered by it.”
— Owner of a machine shop in Wisconsin

“I just feel violated because I never applied for any loans. It’s a scary feeling wondering how these people get your information.”
— Owner of a medical transport business in Louisiana

“I received 20+ calls a week after I secured a loan with [an online lender].”
— Co-owner of a parking lot maintenance business in Arkansas

Virtual Shopping Experiences

Participants were asked to visit a few online lender websites and browse as if they were shopping for a $50,000 loan, keeping in mind the pieces of information they would be looking for if they were actually researching financing alternatives for their businesses.

- The most common details participants reported they looked for:
  - application process and information required by lender for the application
  - approval requirements/qualifications
  - interest rates, fees, and other charges
  - repayment terms (frequency, length of term, method of repayment)
  - maximum available loan amounts
  - time to approve application and speed of funding
Other details some participants looked for:
- background information on the lender
- customer reviews
- share of applications that are approved (approval rate)
- cost savings for early repayment

Overall, the websites that provided the most information were most appealing to participants. Numerous participants noted that even though a borrower’s actual interest rate may vary based on credit history and qualifications, they wanted at least some information upon which to compare options and to make decisions on whether to apply. Participants reacted positively to websites that provided details on rates or costs, as well as financing examples and charts comparing credit products.

While browsing online lender websites, some participants found things they liked.

“[Lender gave] simple upfront information with no worry of hidden fees, charges, etc.”
— Owner of a commercial print shop in Oklahoma

“The websites were well designed and the information was pretty easy to find.”
— Owner of a management consulting firm in Maryland

“They sure make it sound and look easy.”
— Co-owner of a home construction business in Kentucky

“[Lender] offered a lot of information up front like term loans, lines of credit, interest rates, loan qualifications and restrictions. They offer a lot more information and this is something I like to see.”
— Co-owner of a parking lot maintenance business in Arkansas

“All of the information was given clearly and I liked their comparison chart.”
— Owner of a courier business in New York
Conversely, participants were put off by websites that provided little or no information without entering their contact information. Some noted that in order to access the details that were important to them, they would have to enter information about their businesses. On these sites, many found it challenging to find the details they had been seeking on product terms, interest rates, overall cost of the credit, and repayment arrangements. Several perceived that lenders were attempting to “hide” or “conceal” true costs by excluding basic information about their products from their sites or by using terminology with which they were less familiar (for example, “simple interest” or “factor rate” versus APR).

Some participants relayed concerns about what they found (or didn’t find) while visiting online lender websites.

“I hoped to see rates, terms and what I qualified for. [The site] wouldn’t provide any information without an email or contact info.”

— Co-owner of an architecture firm in Illinois

“I couldn’t get info unless I signed in. I wanted to know how much interest, and if I paid back quickly, was there lower interest.”

— Owner of an event staffing agency in New York

“None of the companies I looked at gave solid information. They were all vague statements about how low their rates are, but there were no published rates, loan amounts and credit score information to compare.”

— Owner of a healthcare services business in Illinois

“All these sites are a lot of clicking around and not getting very far without providing information that I’m not ready to provide. I don’t want to be solicited for the rest of my life just because I was looking for some information.”

— Owner of a stone fabrication company in Illinois

“I was wondering if my IP address was being tracked because I was getting solicitations through my email while researching.”

— Co-owner of an executive search firm in Massachusetts
Some participants were surprised by the number and variety of online lenders. Moreover, the attitudes of a number of participants who initially stated they would not consider an online lender shifted to positive after visiting some of the websites. For example, one participant stated he would consider one of the online lenders next time he is seeking a line of credit. Another participant had strongly negative top-of-mind perceptions of online lenders, stating, “My first thoughts are: scam, identity theft, sucker, victim.” After visiting seven of the online lender sites and being particularly impressed with two, she said she “may look into [some] this week.”

Product Evaluation and Comparisons: Confusion Prevails

Following the virtual shopping exercise, participants were shown three sample online credit products for $50,000 and asked a series of questions to gauge their reaction to the products and the information provided. The product examples mimic the language, content, and formatting found on actual lender websites; however, no product or company names were used in the examples. The three sample products were as follows:

- **Product A** is a fixed-fee business loan repaid with a percentage of receipts from each sale. The borrower chooses the percentage and the fee is set accordingly.
- **Product B** is a short-term (one year) loan with weekly payments and a fixed interest rate.
- **Product C** is a merchant cash advance repaid with a percentage of each credit card transaction. A fixed factor rate and repayment amount are provided.

### Product A

“Our loans have a single, fixed fee that you’ll know before you sign up. There’s no periodic interest, no hidden fees, and no late fees.”

**Sample loan:**
- **Business’s annual sales:** $500,000
- **Loan amount:** $50,000

<table>
<thead>
<tr>
<th>Repayment percentage options*</th>
<th>One-time fixed fee**</th>
<th>Total to be repaid</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>$2,300</td>
<td>$52,300</td>
</tr>
<tr>
<td>20%</td>
<td>$3,500</td>
<td>$53,500</td>
</tr>
<tr>
<td>10%</td>
<td>$7,700</td>
<td>$57,700</td>
</tr>
</tbody>
</table>

* Repayment percentage is the percent of each sale that is deducted to repay the loan. Choosing a higher repayment percentage lowers your fee. Choosing a lower repayment percentage results in a higher fee, but more flexibility for your business since you’ll get to keep a larger percentage of your sales.

** Your actual fee is based on your business’s sales history, your loan amount, and the repayment percentage you choose.
Product B

“Apply online in just minutes, and receive funding as fast as one day to grow and invest in your business. Rates as low as 9%.”

Sample loan:
- **Loan amount**: $50,000
- **Repayment period**: 12 months
- **Payment frequency**: Weekly
- **Simple interest**: 9%
- **Interest cost**: $4,500
- **Total payback amount**: $54,500

* Simple interest calculates the total amount of interest you pay as a percentage of your loan amount. It is not an annualized rate. This rate excludes any fees, including a one-time origination fee of 3.0%.

Product C

“Our cash advance product offers flexible payments and no hidden costs.”

Sample product:
- **Business’s annual sales**: $500,000 (about $2,000 per day, on average, Monday–Friday)
- **Merchant cash advance amount**: $50,000
- **Cost**: 1.2 / factor
- **Repayment amount**: $60,000

* We either take a small percentage from your daily credit card sales or a daily ACH payment from your bank. Rather than fixed payments like traditional business loans, the repayment for a merchant cash advance is totally flexible and is structured to fluctuate with the cash flow of the business. There is no set payback period with merchant cash advances, because the payments are aligned with the income of the business. Our merchant cash advances don’t use interest rates, but instead a fixed cost or “factor rate” that does not change throughout the duration of the MCA.

As for preferences among the products, participants tended to evaluate the options in terms of which made the most sense for their businesses. Not surprisingly, participants with business models
that rely on invoice payments rather than credit card sales found Products A and C (with repayments based on daily sales) to be less appealing and somewhat less intuitive. Product B generally was preferred by these businesses likely because it most closely resembles a standard term loan. In general, participants found those products that were not applicable to their business model to be more confusing, and it’s likely that business owners would filter out these products during an actual credit search.

That said, the goal was to ascertain participants’ understanding of real products. Note that in the 2015 focus group study, participants were provided with a comparison chart summarizing the hypothetical features and costs in a consistent way for three credit products. In this study, inconsistencies across the product descriptions largely reflect what potential borrowers actually encounter when searching the online marketplace for credit. Several useful findings emerged from this exercise:

- **Whether or not the products were applicable to their businesses, participants found it challenging to identify interest rates or estimate costs on any of the three products.** When asked to estimate the interest rate on the products, many participants said they did not know or declined to guess. Those that did provide a figure were far more likely to underestimate than overestimate the rate. See, for instance, the box below showing “best guesses” of the interest rate for Product C. In addition, participants had difficulty comparing the costs of the products to other offline alternatives. For example, when asked whether Product B was more or less expensive than taking an advance on a credit card with a 21.9 percent rate, the majority of participants guessed it was less expensive (although it is, in fact, more costly at 23.4 percent).

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**What is your “best guess” of the interest rate on Product C if repaid in one year?**

- “20%”
- “10%”
- “12–21%”
- “24%”
- “53%”
- “18–20%”
- “very high”
- “27%”
- “I have no idea”

**Note:** The interest owed on Product C is 20 percent of the principal value. While the product description does not provide a percentage of receipts used for repayment, assuming steady monthly sales and consistent daily payments, the effective interest rate is on the order of 38 percent, and higher if funds are repaid sooner than one year.
Most participants found aspects of the product descriptions confusing or lacking sufficient detail. Others only became aware of missing information after they were asked to identify and compare costs. These participants had initially characterized the products as “straightforward” or “cut-and-dry,” but, when probed further, reported difficulty estimating costs without more clarification.

Participants were confused by terminology used to describe all three products. For Product A, “repayment percentage options” was a confusing term for some participants who thought this was an interest rate, rather than a share of sales. For Product B, participants most commonly conflated “simple interest” with the APR. In addition, the phrasing of the statement “this rate excludes any fees, including a one-time origination fee of 3%” (emphasis added) perplexed some participants. For Product C, the term “factor rate” was the main source of confusion for a majority of participants who stated they had not heard it before.

Participants strongly disliked that information they considered important appeared in fine print or footnotes. For example, for Product B, participants were presented with fine print, stating that “The typical simple interest rate charged is 24%.” This triggered annoyance among virtually all the participants, including those who initially found the product attractive. Most of these participants noted they would no longer consider this product, some for reasons of cost (“way too high” and “a deal killer”), and some because they felt the presentation of this information was “misleading” or “terribly deceptive.” Several others were less deterred and thought the additional information was useful, but “should have been presented upfront.” Participants also were asked whether they had noticed fine print when they had visited websites in the virtual shopping exercise. All but a few reported they had not noticed fine print, with several commenting they would now know to look for it.

Participants tended to make (sometimes mistaken) assumptions about the products based on past experiences with traditional bank loans. For example, some participants assumed their borrowing costs would decline if the loan were paid off quickly even when, as was the case in Products A and C, that repayment was presented as a total amount owed rather than an interest rate. Asked about the impact of faster sales growth on total repayment and interest costs on these two products, a number of participants assumed that, as with conventional loan products, they would incur some savings by repaying early. Others were uncertain, especially about the impact on the interest rate they would be paying. (In fact, total repayment amounts on these two products would be unchanged, there would be no savings on interest, and effective
interest rates would rise because of the shortened repayment period.)

Many participants were confused or uncertain about the impact of early repayment on their total costs and interest rates. This was particularly true for Product C, though Product A also was confusing to some.

“The stronger the sales the faster you could pay off the loan which would in effect lower the interest rate.” (referring to Product A)

— Owner of a commercial janitorial business in Washington

“Obviously repayment could be quicker. However, if you are locked in to a certain percentage rate and cannot change it during the term of your loan, it wouldn’t affect your interest rate.” (referring to Product A)

— Owner of a commercial print shop in Oklahoma

“If the sales were stronger and I had gone with the 30% option I would be paying it back very quickly to not incur more interest.” (referring to Product A)

— Owner of a medical billing practice in Kansas

“Your daily repayments are going to be higher and you will pay off the loan quicker, which in a normal world would lower the interest. But I think with this product it would stay the same.” (referring to Product C)

— Co-owner of a parking lot maintenance business in Arkansas

“I think the total repayment amount might be less. With a faster repayment, the effective interest rate might be less. With higher sales, you would likely pay back the loan more quickly.” (referring to Product C)

— Co-owner of a video production business in New York

“If sales increased, I would definitely plan to [pay] the loan back much sooner and have a lesser repayment amount.” (referring to Product C)

— Owner of a retail food products business in Georgia
The different presentations of information for each of the Products A, B, and C reflect the variety of products and product descriptions in the online credit marketplace. At the same time, most participants found the lack of standardization in presentation and the inconsistency in terminology across the descriptions of product costs and features to be problematic.

When asked about their difficulty comparing products, participants said they wanted transparency and consistency in lenders’ descriptions of costs and terms.

“It’s difficult to decide [between products] because the information is not presented in a consistent way.
— Owner of a management consulting business in Maryland

“I’d do my best to compare apples to apples as much as possible.”
— Owner of a vehicle equipment wholesale business in Missouri

“It is difficult [to compare when] they are using different models and different terminology to try to get our business.”
— Owner of a manufacturing business in Colorado

Impressions of a Standard Format for Credit Product Costs

Following the product review exercise, participants were presented with a stylized sample disclosure box, as shown on page 22, and asked their impressions of the format. Not surprisingly, participants overwhelmingly liked the format and the wealth of information contained in the table. Among their comments: “I like this and see what is important to me!”; “This is exactly how I would like to see the breakdown”; “This is straight to the point”; “It has everything a borrower would want to know”; and “I would prefer a standard format like this when comparing loan rates.”

15 In 2016, several lenders in coordination with a nonprofit organization, launched the SMART Box disclosure initiative, aimed at developing a format for voluntary disclosures in loan documents that would present total cost of the loan, APR, and other repayment terms. The effort is voluntary and still in its early stages. The online focus group exercise presented here, while covering some of the same metrics, is not meant as either an endorsement or a critique of the SMART box effort. For more information on the SMART Box Model Disclosure Initiative, visit http://innovativelending.org/smart-box/.
Participants were then asked what information presented in this box was most important and what additional detail was needed.

- APR, repayment amount, frequency of payments, and prepayment penalties were cited as most important;
- Cents on the dollar was most frequently mentioned as being the least important;
- Among items noted as missing were the compounding method (monthly, weekly, daily), clear information on the effect of prepayment on amounts owed, and whether there are penalties or additional fees if payments are late or if it takes longer to repay than anticipated.

Participants were nearly unanimous in their desire to receive this information early in the process, even if figures are estimated, provided as ranges, or are averages based on a “typical” customer of the lender. Nearly all participants said this information should be available to a prospective borrower before they apply, as the information would be very valuable to them during their credit search. Participants noted that receiving the disclosure box at signing was far too late, as they would already have invested a lot of time into the loan process and turned over their financial information to lenders. As a practical matter, too, businesses may have already committed the anticipated funds, making it difficult for them to back out if the costs and terms are not as expected. Drawing from personal experiences, participants were concerned about the current practice of submitting applications to multiple lenders just to get details they could use to compare products. Several mentioned related concerns about the impact of lenders’ credit checks on their credit scores as they went about exploring their credit options.
When asked when in the process they wanted product details, participants said as early as possible to help them make informed decisions about where to apply.

“I would like preliminary information [average APR and costs] before applying so that I don’t waste my time.”
— Owner of a party rental company in North Carolina

“Even if they have to give a range, it makes the process much more transparent.”
— Co-owner of an environmental consulting firm in North Carolina

“The earlier the better but definitely not at the time the loan closes… I think it’s too late even at the time of approval…and [if] it’s a poor or too high rate, I may back out.”
— Owner of an architecture firm in Illinois

“Before [I apply] allows me to compare lenders. After I submit a loan application, I would expect a lender to send back an updated version of this chart with the actual terms. I would expect something like this to be on the actual loan documents, but if that’s the only option, it’s too late in the process.”
— Co-owner of an IT services business in South Carolina

“I would like it before I apply. This way I can have a basis of comparison with other companies.”
— Owner of a home electronics business in New Jersey

Participants’ Recommendations

Participants were asked what suggestions they had to ensure that online loans best serve the needs of small businesses. Many recommended clearer product descriptions and suggested that information be presented using concepts and terminology already familiar to them; that is, discussed in a manner typically used for traditional credit products. For product details they deem important, such as interest rates, total cost, and repayment amounts, they want the disclosures to be:

- provided up front, before the prospective borrower provides any personal information;
- expressed in clear and easy-to-understand language;
- standardized and consistent;
■ inclusive of all costs (that is, no hidden fees); and
■ explicit about the impact, if any, of prepayment.

They also want a clear sense of the borrower requirements, both in terms of qualifications (credit score, years in business), and information that will be required of them. Other suggestions included requiring a loan rate or cost calculator, disclosure of borrowers’ rights, and prohibiting weekly or daily repayment schedules due to the hardship it places on businesses’ cash flow.

Many participants said they would like to see guidelines for consistent presentation of information across credit products as well as some measure of borrower protection.

“I should be able to enter hypothetical numbers on the site (how much, credit score, etc,) and they should be able to give me a general range of interest and payment amounts.”
— Owner of a theatrical production company in New York

“Keep it simple and upfront. As a small business owner, I don’t have a legal team to read through 15 pages of [jargon].”
— Co-owner of a restaurant and catering business in Iowa

“Give business owners some protection from the predatory lending and constant calling by every lender under the sun.”
— Owner of a vehicle equipment wholesale business in Missouri

“A standardized information sheet would be helpful, not unlike a car manufacturer label or a HUD disclosure statement.”
— Co-owner of a home construction business in Kentucky

“I’m not a fan of asking for more regulations but I think we need to ensure all small business owners are protected. Loan sharks come to mind.”
— Manager of a medical billing practice in Kansas

“There should be a law that requires all institutions to present information up front prior to any of my information being solicited. There should be legal ramifications if my information is used improperly or a “bait and switch” occurs.”
— Owner of a healthcare services business in Illinois
Issues for Consideration

As noted earlier, the findings discussed in this report are based on online focus groups with 42 small business owners and should not be considered representative of the nation's small business population. That said, these discussions are informative and provide insights into the experiences of actual and potential borrowers from online lenders. They also suggest areas for policy consideration and future research.

Observations on Trust

Although price is a primary consideration when seeking credit, other factors matter in borrowing decisions. As previously noted, “a lender I know and trust” ranked second by participants in a list of factors. This may be one reason why banks are still the go-to source for credit for the majority of participants. Banks are where most participants maintain their accounts, and some said they value their banks because “they know me,” and are “safe” and “regulated entities.” Participants who have used an online lender were more likely to rank other factors more highly than trust, such as “likelihood of application being approved,” or “quick/easy application process.”

Since online lending is a relatively new industry, potential borrowers tend to seek out signs of trustworthiness. For example, when shown a list of companies, participants who said they were not familiar with online lenders gravitated toward name brands they recognized as providers of other products and services. In the virtual shopping exercise, quite a few participants sought out user reviews and third-party endorsements in order to ascertain the trustworthiness of the sites they visited. In some cases, where participants indicated they would not use online lenders, positive impressions of a website appeared to increase their trust level such that they would consider using their products. Interestingly, data privacy and security concerns about online lenders were less of a deterrent as compared to the 2015 study. Although some voiced this concern, most participants seemed resigned to the possibility of data breaches at all financial companies, not just online lenders.

That said, many of the participants do mistrust online lenders, and their perceptions of the industry may be influenced by repeated and persistent sales calls and spam emails, which the business owners find bothersome and intrusive. Negative impressions of the websites tended to reinforce mistrust, especially when participants suspected fees and costs were “hidden” or that the advertised “as low as” rates were not what they actually would be offered. When visiting online lender websites during the study, participants often reported they could not view key product details—items essential to their decision whether to apply with a certain lender—unless they entered their business and contact information. Several connected this request for their information to the potential for unwanted contacts from lenders and brokers.

Trust through Better Disclosure

As most participants made clear, they want to work with lenders they can trust. Based on their responses, better disclosures are one way for lenders to establish trust with potential borrowers.
In this study, three sample products were presented to participants mimicking the language and content actually used by online lenders. Many of the participants said they were unsure or answered incorrectly when asked specific questions about repayment amounts or interest rates. Generally, participants recognized their difficulty evaluating and comparing these products, and that may account for their unanimous, enthusiastic response to the sample disclosure box on page 22. They didn’t necessarily know—or care—about technical distinctions between traditional loans and other credit products, such as cash advances. But, they strongly favored an “apples-to-apples” comparison that could give them more confidence in their choice of products and lenders.

Questions remain, however, on how best to design disclosures that include sufficient (but not overwhelming) details, in a visually compelling format, and early enough in the shopping process to actually be useful for decisions about whether and where to apply. Research on consumers shows it is difficult to balance these elements in practice. Experience with disclosures for consumer credit is apropos because many small business owners are consumer-like and rely on personal credit. This experience also underscores the importance of testing model disclosures in the field. Controlled experiments, while challenging and costly to implement in the past, have been shown to significantly improve the effectiveness of disclosures. Today, financial technology could be harnessed, not only to market credit products to businesses, but also to conduct such experiments cost-effectively. This technology also might be used to develop cost calculators, prepayment scenarios, and product comparisons tailored to the specific situation of individual borrowers—tools many participants said they would want.

It is important to acknowledge that better information will not necessarily lead to better borrowing decisions. Some decisions may be rushed because the owner has an urgent need to quickly acquire inventory or to make payroll. Some small business owners may be less financially savvy when it comes to using the information disclosed or simply less motivated to comparison shop. For some, sorting through myriad credit options still would be a challenging task.

Generally, though, improved disclosures could benefit all players in the online credit market. Online lenders could engender trust and increase their customer base. Borrowers could evaluate competing products based, not only on the costs and features offered, but also on the degree to which lenders are forthright about product details. As one participant noted, if sufficient product details are not provided, “I will run, not walk away.” Certainly, online credit products, even with high APRs or total repayment amounts, can serve small businesses well and help them capitalize on opportunities. Going forward, policy discussions should aim at how best to inform prospective borrowers so that they can choose the credit products most suitable to help their small businesses thrive and grow.

18 That said, numerous participants noted that the comparison exercises and follow-up questions in the study prompted them to more carefully consider aspects of credit they had not previously. This suggests disclosures could play a role in educating potential borrowers by raising their awareness about product features and costs.
Appendix A
About the Participants and Their Businesses

A total of 42 participants took part in the two national online focus groups. They were identified and recruited through a detailed screening process (see appendix B). The pool of participants ranged across revenues, geography, and industry. Participants came from 22 states across the United States and operated in a variety of industries. As seen in the charts below, they were a diverse group reflecting various demographic and business characteristics.

### Industries
- Architecture
- Art gallery and framing
- Bookbinding
- Commercial janitorial services
- Construction site preparation
- Courier service
- Engineering
- Environmental consulting
- Event staffing
- Executive search
- Flood restoration
- Greek restaurant
- Healthcare services
- Home electronics installation
- Home construction
- Hygrometer manufacturing
- Iron works
- IT consulting
- Law office
- Machine tooling
- Management consulting
- Medical billing
- Medical spa
- Medical transport
- Motion picture equipment
- Parking lot maintenance
- Party supplies rental
- Pest control
- Photography services
- Pillow manufacturing
- Printing services
- Restaurant and catering
- Retail food products
- Retail general merchandise
- Skin care spa
- Software content management
- Stone fabrication
- Theatrical production
- Travel agency
- Vehicle equipment wholesale
- Video production
- Writing services
Appendix B
Focus Group Screener Questions

The qualitative research team at Harris Insights & Analytics and their partners recruited participants for the online focus groups using the criteria noted in box 1 on page 8 of this report. Participants were asked a series of screener questions to determine if they met those criteria. Below, items italicized and in brackets are instructions for the interviewer to probe more deeply on specific questions or to terminate the interview if the criteria are not met.

Besides yourself, how many employees, either full or part time, are in the company that you work for?
1. 1–20 employees [Terminate if no employees other than the owner]
2. 21 or greater [Terminate]

Which of the following statements best describes your involvement at your business?
1. I am the sole owner of the business
2. I am part owner of the business
3. I manage the business, but don’t own it
4. Not an owner or manager of the business [Ask to speak to; otherwise, terminate]

Which of the following best describes your role in financial decisionmaking for your business? (Select one.)
1. I am a final decisionmaker in all financial business decisions
2. I share the decisionmaking in all financial business decisions
3. I have no involvement in financial business decisions [Ask to speak to the financial decisionmaker; otherwise, terminate]

Does your business fit into any of the following industries?
1. Nonprofit organization [Terminate]
2. Retail Trade
3. Health-care
4. Technology
5. Marketing research [Terminate]
6. Lending industry, such as a bank, credit union, or loan firm [Terminate]
7. Other

Please describe your business. [Categorize for purposes of obtaining a mixture of industries]

How long has your company been in business? [If less than two years, terminate]

Is this business your primary source of income? [If “no,” terminate]
To ensure a wide range of respondents, which of the following best describes the total annual revenue for your business before taxes? Your best estimate is fine.

1. Less than $200,000 [Terminate]
2. $200,000 to less than $500,000
3. $500,000 to less than $1,000,000
4. $1,000,000 to less than $2,000,000
5. More than $2,000,000 [Terminate]

We are interested in understanding your familiarity and experience with different lending sources and ways of obtaining funds. Have you ever applied to any of the following sources to obtain funds or loans for the purposes of operating or growing your business, debt consolidation, or refinancing?

1. Traditional financial institutions such as a bank or credit union, either in person or online
2. Online lenders such as merchant cash advance companies, peer-to-peer lenders, or online direct lenders (We do not mean an online application to a bank or credit union)
3. Credit cards, either business or personal
4. Other (Specify)

We are looking for a mixture of respondents who have applied/have not applied at online lenders. When was the last time you applied for credit?

1. Within the past 6 months
2. Within the past 6–12 months
3. 1+ years ago [Terminate]

Which of the following online funding sources have you heard of:

- Lending Club
- Prosper
- CAN Capital
- Rapid Advance
- OnDeck
- Kabbage
- Amazon Capital
- PayPal Working Capital
- Square Capital
- Swift Capital
- Credibly
- BlueVine
- Bizfi
- Any other online direct lenders, merchant cash advance companies, or peer-to-peer lenders you have heard of? (Specify)
- None of the above [If answered “yes,” applied to an online lender, but can’t name, terminate]

Did you apply for a loan or other forms of credit at any of the following sources for the purpose of operating or growing your business, or for debt consolidation? [List each company respondent heard of; looking for a mixture of respondents who have/have not applied at online lenders.]

Did you receive any of the funds you applied for at ________? (Companies that the respondent said they applied to)

[Recruit a mix of those who have and have not received funds from an online lender.]
What age group do you fall into? [Terminate if less than 18]

What do you consider to be your ethnic background?

**Invitation for Bulletin Board:** Based on your responses, we would like to invite you to participate in an online “Bulletin Board” style focus group sponsored by the Federal Reserve to discuss some topics regarding small business lending needs and lending practices.

*(Participants committed to spending 30–45 minutes each day for three days answering questions and were provided with a $200 incentive upon completion.)*
Appendix C
Focus Group Topic Guide

During the online focus group, participants logged into a secure internet site each day over a period of three days to respond to questions. They could view questions one at a time and were able to see others’ responses only after posting their own. The groups were professionally moderated by Harris Insights & Analytics (formerly the Nielsen Company), with Federal Reserve staff observing and conferring with the moderator on follow-up questions for participants, when needed.

Summary of Day One Questions – Introduction, Financial Concerns, and Recent Experiences Seeking Credit

1. Introduce yourselves by talking a bit about your business and some interesting things about what you do, e.g.: What your business is all about; how long you’ve been doing this; your role and responsibilities. What do you like most about running your business? What gives you the greatest satisfaction and joy? What’s the toughest part about running your business?

2. Think about what’s required to keep your business up and running and able to meet your financial obligations. What’s your business’s biggest financial concern today? What is the one thing that’s keeping you up at night and making you nervous?

3. Have you ever been faced with a business problem or opportunity where you needed cash to fund it? What did you do? How did you handle it?

4. When it comes to getting the money you need to meet a financial challenge or fund an opportunity for your business, what’s the biggest challenge you face?

5. Think about your most recent experience applying for a business loan. Tell the story about the process you went through applying for the loan, noting everything you remember, including:
   - What the business loan was for
   - What specific lenders you chose to apply to (and why you picked them)
   - What you may remember about the terms of the loan (the cost of borrowing the money, how you have to pay it back, things like that)
   - What you saw or heard that you liked
   - What you may have been confused by or concerned about
   - What you learned during the process

6. Did you get approved for the loan? Did you take it out? If so, has it worked out the way you thought it would? Any surprises?
Summary of Day Two Questions – Impressions of Online Lenders and Virtual “Shopping” Exercise

1. Think about specific places you go to, or might consider going to, to secure a business loan. Here is a list of some of the factors that you might take into consideration when making decisions about where to go to get your business loan. How would you prioritize each factor (and please list any additional factors)?
   - best price
   - quick and easy loan application process
   - lender offers terms that best meet my needs
   - can get my funds ASAP; quicker than other lenders
   - likelihood application will be approved
   - low monthly payment amounts
   - flexible repayment terms
   - a lender I know and trust

2. In general, which of the following sources are you most likely to consider for a business loan? Which are you least likely to consider? Why?
   - a traditional bank, savings and loan, or a credit union
   - an online lender not affiliated with a traditional banking institution
   - business or personal credit cards
   - personal connections

3. What comes to mind when you see or hear the phrase “online lender”? How do you think online lenders compare to traditional banks? How are they the same? How are they different?

4. Here are the logos of a number of online lenders:
   - What's your reaction to seeing this list?
   - Which of these online lenders had you heard of before this research?
   - How familiar are you with what these companies have to offer?
5. Thinking back, have you seen information or ads from any of these (or other) online lenders? What do you remember seeing? Where did you see them?

6. Have you looked for information about an online lender?
   - What was it like? What did you have to go through to get all the information you needed?
   - Which online lenders did you look at?
   - What did you think about what they had to offer?

7. Have you ever been directly contacted online, by phone, or in other ways by a sales person or broker who wanted to present, talk about, or sell you an online loan? Describe your experience with any solicitations you have received.

8. Have you ever received a pre-approved loan offer from an online lender?
   - If so, did you investigate it?
   - Did you accept the offer?
   - How did you feel about being offered a pre-approved loan? Any concerns?

9. Today, many business owners are focused on making sure their financial and personal records stay secure and protected. Do you feel your personal records (like your social security number and your bank account information) are as secure with an online lender as they would be with a traditional lender like a bank? Why do you feel this way?

10. We’ll be talking more about loans from online lenders. To prepare for our discussion tomorrow, please go online and visit a couple of websites of the online lenders listed or others you may know. [Participants were again shown the box from question 4.] Please go to at least one you haven’t visited before. **PLEASE, don't apply** or provide any personal information.

11. As you browse a few of the online loan websites, assume you are shopping online for a loan of $50,000.
   - Check out how the different lenders present what they are offering.
   - Please take notes about what information you would look for, and how easy or difficult it is to find these details. Also, note how easy or difficult it is to compare information from different lenders.
Summary of Day Three Questions – Product Evaluations and Participant Recommendations

1. Let’s talk about what you saw, and what you learned, when you went online and looked at a few online lender sites last night. For the online lender websites you visited:
   - What information were you looking for?
   - How easy or difficult was it to find that information?
   - Which one site did you feel gave you the best information and what makes you feel this way?

2. What do you think is the most important information you need when applying for or taking out a loan with an online lender?

3. Let’s assume your business needs a $50,000 loan and you find the following on an online lender’s website. [Participants were presented with Products A, B, and C one at a time and asked about each product. See pages 16 and 17 of this report for product descriptions.]
   - Is this a product you would consider?
   - What do you like about what you see here?
   - What concerns you?
   - Is there anything confusing?

4. Is there any additional information you would like to have before deciding if you would want to apply for this loan from this lender?

Product-Specific Questions

5. Product A - Which repayment option would you choose and why: 10%, 20% or 30%? What would you expect the interest rate to be? Let’s say your sales are stronger than expected. How do you think this would affect your repayment? What about the interest rate?

6. Product B - Do you estimate this product would be more or less expensive than taking an advance on your business credit card at 21.9%? [Next, participants were presented with fine print noting 24% typical simple interest rate.] What’s your reaction to seeing this new information? Where in the description of the loan should this be presented? How does this information affect your willingness to consider this product? Did you notice similar “fine print” during your search of online lender websites yesterday?

7. Product C - What would you expect the interest rate to be if you repaid in one year? Let’s say your business expands and sales jump to $3,000 per day. Please think about the following and answer as best as you can using the information supplied by the lender. How do you think this would affect your daily repayments? What about the total amount you repay? What about
the interest rate? Do you think it would be higher, lower, or the same? What about how quickly you’d pay it back?

8. Let’s say you are considering all 3 products and need to decide which works best for you.
   ■ What information would you focus on? What is most important to you?
   ■ Do you find it difficult to compare information from different online lenders because it is not presented in a consistent way?

9. Here’s one way of presenting information so that each and every website product description you look at would be consistent. As you look at it, consider what you said was important to you. [Participants were presented with a sample disclosure box in the format shown on page 22 of this report.]
   ■ What’s your reaction to this way of presenting online lender information?
   ■ What do you like best about what you see here?
   ■ Is there any information here you don’t need?
   ■ Is there anything missing?

10. Which items would be most important to you if you were comparing products?

11. At which point in the process would you most like to have this information?
    ■ Before you apply (even if the rates and amounts are averages or estimates)?
    ■ After your application has been approved (with the actual rates and terms)?
    ■ Or, at the time the loan closes?

12. Based on what you have learned about online loans, what specific recommendations would you make to ensure that online loans best serve the needs of small businesses?
Closing Keynote Session:
Cybersecurity & Artificial Intelligence
Issues Confronting the Legal Profession
by
Christina Montgomery
Chief Privacy Officer
IBM
Artificial Intelligence and Cybersecurity Issues Affecting the Legal Profession

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Artificial Intelligence ("AI"), once only a figment of the imagination of the science fiction writer, is now a reality that permeates our lives. It has continued to expand, grow, and change at a rapid pace over a relatively short period of time, and its impact is widespread.\(^1\) AI is the term used to describe how computers perform tasks normally viewed as requiring human intelligence, such as recognizing speech (think “Alexa” and “Siri”), identifying objects, making decisions based on data, and translating languages.\(^2\) “Machine learning” is an application of AI in which computers use algorithms (rules) embodied in software to learn from data and adapt with experience. Some AI programs train themselves, while others need to be trained by humans feeding them data.\(^3\) AI has already impacted the legal profession and likely will continue to change the way in which law is practiced, how legal services are provided, and how clients are represented.\(^4\)

**It is Not So Elementary My Dear Watson**

Watson, named after IBM’s first CEO, and not the dear doctor and trusty assistant of

\(^*\) This overview was prepared by Kimberly Goodwin-Maigetter, paralegal to the Honorable Michelle M. Harner (Bankr. D. Md.), for purposes of the 2019 National Conference of Bankruptcy Judges Annual Meeting. The materials are intended to provide general background information for the November 1, 2019, keynote address. The materials do not represent the views or work of the keynote speaker.


\(^3\) Id. at 2.

Sherlock Holmes, was initially developed to compete on the game show “Jeopardy”. One night in February 2011, many viewers while watching the game show got the chance to see Watson in action. Three episodes made TV and science history as IBM’s Watson took on the two best players and won. Watson has many offspring now, in many sectors, with some bearing his name and some not. A scan of IBM’s Watson website will reveal that Watson has moved into social services, the health industry, data analytics, wearable technology, the banking sector, and even fantasy football.

Significant to the legal profession is Watson’s lawyer son. The “son of Watson” called “Ross” was born out of a Watson University Competition, at which a group of University of Toronto students built a legal application on top of the Watson platform. The students placed second in the IBM contest. Ross is branded as an artificially intelligent attorney that helps human lawyers research faster. When asked a question in plain English, Ross returns an answer with readings from statutes, cases, and other sources.

Ross’s handlers claim that Ross can think like a lawyer. Furthermore, by taking advantage of the natural language and cognitive computing platform that Watson offers, Ross can predict the outcome of court cases with a confidence rating, assess legal precedents and suggest readings to prepare for cases. Interestingly, as of August 2015, Ross was learning everything there is to know

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7 See id.

8 See, e.g., id. at 37.

9 See, e.g., Edward J. Walters, Jr., Ipse Dixit: Big Data, 64 LA. B.J. 248 (2016).

10 See id. at 248.

about U.S. bankruptcy law.\textsuperscript{12} Ross’s powerful software is currently changing the way bankruptcy and restructuring lawyers research the law. Its natural language search capabilities enable sophisticated queries that go beyond ordinary key word searches.\textsuperscript{13} Not surprisingly, Ross is being utilized in several elite law firms.\textsuperscript{14}

Besides Ross, there are numerous technologies in the subfield of AI and the law to consider in a discussion on the effect of AI and the legal profession.\textsuperscript{15} A few to mention here (although there are more, and the numbers are growing) are IBM’s Watson Debater, ModusP, Lex Machina, Modria, Premonition, BEAGLE, and COMPAS. Watson Debater is a new feature of IBM’s Watson computer. When asked to discuss any topic, it can autonomously scan its knowledge database for relevant content, comprehend the data, select what it believes are the strongest arguments, and then construct sentences in natural language to illustrate the points it had selected, in favor and against the topic.\textsuperscript{16}

The Israeli startup company, ModusP, has created an advanced search engine using sophisticated algorithms based on AI. The search function helps jurists reduce legal research hours by finding legal knowledge and insights more efficiently.\textsuperscript{17} Another AI tool, Lex Machina, acquired by LexisNexis in 2015, transforms data from federal court dockets into live charts.\textsuperscript{18} In Lexis Advance, one can access this data by clicking on the hyperlinked judge’s name in the text of a case that shows a summary with the judge’s biographical information, open cases by practice

\textsuperscript{12} Nelson & Simek, \textit{Watson’s Children}, supra note 6, at 38.
\textsuperscript{13} See, e.g., Internet Law Researcher, 21 No. 11 GLILR-NL 5, \textit{The Search Engine and AI Review Primer on Machine Learning and Artificial Intelligence}, November, 2016.
\textsuperscript{14} Nelson & Simek, \textit{Watson’s Children}, supra note 6, at 38.
\textsuperscript{16} Id. at 55.
\textsuperscript{17} Id. at 55.
area, comparisons to other judges in the district, cases filed by year and case timelines. The latter charts can give one a sense of how long the dispute may take to resolve, and the odds of winning at trial. Lex Machina’s Motion Chains enables one to analyze the odds of success for a specific type of motion based on historical data. Similarly, an attorney can see how opposing counsel has performed on similar cases or before a particular judge. Further, one can also research parties, case damages, venues, practice areas (and so on) for business development purposes.

Another company, Modria, seeks to increase efficiency still further, through automating the dispute resolution process through the use of algorithms, effectively removing humans from the justice delivery system. There is also Premonition, which is a legal analytics software that can rank arbitrators based on past decisions, help select expert witnesses based on their persuasiveness and past case results, and can help analyze the court, judge and opposing counsel based on their win rate and results. It can also help with tailoring client pitch data, finding local counsel and recruiting new litigators.

BEAGLE utilizes AI to quickly highlight the most important clauses in a contract. It also provides a real-time collaboration platform that enables lawyers to easily negotiate a contract or pass it around an organization for quick feedback. BEAGLE’s learning process allows the program to adapt to focus on what users care about most. COIN, which is short for Contract Intelligence, is another contract review tool, used since June 2017, by JPMorgan, is an AI powered program.

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19 See id. at 24.
20 See id. at 24.
21 See id. at 24.
22 See id. at 24.
25 See, e.g., Ben-Ari et. al., supra note 15, at 55.
26 Id. at 55.
used to interpret commercial loan agreements. The bank plans to use the technology to interpret other legal documents as well.27

Finally, another AI tool developed by a private company called Equivant (formerly Northpointe), Its name COMPAS—or the Correctional Offender Management Profiling for Alternative Sanctions—purports to predict a defendant’s risk of committing another crime.28 It works through a proprietary algorithm that considers some of the answers to a 137-item questionnaire.29 The American Bar Association has urged states to adopt risk assessment tools in an effort to reduce recidivism and increase public safety. Some states that use COMPAS have conducted validation studies of COMPAS concluding that it is a sufficiently accurate risk assessment tool.30 Although not directly used by law firms, it can significantly impact the way counsel represents a criminal defendant.31

**Changing How Legal Services are Provided**

Although AI can’t yet replace advocacy, negotiation, or structuring of complex deals, it can do things like review documents during litigation and due diligence, analyze contracts to determine whether they meet pre-determined criteria, perform legal research, and predict case outcomes.32

The development of the field of AI and law starts with programs that analyze cases and continues with technologies that make lawyers’ tasks efficient, solve disputes, and replace human intervention.33 This is not to say that the legal profession is going away. Many argue that these AI technological advancements will allow and provide more opportunities for those willing to work

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27 Donahue, *supra* note 2.
29 Id.
32 Donahue, *supra* note 2.
33 Ben-Ari et. al., *supra* note 15, at 56.
with the AI.\textsuperscript{34} To take advantage of these opportunities, it is vital that attorneys know what the emerging technologies are and how to work with them.\textsuperscript{35}

There are numerous examples to illustrate how AI can change the provision of legal services, but only a few are discussed here. One example, and probably AI’s most used aspect, is legal research. Any lawyer who has performed legal research using Lexis or Westlaw has used legal automation, but AI takes research to the next level.\textsuperscript{36} Ross, for an example, uses the power of Watson to find similar cases, even responding to queries in plain English.\textsuperscript{37} Andrew Arruda, CEO and co-founder of Ross, said this is just one of many success stories. Ross’s breakthroughs in legal research software using “natural language processing” means that “legal research now goes from a task that takes hours down to a task that might take half that time to find the same results.”\textsuperscript{38} Arruda added that lawyers are also “finding cases they literally never would have found anywhere else.”\textsuperscript{39} Because Ross is a cognitive computing platform, it learns from past interactions, that is, Ross’s responses increase in accuracy as lawyers continue to use it. This feature can help lawyers reduce the time spent on research. This will affect how much time a lawyer has in preparing a case which will better serve the client.\textsuperscript{40}

Another example is contract review. BEAGLE purports to review legal documents and reduce manual reviewing error rates, reducing the average time for legal review to less than 20 minutes, and increasing legal review accuracy by twenty percent (20%) (BEAGLE’s website

\textsuperscript{34} See, e.g., William J. Connell, Esq., M.Ed. \& Megan Hamlin-Black, Artificial Intelligence and Legal Education, 67 R.I.B.J., 5, at 6 (2019).
\textsuperscript{35} See, e.g., Id. at 6.
\textsuperscript{36} See, e.g., Donahue, supra note 2.
\textsuperscript{37} Id.
\textsuperscript{39} Id.
\textsuperscript{40} See, e.g. Ben-Ari et. al., supra note 15, at 55.
The contract review applications such as BEAGLE and COIN are not only being used by law firms, they are being used by companies to save money by not having to pay attorneys for contract review. In-house departments are increasingly pressured to become more efficient and measure performance. These pressures ensure that every in-house leader will need to consider AI at some point. Thomas Trujillo, who up until approximately 2017, served as a chief operating officer in Bank of America’s legal department, explains the typical plight: “There is more and more pressure on companies and law departments to evolve and reduce costs. We must balance competing demands and a limited budget.” Fortunately, a wealth of AI technology is already here, and is rapidly changing and automating the way law is practiced, from research and contract review to other areas of services. AI will put pressure on lawyer billing, as clients will expect less time to be spent on research and contract review. That is not to say that these items will not be a part of a lawyer’s billable practice, but clients will be seeking attorneys who use AI in a cost-effective manner.

Adapting Client Representation and the Practice of Law When AI is Involved

AI is affecting client representation both in- and outside of the firm and the courtroom. For an example, Watson Debater can assist lawyers by suggesting the most persuasive arguments and precedents when dealing with a legal matter, enabling them to represent clients more effectively. Other AI technologies such as Lex Machina that give lawyers more information on specific judges, a client’s history, and information on what they can do to have a better chance of winning could

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43 Id.
44 Id.
45 See, e.g., Connell, supra note 41, at 7.
46 See, e.g., Ben-Ari et. al., supra note 15, at 55.
possibly impact not only representation in the courtroom, but also in whether to enter into settlement negotiations. The same can be said with Premonition and its suggestions on which lawyers win the most cases before which judges. This might impact leaning towards attempting settlement instead of litigation or litigating instead of accepting a settlement.47

Perhaps, a telling example of how AI can affect client representation is the use of COMPAS by the court. Initially, risk assessment tools such as COMPAS were only used by probation and parole departments to help determine the best supervision and treatment strategies for offenders.48 However, in State v. Loomis, the court held that if used properly, observing the limitations and cautions set forth in its opinion, a court’s consideration of a COMPAS risk assessment at sentencing does not violate a defendant’s right to due process.49 In Loomis, the defendant denied involvement in the crime but waived his right to trial by agreeing to a plea deal. The plea deal left the actual sentence to the discretion of the Wisconsin circuit court judge.50

The judge accepted the guilty plea from the defendant and ordered a risk assessment. The assessment predicted the defendant had a high risk of recidivism.51 “Instead of one year in county jail with probation, which the prosecution and defense had agreed upon, the circuit court sentenced the defendant to ‘seven years with four years initial confinement’ for operating a motor vehicle without the owner’s consent.”52 In addition, the court sentenced the defendant to four years with two years suspended for attempting to flee an officer. Although the judge in Loomis also relied on other factors in addition to COMPAS, the COMPAS results affected the way the judge sentenced

47 Id. at 55.
48 See Loomis, 881 N.W. 2d. 749 at 753.
49 Id. at 750.
51 Id. at 139.
52 Id. (emphasis added).
the defendant. The defendant in *Loomis* argued that it was impossible to challenge a risk assessment without sufficient information about how COMPAS functions, such as how risk is determined and how factors are weighed to calculate the assessment, but because the defendant could correct responses to questions, the court determined that he had the ability to determine the accuracy of his risk assessment. The takeaway is that attorneys need to be aware of and learn how to deal with these novel tools in court in order to reinforce the rule of law and protect their client’s rights.

**Conclusion**

Artificial Intelligence and its growth need not be feared. AI is not beating humans when it comes to many legal skills and tasks. Whether for data analytics or for streamlined legal research, the use of AI can keep client costs down. Some even theorize that the failure to use AI could be considered malpractice one day. AI, however, does not have judgment, creativity and most importantly empathy. It does not equate with emotional intelligence. AI is a tool and those in the legal profession, including lawyers and judges need to know how to utilize it. Lawyers and judges are only as good as the information they receive, and AI has the potential to significantly improve the quality of that information.

53 *Id.* at 139.
54 *Id.* at 139.
56 See, e.g., Connell, *supra* note 41 at 43–44.
57 Browning and Downs, *supra* note 38, at 509.
58 See, e.g., Connell, *supra* note 41, at 44
59 See, e.g., *id.* at 44 (quoting Microsoft Assistant General Counsel Dennis Garcia).
60 See, e.g., Connell, *supra* note 41, at 44.
61 Browning & Downs, *supra* note 38, at 509.
A Primer on Using Artificial Intelligence in the Legal Profession

By Lauri Donahue
January 03, 2018

Lauri Donahue is a 1986 graduate of Harvard Law School and was one of the co-founders of the Harvard Journal of Law & Technology. She is now the Director of Legal Content for LawGeek, a Tel Aviv legaltech startup.

What's artificial intelligence ("AI") and why should lawyers care about it? On a practical level, lawyers should be aware that software powered by AI already carries out legal tasks. Within a few years, AI will be taking over (or at least affecting) a significant amount of work now done by lawyers. Thirty-nine percent of in-house counsel expect that AI will be commonplace in legal work within ten years.

On a more philosophical level, lawyers should understand that the "decisions" made by AI-powered software will raise significant legal questions, including those of tort liability and of criminal guilt. For example, if AI is controlling a driverless car and someone’s killed in an accident, who’s at fault?

While the philosophical questions are important to resolve, this Comment will focus on the practical issues. To provide an overview of what AI is and how it will be used in the legal profession, this Comment addresses several questions:

- What is AI?
- How does AI work?
- What can AI do?
- How are lawyers using AI?
- How will AI affect the legal profession?

What is AI?

Let’s start with a few definitions:

‘Artificial Intelligence’ is the term used to describe how computers can perform tasks normally viewed as requiring human intelligence, such as recognizing speech and objects, making decisions based on data, and translating languages. AI mimics certain operations of the human mind.
"Machine learning" is an application of AI in which computers use algorithms (rules) embodied in software to learn from data and adapt with experience.

A "neural network" is a computer that classifies information -- putting things into "buckets" based on their characteristics. The hot-dog identifying app from HBO's Silicon Valley is an example of one application of this technology.

How Does AI Work?

Some AI programs train themselves, through trial and error. For example, using a technique called neuroevolution, researchers at Elon Musk's OpenAI research center set up an algorithm with policies for getting high scores on Atari videogames. Several hundred copies of these rules were created on different computers, with random variations. The computers then "played" the games to learn which policies were most effective and fed those results back into the system. AI can also be used to build better AI. Google is building algorithms that analyze other algorithms, to learn which methods are more successful.

Other AI programs need to be trained by humans feeding them data. The AI then derives patterns and rules from that data. AI programs trained through machine learning are well-suited to solve classification problems. This basically means calculating the probability that certain information is either of type A or type B. For example, determining whether a given bear is a panda or a koala is a classification problem.
The training starts with showing the computer lots of samples of pandas and koalas. These initial samples are called the training set, and clearly identify which type of bear is being presented to the AI.

The AI builds a model—a set of rules—to distinguish between pandas and koalas. That model might be based on things like size, coloring, the shape of the ears, and what the animal eats (bamboo or eucalyptus).

After training, the AI can be tested with new pandas and koalas to see whether it classifies them correctly. If it doesn't do very well, the algorithm may need to be tweaked or the training set may need to be expanded to give the AI more data to crunch.

**What Can AI Do?**

At this point in its development, AI is good at finding items that meet human-defined criteria and detecting patterns in data. In other words, AI can figure out what makes a panda a panda and what
distinguishes it from a koala—which lets it find the pandas in a collection of random bears. These are sometimes called "search-and-find type" tasks.

Once it's identified something, the AI can then apply human-defined rules and take actions. In the case of legal work, an AI can carry out tasks like:

- IF this document is a non-disclosure agreement, THEN send it to the legal department for review
- IF this NDA meets the following criteria, THEN approve it for signature
- FIND all my contracts with automatic renewal clauses and NOTIFY ME four weeks before they renew
- TELL ME which patents in this portfolio will expire in the next six months

According to Stefanie Yuen Thio, joint managing partner and head of corporate at TSMP Law Corp. in Singapore, legal work that's repetitive, requiring minimal professional intervention, or based on a template will become the sole province of software. In addition, she says,

> any legal work that depends on collating and analyzing historical data such as past judicial decisions, including legal opinions or evaluating likely litigation outcomes, will become the dominion of AI. No human lawyer stands a chance against the formidable processing power of a mainframe when it comes to sifting through voluminous data.

AI can help consumers by providing a form of "legal service" to clients who might otherwise not be able to afford a lawyer. The free service DoNotPay, created by a 19-year-old, is an AI-powered chatbot that lets users contest parking tickets in London and New York. In its first 21 months, it took on 250,000 cases and won 160,000 of them, saving users more than $4 million worth of fines. The same program is helping consumers file databreach-related suits against Equifax for up to $25,000—though it can't help them litigate their cases.

**What AI Can't Do**

According to Yuen Thio, AI can't yet replicate advocacy, negotiation, or structuring of complex deals. The New York Times suggested that tasks like advising clients, writing briefs, negotiating deals, and appearing in court were beyond the reach of computerization, at least for a while. AI also isn't yet very good at the type of creative writing in a Supreme Court brief. Or a movie script.

**How Are Lawyers Using AI?**

Lawyers are already using AI to do things like reviewing documents during litigation and due diligence, analyzing contracts to determine whether they meet pre-determined criteria, performing legal research, and predicting case outcomes.

**Document Review**

Document review for litigation involves the task of looking for relevant documents—for example, documents containing specific keywords, or emails from Ms. X to Mr. Y concerning topic Z during March, 2016. Setting search parameters for document review doesn't require AI, but using AI improves the speed, accuracy, and efficiency of document analysis.

For example, when lawyers using AI-powered software for document review flag certain documents as relevant, the AI learns what type of documents it's supposed to be looking for. Hence, it can more accurately identify other relevant documents. This is called "predictive coding." Predictive coding offers many advantages over old-school manual document review. Among other things, it:
leverages small samples to find similar documents
reduces the volume of irrelevant documents attorneys must wade through
produces results that can be validated statistically
is at least modestly more accurate than human review
is much faster than human review

Predictive coding has been widely accepted as a document review method by US courts since the 2012 decision in Da Silva Moore v. Publicus Groupe.

Analyzing Contracts

Clients need to analyze contracts both in bulk and on an individual basis.

For example, analysis of all contracts a company has signed can identify risks, anomalies, future financial obligations, renewal and expiration dates, etc. For companies with hundreds or thousands of contracts, this can be a slow, expensive, labor-intensive, and error-prone process (assuming the contracts aren't already entered into a robust contract management system). It's also boring for the lawyers (or others) tasked with doing it.

On a day-to-day basis, lawyers review contracts, make comments and redlines, and advise clients on whether to sign contracts as-is or try to negotiate better terms. These contracts can range from simple (e.g., NDAs) to complex. A backlog of contracts to review can create a bottleneck that delays deals (and the associated revenues). Lawyers (especially inexperienced ones) can miss important issues that can come back to bite their clients later.

AI can help with both bulk and individual contract review.

At JPMorgan, an AI-powered program called COIN has been used since June 2017 to interpret commercial loan agreements. Work that previously took 360,000 lawyer-hours can now be done in seconds. The bank is planning to use the technology for other types of legal documents as well.

Some AI platforms, such as the one provided by Kira Systems, allow lawyers to identify, extract, and analyze business information contained in large volumes of contract data. This is used to create contract summary charts for M&A due diligence.

The company I work for, LawGeex, uses AI to analyze contracts one at a time, as part of a lawyer's daily workflow. To start with, lawyers set up their LawGeex playbooks by selecting from a list of clauses and variations to require, accept, or reject. For example, a California governing law clause might be OK, but Genovian law isn't. Then, when someone uploads a contract, the AI scans it and determines what clauses and variations are present and missing. The relevant language is highlighted and marked with a green thumbs-up or a red thumbs-down based on the client's preset criteria.

In-house lawyers use LawGeex to triage standard agreements like NDAs. Contracts meeting pre-defined criteria can be pre-approved for signature; those that don't are kicked to the legal department for further review and revision.

Legal Research

Any lawyer who's ever done research using Lexis or Westlaw has used legal automation. Finding relevant cases in previous eras involving the laborious process of looking up headnote numbers and Shepardizing in paper volumes. But AI takes research to the next level. For example, Ross Intelligence uses the power of IBM's Watson supercomputer to find similar cases. It can even respond to queries in plain English. The power of AI-enabled research is striking: using common research methods, a
bankruptcy lawyer found a case nearly identical to the one he was working on in 10 hours. Ross's AI found it almost instantly.

Predicting Results

Lawyers are often called upon to predict the future: If I bring this case, how likely is it that I'll win – and how much will it cost me? Should I settle this case (or take a plea), or take my chances at trial? More experienced lawyers are often better at making accurate predictions, because they have more years of data to work with.

However, no lawyer has complete knowledge of all the relevant data.

Because AI can access more of the relevant data, it can be better than lawyers at predicting the outcomes of legal disputes and proceedings, and thus helping clients make decisions. For example, a London law firm used data on the outcomes of 600 cases over 12 months to create a model for the viability of personal injury cases. Indeed, trained on 200 years of Supreme Court records, an AI is already better than many human experts at predicting SCOTUS decisions.

How Will AI Affect the Legal Profession?

A consensus has emerged that AI will significantly disrupt the legal market. AI will impact the availability of legal sector jobs, the business models of many law firms, and how in-house counsel leverage technology.

According to Deloitte, about 100,000 legal sector jobs are likely to be automated in the next twenty years. Deloitte claims 39% of legal jobs can be automated; McKinsey Global Institute estimates that 23% of a lawyer's job could be automated. Some estimates suggest that adopting all legal technology (including AI) already available now would reduce lawyers' hours by 13%.

How Law Firms are Responding to AI

Law firms are notoriously slow to adapt to new technologies. Enhancing efficiency is often seen as contrary to the economic goal of maximizing billable hours. Lawyers are also seen as being technophobic.

However, many law firms are trying to understand and use new legal technologies, including AI. According to the London Times, "[t]he vast majority of the UK’s top 100 law firms are either using artificial intelligence or assessing the technology." Firms adopting AI systems include Latham & Watkins, Baker & McKenzie, Slaughter & May, and Singapore's Dentons Rodyk & Davidson.

Ron Dolin, a senior research fellow at Harvard Law School's Center on the Legal Profession, says that traditional law firm business models based on armies of first year associates racking up billable hours doing M&A contract review are doomed by the advent of AI. This isn't necessarily bad news for junior associates--or at least for the ones who still have jobs--as many hated doing contract review in the first place.

Firms that fail to take advantage of AI-powered efficiencies may lag in competing with those who do--at least to the extent clients insist on fixed-rate billing. Thus, lawyers who understand technology, and educate themselves about the latest legaltech developments, may be of increasing value to their firms.

How In-House Counsel Are Using AI
Corporate counsel have obvious reasons to adopt AI. Unlike attorneys in law firms, corporate counsel have no incentive to maximize their hours. Indeed, many lawyers go in-house to improve their work-life balance, which includes getting home at a reasonable hour. They’re also often subject to strict budget and headcount constraints, so they have to figure out how to get more done with limited resources. AI helps in-house lawyers get home earlier without increasing their departmental budgets.

**AI and the Future of the Legal Profession**

The ABA Model Rules of Professional Conduct ("Model Rules") require that lawyers be competent—and that they keep up with new technology. As Comment 8 states:

> To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology...

At least 27 states have adopted some form of this Model Rule. In January of 2017, Florida became the first state to require technology training as part of its continuing legal education requirement. Other states seem likely to follow suit. Indeed, failing to use commonly available technology, like email and e-discovery software, can be grounds for a malpractice claim or suspension by the bar.

Of course, AI-powered legal automation is not yet common. But it soon will be. Spending on AI is expected to grow rapidly—from $8 billion in 2016 to $47 billion in 2020—as AI is seen as reducing costs and increasing efficiency. Top MBA programs already have courses on how managers can use AI applications.

As they come to rely on AI, C-level executives may expect that their inside and outside lawyers are also up-to-speed.

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The lead opinion concludes that Lands’ End’s right to the 12 percent interest rate was “contingent on a subsequent determination by a court.” Lead op., ¶ 77. But the lead opinion forces Lands’ End to bear the burden of the right court making the wrong determination at a critical time. Had the same court decided the case six weeks later, the result would have been different.

¶ 229 For the foregoing reasons, I respectfully dissent.

¶ 230 I am authorized to state that Chief Justice PATIENCE DRAKE ROGGENSACK joins this dissent.

City’s issue preclusion argument is that the City miscasts the “issue” to which issue preclusion applies. The “issue” is not the proper 2008 assessed value of Lands’ End’s property. Rather, we determine here that issue preclusion applied only to the “issue” of the correct 2006 assessment. The resolution of that issue through the application of issue preclusion does not, by itself, establish the proper 2008 assessed value. Rather, it is the combination of issue preclusion and a new undisputed fact in the present case that persuades us that Lands’ End is entitled to summary judgment. The new undisputed fact is that the value of the subject property did not materially change between 2006 and 2008.

....

Giving preclusive effect to Judge Leineweber’s finding that the 2006 value of the property was $25,000,000, and combining that finding with the undisputed fact in this case that the value of the property essentially stayed the same, leads us to conclude that the value of the property in 2008 must be $25,000,000. Because there is no genuine dispute that the 2008 value of the property is $25,000,000, we conclude that Lands’ End is entitled to judgment as a matter of law.

Affirmed.
Patience Drake Roggensack, Chief Justice, filed a concurring opinion.
Shirley S. Abrahamson, J., filed a concurring opinion.

1. Criminal Law ☑1134.29, 1179

Whether a defendant’s right to due process has been violated presents a question of law, which the Supreme Court reviews independently of the determinations of a circuit court or a court of appeals. U.S.C.A. Const.Amend. 14.

2. Criminal Law ☑1156.2

The Supreme Court reviews sentencing decisions under the erroneous exercise of discretion standard.

3. Criminal Law ☑1156.2

An erroneous exercise of discretion occurs when a circuit court imposes a sentence without the underpinnings of an explained judicial reasoning process.

4. Criminal Law ☑1156.2

A sentencing court erroneously exercises its discretion when its sentencing decision is not based on the facts in the record or it misapplies the applicable law.

5. Sentencing and Punishment ☑59

A sentencing court misapplies the law when it relies on clearly irrelevant or improper factors.

6. Criminal Law ☑1141(2)

The defendant bears the burden of proving that a sentencing court relied on clearly irrelevant or improper factors by clear and convincing evidence.

7. Criminal Law ☑1134.75

A discretionary sentencing decision will be sustained if it is based upon the facts in the record and relies on the appropriate and applicable law.

8. Constitutional Law ☑3875

The process that is due under the federal constitution differs with the types of decisions and proceedings involved. U.S.C.A. Const.Amend. 14.

9. Constitutional Law ☑3875

Due process is flexible and calls for such procedural protections as the particular situation demands. U.S.C.A. Const. Amend. 14.

10. Constitutional Law ☑4705

Sentencing and Punishment ☑283

Use of “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment tool at sentencing did not violate defendant’s due process right to be sentenced based on accurate information; although defendant could not review and challenge how the proprietary algorithm calculated risk, he could at least review and challenge the resulting risk scores set forth in the report attached to the presentence investigation report (PSI), risk assessment was based upon defendant’s answers to questions and publicly available data about his criminal history, court and defendant had access to same copy of risk assessment, and studies of tool have determined that it was reasonably accurate. U.S.C.A. Const.Amend. 14.

11. Constitutional Law ☑4705


12. Constitutional Law ☑4705

The due process right to be sentenced based upon accurate information includes the right to review and verify information contained in the presentence investigation report (PSI) upon which the circuit court bases its sentencing decision. U.S.C.A. Const.Amend. 14.
13. Constitutional Law ☀4705  
**Sentencing and Punishment ☀283**

Use of “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment tool at sentencing did not violate defendant’s due process right to an individualized sentence; although assessment was based partially on group data, consideration of a risk assessment at sentencing along with other supporting factors was helpful in providing the sentencing court with as much information as possible in order to arrive at an individualized sentence. U.S.C.A. Const. Amend. 14.

14. Constitutional Law ☀4705  
**Sentencing and Punishment ☀283**

The “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment tool’s consideration of a defendant’s gender did not violate defendant’s due process rights at sentencing, where there was a factual basis underlying the tool’s use of gender in calculating risk scores, and defendant failed to establish that sentencing court actually considered gender in imposing his sentence. U.S.C.A. Const. Amend. 14.

15. Sentencing and Punishment ☀1900

Although it cannot be determinative, a sentencing court may use a “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment as a relevant factor for such matters as: (1) diverting low-risk prison-bound offenders to a non-prison alternative; (2) assessing whether an offender can be supervised safely and effectively in the community; and (3) imposing terms and conditions of probation, supervision, and responses to violations.

16. Sentencing and Punishment ☀283

A “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment may be used to enhance a judge’s evaluation, weighing, and application of the other sentencing evidence in the formulation of an individualized sentencing program appropriate for each defendant.

17. Sentencing and Punishment ☀1900

“Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk scores may not be used at sentencing as the determinative factor in deciding whether an offender can be supervised safely and effectively in the community.

18. Sentencing and Punishment ☀283

“Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk scores may not be used to determine whether an offender is incarcerated or to determine the severity of the sentence.

19. Sentencing and Punishment ☀117, 373

A circuit court must explain the factors in addition to a “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment that independently support the sentence imposed, and a COMPAS risk assessment is only one of many factors that may be considered and weighed at sentencing.

20. Sentencing and Punishment ☀283

Any presentence investigation report (PSI) containing a “Correctional Offender Management Profiling for Alternative Sanctions (COMPAS)” risk assessment filed with the court must contain a written advisement listing the limitations.

21. Sentencing and Punishment ☀98

Sentencing court was permitted to consider read-in charges in sentencing defendant following guilty plea premised on plea agreement; although court initially
misstated that there was no distinction between read-in charges and dismissed charges, it ultimately corrected itself and proceeded under the correct framework.

22. Sentencing and Punishment

Read-in charges are expected to be considered at sentencing with the understanding that the read-in charges could increase the sentence up to the maximum that the defendant could receive for the conviction in exchange for the promise not to prosecute those additional offenses.

For the defendant-appellant, there were briefs by Michael D. Rosenberg and Community Justice, Inc., Madison, and oral argument by Michael D. Rosenberg.

For the plaintiff-respondent, the cause was argued by Christine A. Remington, assistant attorney general, with whom on the brief was Brad D. Schimel, attorney general.

ON CERTIFICATION FROM THE COURT OF APPEALS

ANN WALSH BRADLEY, J.

¶ 1 In 2007, the Conference of Chief Justices adopted a resolution entitled “In Support of Sentencing Practices that Promote Public Safety and Reduce Recidivism.” It emphasized that the judiciary “has a vital role to play in ensuring that criminal justice systems work effectively and efficiently to protect the public by reducing recidivism and holding offenders accountable.”

The conference committed to “support state efforts to adopt sentencing and corrections policies and programs based on the best research evidence of practices shown to be effective in reducing recidivism.”

¶ 2 Likewise, the American Bar Association has urged states to adopt risk assessment tools in an effort to reduce recidivism and increase public safety. It emphasized concerns relating to the incarceration of low-risk individuals, cautioning that the placement of low-risk offenders with medium and high-risk offenders may increase rather than decrease the risk of recidivism. Such exposure can lead to negative influences from higher risk offenders and actually be detrimental to the individual’s efforts at rehabilitation.

¶ 3 Initially risk assessment tools were used only by probation and parole departments to help determine the best supervision and treatment strategies for offenders. With nationwide focus on the need to reduce recidivism and the importance of evidence-based practices, the use of such


2. Id.

3. Id.


5. Id. at 19.

6. Id.

tools has now expanded to sentencing. Yet, the use of these tools at sentencing is more complex because the sentencing decision has multiple purposes, only some of which are related to recidivism reduction.

¶ 4 When analyzing the use of evidence-based risk assessment tools at sentencing, it is important to consider that tools such as COMPAS continue to change and evolve. The concerns we address today may very well be alleviated in the future. It is incumbent upon the criminal justice system to recognize that in the coming months and years, additional research data will become available. Different and better tools may be developed. As data changes, our use of evidence-based tools will have to change as well. The justice system must keep up with the research and continuously assess the use of these tools.

¶ 5 Use of a particular evidence-based risk assessment tool at sentencing is the heart of the issue we address today. This case is before the court on certification from the court of appeals. Petitioner, Eric L. Loomis, appeals the circuit court’s denial of his post-conviction motion requesting a resentencing hearing.

¶ 6 The court of appeals certified the specific question of whether the use of a COMPAS risk assessment at sentencing violates a defendant’s right to due process. Additionally, he contends that the circuit court erroneously exercised its discretion by assuming that the factual bases for the read-in charges were true.

¶ 8 Ultimately, we conclude that if used properly, observing the limitations and cautions set forth herein, a circuit court’s consideration of a COMPAS risk assessment at sentencing does not violate a defendant’s right to due process.

¶ 9 We determine that because the circuit court explained that its consideration of the COMPAS risk scores was supported by other independent factors, its use was not determinative in deciding whether Loomis could be supervised safely and effectively in the community. Therefore, the circuit court did not erroneously exercise its discretion. We further conclude that the circuit court’s consideration of the read-in charges was not an erroneous ex-


exercise of discretion because it employed recognized legal standards.

¶ 10 Accordingly, we affirm the order of the circuit court denying Loomis's motion for post-conviction relief requesting a resentencing hearing.

I

¶ 11 The facts of this case are not in dispute. The State contends that Loomis was the driver in a drive-by shooting. It charged him with five counts, all as a repeater: (1) First-degree recklessly endangering safety (PTAC); (2) Attempting to flee or elude a traffic officer (PTAC); (3) Operating a motor vehicle without the owner's consent; (4) Possession of a firearm by a felon (PTAC); (5) Possession of a short-barreled shotgun or rifle (PTAC).

¶ 12 Loomis denies involvement in the drive-by shooting. He waived his right to trial and entered a guilty plea to only two of the less severe charges, attempting to flee a traffic officer and operating a motor vehicle without the owner's consent. The plea agreement stated that the other counts would be dismissed but read in:

After accepting Loomis's plea, the circuit court ordered a presentence investigation. The Presentence Investigation Report (“PSI”) included an attached COMPAS risk assessment.

¶ 13 COMPAS is a risk-need assessment tool designed by Northpointe, Inc. to provide decisional support for the Department of Corrections when making placement decisions, managing offenders, and planning treatment. The COMPAS risk assessment is based upon information gathered from the defendant's criminal file and an interview with the defendant.

¶ 14 A COMPAS report consists of a risk assessment designed to predict recidivism and a separate needs assessment for identifying program needs in areas such as employment, housing and substance abuse. The risk assessment portion of COMPAS generates risk scores displayed in the form of a bar chart, with three bars that represent pretrial recidivism risk, general recidivism risk, and violent recidivism risk. Each bar indicates a defendant's level of risk on a scale of one to ten.

¶ 15 As the PSI explains, risk scores are intended to predict the general likelihood that those with a similar history of offending are either less likely or more likely to commit another crime following release from custody. However, the COMPAS risk assessment does not predict the specific likelihood that an individual offender will reoffend. Instead, it provides a prediction based on a comparison of information about the individual to a similar data group.

13. “PTAC” refers to party to a crime.


15. Id. at 12, 16.

16. Id. at 3, 26.

17. Id. at 8.
¶ 16 Loomis’s COMPAS risk scores indicated that he presented a high risk of recidivism on all three bar charts. His PSI included a description of how the COMPAS risk assessment should be used and cautioned against its misuse, instructing that it is to be used to identify offenders who could benefit from interventions and to target risk factors that should be addressed during supervision.

¶ 17 The PSI also cautions that a COMPAS risk assessment should not be used to determine the severity of a sentence or whether an offender is incarcerated:

For purposes of Evidence Based Sentencing, actuarial assessment tools are especially relevant to: 1. Identify offenders who should be targeted for interventions. 2. Identify dynamic risk factors to target with conditions of supervision. 3. It is very important to remember that risk scores are not intended to determine the severity of the sentence or whether an offender is incarcerated.

(Emphasis added.)

¶ 18 At sentencing, the State argued that the circuit court should use the COMPAS report when determining an appropriate sentence:

In addition, the COMPAS report that was completed in this case does show the high risk and the high needs of the defendant. There’s a high risk of violence, high risk of recidivism, high pretrial risk; and so all of these are factors in determining the appropriate sentence.

¶ 19 Ultimately, the circuit court referenced the COMPAS risk score along with other sentencing factors in ruling out probation:

You’ve identified, through the COMPAS assessment, as an individual who is at high risk to the community.

In terms of weighing the various factors, I’m ruling out probation because of the seriousness of the crime and because your history, your history on supervision, and the risk assessment tools that have been utilized, suggest that you’re extremely high risk to re-offend.

¶ 20 In addition to the COMPAS assessment, the circuit court considered the read-in charges at sentencing. For sentencing purposes, it assumed that the factual bases for the read-in charges were true and that Loomis was at least involved in conduct underlying the read-in charges. The circuit court explained further that Loomis “needs to understand that if these shooting related charges are being read in that I’m going to view that as a serious, aggravating factor at sentencing.” Defense counsel protested the circuit court’s assumption that the read-in charges were true and explained that Loomis did not concede that he was involved in the drive-by shooting.

¶ 21 Although a review of the transcript of the plea hearing reveals miscommunications and uncertainty about the consequences of a dismissed but read-in offense, the circuit court ultimately quoted directly from a then-recent decision of this court explaining the nature of such a read-in offense. It explained to Loomis that a circuit court can consider the read-in offense at sentencing and that such consideration could increase a defendant’s sentence:

The Court: Mr. Loomis, I just—there is a recent Supreme Court decision in State v. Frey that describes what a read-in offense is. And I just want to quote from that decision so that you fully understand it . . . .

“[T]he defendant exposes himself to the likelihood of a higher sentence within the sentencing range and the additional
possibility of restitution for the offenses that are ‘read in.’ ”

So you’re limited in this agreement to a sentencing range within—up to the maximums for the charges that you’re pleading guilty. You’re agreeing, as the Supreme Court decision indicates, that the charges can be read in and considered, and that has the effect of increasing the likelihood, the likelihood of a higher sentence within the sentencing range. You understand that?

Loomis: Yes.

¶ 22 The plea questionnaire/waiver of rights form stated that the maximum penalty Loomis faced for both charges was seventeen years and six months imprisonment. The court sentenced him within the maximum on the two charges for which he entered a plea.18

¶ 23 Loomis filed a motion for post-conviction relief requesting a new sentencing hearing. He argued that the circuit court’s consideration of the COMPAS risk assessment at sentencing violated his due process rights. Loomis further asserted that the circuit court erroneously exercised its discretion by improperly assuming that the factual bases for the read-in charges were true.

¶ 24 The circuit court held two hearings on the post-conviction motion. At the first hearing, the circuit court addressed Loomis’s claim that it had erroneously exercised its discretion in how it considered the read-in charges. Considering the relevant case law and legal standards, the circuit court concluded that it had applied the proper standard and denied Loomis’s motion on that issue.

18. On the attempting to flee an officer charge, the circuit court sentenced Loomis to four years, with initial confinement of two years and extended supervision of two years. For operating a vehicle without the owner’s con-

¶ 25 During the first post-conviction motion hearing, the circuit court reviewed the plea hearing transcript and the sentencing transcript and explained that it did not believe Loomis’s explanation:

I felt Mr. Loomis’s explanation was inconsistent with the facts. The State’s version was more consistent with the facts and gave greater weight to the State’s version at sentencing.

¶ 26 At the second hearing, the circuit court addressed the due process issues. The defendant offered the testimony of an expert witness, Dr. David Thompson, regarding the use at sentencing of a COMPAS risk assessment. Dr. Thompson opined that a COMPAS risk assessment should not be used for decisions regarding incarceration because a COMPAS risk assessment was not designed for such use. According to Dr. Thompson, a circuit court’s consideration at sentencing of the risk assessment portions of COMPAS runs a “tremendous risk of over estimating an individual’s risk and ... mistakenly sentencing them or basing their sentence on factors that may not apply....”

¶ 27 Dr. Thompson further testified that sentencing courts have very little information about how a COMPAS assessment analyzes the risk:

The Court does not know how the COMPAS compares that individual’s history with the population that it’s comparing them with. The Court doesn’t even know whether that population is a Wisconsin population, a New York population, a California population.... There’s all kinds of information that the court doesn’t have, and what we’re doing is we’re mis-informing the court when we sent, the circuit court sentenced Loomis to seven years, with four years of initial confinement and three years of extended supervision, to be served consecutively with the prior sentence.


¶ 28 In denying the post-conviction motion, the circuit court explained that it used the COMPAS risk assessment to corroborate its findings and that it would have imposed the same sentence regardless of whether it considered the COMPAS risk scores. Loomis appealed and the court of appeals certified the appeal to this court.

II

¶ 29 Whether the circuit court's consideration of a COMPAS risk assessment violated Loomis's constitutional right to due process presents a question of law, which this court reviews independently of the determinations of a circuit court or a court of appeals. See Jackson v. Buchler, 2010 WI 135, ¶ 39, 330 Wis.2d 279, 793 N.W.2d 826.

¶ 30 “This court reviews sentencing decisions under the erroneous exercise of discretion standard.” State v. Frey, 2012 WI 99, ¶ 37, 343 Wis.2d 358, 817 N.W.2d 436. An erroneous exercise of discretion occurs when a circuit court imposes a sentence “without the underpinnings of an explained judicial reasoning process.” McCleary v. State, 49 Wis.2d 263, 278, 182 N.W.2d 512 (1971); see also State v. Gallion, 2004 WI 42, ¶ 3, 270 Wis.2d 535, 678 N.W.2d 197.

¶ 31 Additionally, a sentencing court erroneously exercises its discretion when its sentencing decision is not based on the facts in the record or it misapplies the applicable law. State v. Travis, 2013 WI 38, ¶ 16, 347 Wis.2d 142, 832 N.W.2d 491. It misapplies the law when it relies on clearly irrelevant or improper factors. McCleary, 49 Wis.2d at 278, 182 N.W.2d 512. The defendant bears the burden of proving such reliance by clear and convincing evidence. State v. Harris, 2010 WI 79, ¶ 3, 326 Wis.2d 685, 786 N.W.2d 409.

¶ 32 In a similar manner we review the issue of whether a circuit court erroneously exercises its discretion when it relies on the factual basis of the read-in charge when fashioning the defendant's sentence. Frey, 343 Wis.2d 358, ¶¶ 37–39, 817 N.W.2d 436. “A discretionary sentencing decision will be sustained if it is based upon the facts in the record and relies on the appropriate and applicable law.” Travis, 347 Wis.2d 142, ¶ 16, 832 N.W.2d 491.

III

¶ 33 At the outset we observe that the defendant is not challenging the use of a COMPAS risk assessment for decisions other than sentencing, and he is not challenging the use of the needs portion of the COMPAS report at sentencing. Instead, Loomis challenges only the use of the risk assessment portion of the COMPAS report at sentencing.

¶ 34 Specifically, Loomis asserts that the circuit court’s use of a COMPAS risk assessment at sentencing violates a defendant’s right to due process for three reasons: (1) it violates a defendant’s right to be sentenced based upon accurate information, in part because the proprietary nature of COMPAS prevents him from assessing its accuracy; (2) it violates a defendant’s right to an individualized sentence; and (3) it improperly uses gendered assessments in sentencing.

¶ 35 Although we ultimately conclude that a COMPAS risk assessment can be used at sentencing, we do so by circumscribing its use. Importantly, we address how it can be used and what limitations and cautions a circuit court must observe in order to avoid potential due process violations.
¶ 36 It is helpful to consider Loomis’s due process arguments in the broader context of the evolution of evidence-based sentencing. Wisconsin has been at the forefront of advancing evidence-based practices. In 2004, this court’s Planning and Policy Advisory Committee (PPAC) created a subcommittee “to explore and assess the effectiveness of policies and programs . . . designed to improve public safety and reduce incarceration.” 19

¶ 37 From that initial charge, Wisconsin’s commitment to evidence-based practices and its leadership role have been well documented.20 Initially, a variety of risk and needs assessment tools were used by various jurisdictions within the state. In 2012, however, the Wisconsin Department of Corrections selected COMPAS as the statewide assessment tool for its correctional officers, providing assessment of risk probability for pretrial release misconduct and general recidivism.21

¶ 38 The question of whether COMPAS can be used at sentencing has previously been addressed. In State v. Samsa, 2015 WI App 6, 359 Wis.2d 580, 859 N.W.2d 149, the court of appeals approved of a circuit court’s consideration of a COMPAS assessment at sentencing. However, it was not presented with the due process implications that we face here. Citing to a principle for sentencing courts set forth in State v. Gallion, 2002 WI App 265, ¶ 26, 258 Wis.2d 473, 654 N.W.2d 446, aff’d, 2004 WI 42, 270 Wis.2d 535, 678 N.W.2d 197, the Samsa court emphasized that “COMPAS is merely one tool available to a court at the time of sentencing.” 359 Wis.2d 580, ¶ 13, 859 N.W.2d 149.

¶ 39 In Gallion we warned of ad hoc decision making at sentencing: “Experience has taught us to be cautious when reaching high consequence conclusions about human nature that seem to be intuitively correct at the moment. Better instead is a conclusion that is based on more complete and accurate information . . . .” 270 Wis.2d 535, ¶ 36, 678 N.W.2d 197. We encouraged circuit courts to seek “more complete information upfront, at the time of sentencing. Judges would be assisted in knowing about a defendant’s propensity for causing harm [and] the circumstances likely to precipitate the harm . . . .” Id., ¶ 34.

¶ 40 Concern about ad hoc decision making is justified. A myriad of determinations are made throughout the criminal justice system without consideration of tested facts of any kind. Questions such as whether to require treatment, if so what kind, and how long supervision should last often have been left to a judge’s intuition or a correctional officer’s standard practice.


¶ 41 The need to have additional sound information is apparent for those working in corrections, but that need is even more pronounced for sentencing courts. Sentencing decisions are guided by due process protections that may not apply to many run of the mill correctional decisions. This distinction is of import given that the risk and needs assessment tools were designed for use by those within the Department of Corrections and that design is being transitioned to a sentencing venue governed by different guiding principles.

¶ 42 In response to a call to reduce recidivism by employing evidence-based practices, several states have passed legislation requiring that judges be provided with risk assessments and recidivism data at sentencing. Other states permit, but do not mandate, the use of risk assessment tools at sentencing.

¶ 43 But other voices are challenging the efficacy of evidence-based sentencing and raise concern about overselling the results. They urge that judges be made aware of the limitations of risk assessment tools, lest they be misused:

In the main, [supporters] have been reticent to acknowledge the paucity of reliable evidence that now exists, and the limits of the interventions about which we do possess evidence. Unless criminal justice system actors are made fully aware of the limits of the tools they are

22. The process that is due under the Constitution differs with the types of decisions and proceedings involved. "Due process is flexible and calls for such procedural protections as the particular situation demands." Schweiker v. McClure, 456 U.S. 188, 200, 102 S.Ct. 1665, 72 L.Ed.2d 1 (1982); see also Londoner v. City and Cty. of Denver, 210 U.S. 373, 386, 28 S.Ct. 708, 52 L.Ed. 1103 (1908) ("Many requirements essential in strictly judicial proceedings may be dispensed with [in the administrative forum]").


24. See, e.g., Idaho Code § 19–2517 (2016) (if an Idaho court orders a presentence investigation, the investigation report for all offenders sentenced directly to a term of imprisonment and for certain offenders placed on probation must include current recidivism rates differentiated based on offender risk levels of low, moderate, and high); Malenchik v. State, 928 N.E.2d 564, 566, 571–73, 575 (Ind.2010) (encouraging the use of evidence based offender assessment instruments at sentencing); La. Stat. Ann. § 15:326(A) (2016) (some Louisiana courts may use a single presentence investigation validated risk and needs assessment tool prior to sentencing an adult offender eligible for assessment); Wash. Rev.Code § 9.94A.500(1) (2016) (requiring a court to consider risk assessment reports at sentencing if available); State v. Rogers, No. 14–0373, 2015 WL 869323, at *4 (W.Va. Jan. 9, 2015) (Loughry, J., concurring) (in an unpublished Memorandum Decision, the Supreme Court of Appeals of West Virginia explained that although probation officers are required to conduct standardized risk and needs assessments pursuant to W. Va.Code § 62–12–6(a)(2) (2016), the use of these tools at sentencing to inform sentencing decisions is left to the discretion of the circuit court).
being asked to implement, they are likely to misuse them.


¶ 44 We heed this admonition. The DOC already recognizes limitations on the PSI, instructing that “[i]t is very important to remember that risk scores are not intended to determine the severity of the sentence or whether an offender is incarcerated.” We are in accord with these limitations. Further, we set forth the corollary limitation that risk scores may not be considered as the determinative factor in deciding whether the offender can be supervised safely and effectively in the community.25

¶ 45 In addressing Loomis’s due process arguments below, we additionally raise cautions that a sentencing court must observe in order to avoid potential due process violations.

IV

[10] ¶ 46 We turn to address Loomis’s first argument that a circuit court’s consideration of a COMPAS risk assessment violates a defendant’s due process right to be sentenced based on accurate information. Loomis advances initially that the proprietary nature of COMPAS prevents a defendant from challenging the scientific validity of the risk assessment. Accordingly, Loomis contends that because a COMPAS risk assessment is attached to the PSI, a defendant is denied full access to information in the PSI and therefore cannot ensure that he is being sentenced based on accurate information.


26. Although Gardner v. Florida, 430 U.S. 349, 97 S.Ct. 1197, 51 L.Ed.2d 393 (1977) was a death penalty case, State v. Skaff, 152 Wis.2d 48, 55, 447 N.W.2d 84 (Ct.App.1989), determined that “we perceive no reason why its rationale should not be applied to penalties of lesser severity.”
¶ 50 Skaff reasoned that given the discretion accorded the circuit court in sentencing decisions, any significant inaccuracies would likely affect the defendant’s sentence. *Id.* Therefore, denial of access to the PSI denied the defendant “an essential factor of due process, i.e., a procedure conducive to sentencing based on correct information.” *Id.* at 57, 447 N.W.2d 84 (citing *Mathews v. Eldridge*, 424 U.S. 319, 335, 96 S.Ct. 893, 47 L.Ed.2d 18 (1976)).

¶ 51 Loomis analogizes the COMPAS risk assessment to the PSI in *Gardner* and *Skaff*. Northpointe, Inc., the developer of COMPAS, considers COMPAS a proprietary instrument and a trade secret. Accordingly, it does not disclose how the risk scores are determined or how the factors are weighed. Loomis asserts that because COMPAS does not disclose this information, he has been denied information which the circuit court considered at sentencing.

¶ 52 He argues that he is in the best position to refute or explain the COMPAS risk assessment, but cannot do so based solely on a review of the scores as reflected in the bar charts. Additionally, Loomis contends that unless he can review how the factors are weighed and how risk scores are determined, the accuracy of the COMPAS assessment cannot be verified.27

¶ 53 Loomis’s analogy to *Gardner* and *Skaff* is imperfect. Although Loomis cannot review and challenge how the COMPAS algorithm calculates risk, he can at least review and challenge the resulting risk scores set forth in the report attached to the PSI. At the heart of *Gardner* and *Skaff* is the fact that the court relied on information the defendant did not have any opportunity to refute, supplement or explain. *Gardner*, 430 U.S. at 362, 97 S.Ct. 1197. That is not the case here.

¶ 54 Loomis is correct that the risk scores do not explain how the COMPAS program uses information to calculate the risk scores. However, Northpointe’s 2015 Practitioner’s Guide to COMPAS explains that the risk scores are based largely on static information (criminal history), with limited use of some dynamic variables (i.e. criminal associates, substance abuse).28

¶ 55 The COMPAS report attached to Loomis’s PSI contains a list of 21 questions and answers regarding these static factors such as:

- How many times has this person been returned to custody while on parole? 5 +
- How many times has this person had a new charge/arrest while on probation? 4
- How many times has this person been arrested before as an adult or juvenile (criminal arrest only)? 12

Thus, to the extent that Loomis’s risk assessment is based upon his answers to questions and publicly available data about his criminal history, Loomis had the opportunity to verify that the questions and answers listed on the COMPAS report were accurate.

¶ 56 Additionally, this is not a situation in which portions of a PSI are considered by the circuit court, but not released to the defendant. The circuit court and Loomis had access to the same copy of the risk assessment. Loomis had an opportunity to challenge his risk scores by arguing that evidence do not apply at sentencing, we need not address that argument here. *State v. Straszkowski*, 2008 WI 65, ¶ 52, 310 Wis.2d 259, 750 N.W.2d 835.

27. In a similar vein, Loomis asserts that the COMPAS assessment would not pass the Daubert test and therefore would be inadmissible at trial. See *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993). Given that the rules of evidence do not apply at sentencing, we need not address that argument here. *State v. Straszkowski*, 2008 WI 65, ¶ 52, 310 Wis.2d 259, 750 N.W.2d 835.

other factors or information demonstrate their inaccuracy.

¶ 57 Yet, regardless of whether Gardner and Skaff are analogous to this case, Loomis correctly asserts that defendants have the right to be sentenced based on accurate information. Travis, 347 Wis.2d 142, ¶ 17, 832 N.W.2d 491.

¶ 58 Some states that use COMPAS have conducted validation studies of COMPAS concluding that it is a sufficiently accurate risk assessment tool. New York State’s Division of Criminal Justice Services conducted a study examining a COMPAS assessment’s recidivism scale’s effectiveness and predictive accuracy and concluded that “the Recidivism Scale worked effectively and achieved satisfactory predictive accuracy.” Unlike New York and other states, Wisconsin has not yet completed a statistical validation study of COMPAS for a Wisconsin population.31

¶ 59 However, Loomis relies on other studies of risk assessment tools that have raised questions about their accuracy. For example, he cites to a 2007 California Department of Corrections and Rehabilitation (“CDCR”) study which concludes that although COMPAS appears to be assessing criminogenic needs and recidivism risk, “there is little evidence that this is what [ ] COMPAS actually assesses.” 32

¶ 60 The California Study reached the further conclusion that there “is no sound evidence that the COMPAS can be rated consistently by different evaluators, that it assesses the criminogenic needs it purports to assess, and (most importantly) that it predicts inmates’ recidivism for

29. This analysis references current research studies in order to caution sentencing courts regarding concerns that have been raised about evidence-based risk assessment tools such as COMPAS. However, we are not in a position to evaluate or opine on the scientific reliability of this data. Accordingly, this opinion should not be read as an endorsement of any particular research study or article, regardless of whether its conclusion is critical or supportive of the COMPAS risk assessment tool.


32. The State acknowledges that no method of risk assessment is without error. For example, the State cites to a primer on COMPAS which summarizes multiple studies that have assessed COMPAS’s predictive validity as moderate, with scores ranging from .50–.73. Pamela M. Casey, et al., National Center for State Courts (NCSC), Offender Risk & Needs Assessment Instruments: A Primer for Courts at A–23 (2014), http://www.ncsc.org/media/Microsites/Files/CSI/BJA%20RNA%20Final%20Report_Combined%20Files%208–22–14-ashx. However, it also summarizes other studies that assign COMPAS higher scores of .70 for internal consistency and .70–1.0 for re-test reliability. Id.

CDCR offenders.” 34 Ultimately, the authors of the study could not recommend that CDCR use COMPAS for individuals.35

¶ 61 Subsequently, however, the CDCR published its 2010 final report on California’s COMPAS validation study.36 The 2010 study concluded that although not perfect, “COMPAS is a reliable instrument....” 37 Specifically, it explained that the general recidivism risk scale achieved the value of .70, which is the conventional standard, though the violence risk scale did not.38

¶ 62 In addition to these problems, there is concern that risk assessment tools may disproportionately classify minority offenders as higher risk, often due to factors that may be outside their control, such as familial background and education.39 Other state studies indicate that COMPAS is more predictive of recidivism among white offenders than black offenders.40

¶ 63 A recent analysis of COMPAS’s recidivism scores based upon data from 10,000 criminal defendants in Broward County, Florida, concluded that black defendants “were far more likely than white defendants to be incorrectly judged to be at a higher risk of recidivism.” 41 Likewise, white defendants were more likely than black defendants to be incorrectly flagged as low risk.42 Although Northpointe disputes this analysis, this study and others raise concerns regarding how a COMPAS assessment’s risk factors correlate with race.43

¶ 64 Additional concerns are raised about the need to closely monitor risk assessment tools for accuracy. At least one commentator has explained that in order to remain accurate, risk assessment tools “must be constantly re-normed for changing populations and subpopulations.” Klingele, The Promises and Perils of Evidence-Based Corrections, 91 Notre Dame L. Rev. at 576. Accordingly, jurisdictions that utilize risk assessment tools must ensure they have the capacity for maintaining those tools and monitoring their continued accuracy. Id. at 577.

¶ 65 Focusing exclusively on its use at sentencing and considering the expressed due process arguments regarding accuracy, we determine that use of a COMPAS risk assessment must be subject to certain cautions in addition to the limitations set forth herein.

¶ 66 Specifically, any PSI containing a COMPAS risk assessment must inform the sentencing court about the following cautions regarding a COMPAS risk assessment’s accuracy: (1) the proprietary

34. Id.
35. Id.
37. Id. at 29.
38. Id.
42. Id.
nature of COMPAS has been invoked to prevent disclosure of information relating to how factors are weighed or how risk scores are to be determined; (2) risk assessment compares defendants to a national sample, but no cross-validation study for a Wisconsin population has yet been completed; (3) some studies of COMPAS risk assessment scores have raised questions about whether they disproportionately classify minority offenders as having a higher risk of recidivism; and (4) risk assessment tools must be constantly monitored and re-normed for accuracy due to changing populations and subpopulations. Providing information to sentencing courts on the limitations and cautions attendant with the use of COMPAS risk assessments will enable courts to better assess the accuracy of the assessment and the appropriate weight to be given to the risk score.

V

¶ 67 We address next Loomis’s argument that a circuit court’s consideration of a COMPAS risk assessment amounts to sentencing based on group data, rather than an individualized sentence based on the charges and the unique character of the defendant. As this court explained in Gallion, individualized sentencing “has long been a cornerstone to Wisconsin’s criminal justice jurisprudence.” 270 Wis.2d 535, ¶ 48, 678 N.W.2d 197.

¶ 68 If a COMPAS risk assessment were the determinative factor considered at sentencing this would raise due process challenges regarding whether a defendant received an individualized sentence. As the defense expert testified at the post-conviction motion hearing, COMPAS is designed to assess group data. He explained that COMPAS can be analogized to insurance actuarial risk assessments, which identify risk among groups of drivers and allocate resources accordingly.

¶ 69 Similarly, the 2015 Practitioner’s Guide to COMPAS explains that “[r]isk assessment is about predicting group behavior . . . it is not about prediction at the individual level.” 44 Risk scales are able to identify groups of high-risk offenders—not a particular high-risk individual. 45 A pointed example of potential misunderstanding arising from the use of group data is that an individual who has never committed a violent offense may nevertheless be labeled as a high risk for recidivism on the violent risk scale. As the DOC explains: “[a]n offender who is young, unemployed, has an early age-at-first-arrest and a history of supervision failure, will score medium or high on the Violence Risk Scale even though the offender never had a violent offense.” 46

¶ 70 To ameliorate this problem, the DOC explains that “staff are predicted to disagree with an actuarial risk assessment (e.g. COMPAS) in about 10% of the cases due to mitigating or aggravating circumstances to which the assessment is not sensitive.” 47 Thus, “staff should be encouraged to use their professional judgment and override the computed risk as appropriate . . . .” 48

¶ 71 Just as corrections staff should disregard risk scores that are inconsistent with other factors, we expect that circuit courts will exercise discretion when as-

45. Id.
47. Id.
ing a COMPAS risk score with respect to each individual defendant.

¶ 72 Ultimately, we disagree with Loomis because consideration of a COMPAS risk assessment at sentencing along with other supporting factors is helpful in providing the sentencing court with as much information as possible in order to arrive at an individualized sentence. In Gallion, this court explained that circuit courts “have an enhanced need for more complete information upfront, at the time of sentencing.” 270 Wis.2d 535, ¶ 34, 678 N.W.2d 197.

¶ 73 COMPAS has the potential to provide sentencing courts with more complete information to address this enhanced need. The Indiana Supreme Court examined similar risk assessment tools and explained that these tools assist courts in weighing all the sentencing factors:

Such assessment instruments enable a sentencing judge to more effectively evaluate and weigh several express statutory sentencing considerations such as criminal history, the likelihood of affirmative response to probation or short term imprisonment, and the character and attitudes indicating that a defendant is unlikely to commit another crime. Malenchik v. State, 928 N.E.2d 564, 574 (Ind.2010) (internal quotations omitted).

¶ 74 However the due process implications compel us to caution circuit courts that because COMPAS risk assessment scores are based on group data, they are able to identify groups of high-risk offenders—not a particular high-risk individual. Accordingly, a circuit court is expected to consider this caution as it weighs all of the factors that are relevant to sentencing an individual defendant.

VI

¶ 75 We turn now to address Loomis’s argument that a COMPAS risk assessment’s use of gender violates a defendant’s due process rights. Relying on Harris, 326 Wis.2d 685, ¶ 33, 786 N.W.2d 409, Loomis asserts that because COMPAS risk scores take gender into account, a circuit court’s consideration of a COMPAS risk assessment violates a defendant’s due process right not to be sentenced on the basis of gender.

¶ 76 Due to the proprietary nature of COMPAS, the parties dispute the specific method by which COMPAS considers gender. Loomis asserts that it is unknown exactly how COMPAS uses gender, but contends that COMPAS considers gender as a criminogenic factor. The State disagrees, contending that the DOC uses the same COMPAS risk assessment on both men and women, but then compares each offender to a “norming” group of his or her own gender.

¶ 77 Regardless of whether gender is used as a criminogenic factor or solely for statistical norming, Loomis objects to any use of gender in calculating COMPAS’s risk scores. In response, the State contends that considering gender in a COMPAS risk assessment is necessary to achieve statistical accuracy. The State argues that because men and women have different rates of recidivism and different rehabilitation potential, a gender neutral risk assessment would provide inaccurate results for both men and women.

¶ 78 Both parties appear to agree that there is statistical evidence that men, on average, have higher recidivism and violent crime rates compared to women. Commentators also have noted and discussed statistical evidence differentiating men and women in this context. See, e.g., Sonja B. Starr, Evidence-Based Sentencing and the Scientific Rationalization of Discrimination, 66 Stan. L. Rev. 803, 813 (2014) (“if the instrument includes gender,
men will always receive higher risk scores than otherwise-identical women (because, averaged across all cases, men have higher recidivism rates . . .”); John Monahan, A Jurisprudence of Risk Assessment: Forecasting Harm Among Prisoners, Predators, and Patients, 92 Va. L. Rev. 391, 416 (2006) (“That women commit violent acts at a much lower rate than men is a staple in criminology and has been known for as long as official records have been kept.”).

¶ 79 However, Loomis asserts that even if statistical generalizations based on gender are accurate, they are not necessarily constitutional. He cites to Craig v. Boren, 429 U.S. 190, 208–210, 97 S.Ct. 451, 50 L.Ed.2d 397 (1976), a case where the United States Supreme Court concluded that an Oklahoma law that prohibited the sale of 3.2% beer to men under the age 21 and to women under the age of 18 violated the equal protection clause of the Fourteenth Amendment. The Court explained that although state officials offered sociological or empirical justifications for the gender-based difference in the law, “the principles embodied in the Equal Protection Clause are not to be rendered inapplicable by statistically measured but loose-fitting generalities concerning the drinking tendencies of aggregate groups.” Id. at 208–09, 97 S.Ct. 451.

¶ 80 Notably, however, Loomis does not bring an equal protection challenge in this case. Thus, we address whether Loomis’s constitutional due process right not to be sentenced on the basis of gender is violated if a circuit court considers a COMPAS risk assessment at sentencing. See Harris, 326 Wis.2d 685, ¶ 33, 786 N.W.2d 409.

¶ 81 Loomis misinterprets Harris in arguing that a sentencing court cannot consider a COMPAS risk assessment because it takes gender into account in calculating risk scores. In Harris, the defendant asserted that the circuit court imposed its sentence on the basis of gender when it criticized him for being unemployed while his child’s mother worked. Id., ¶ 61. Harris argued that he should not be penalized for being a stay-at-home father and that the circuit court used this fact as an aggravating factor when fashioning his sentence. Id.

¶ 82 In determining whether the circuit court improperly considered gender in sentencing Harris, this court concluded that there was a factual basis underlying the circuit court’s statements that was not related to Harris’s gender. Id., ¶¶ 62-63. The record revealed that Harris was not his daughter’s stay-at-home primary caregiver and that other factors demonstrated that he was not a responsible father. Id., ¶ 63.

¶ 83 Likewise, there is a factual basis underlying COMPAS’s use of gender in calculating risk scores. Instead, it appears that any risk assessment tool which fails to differentiate between men and woman will misclassify both genders. As one commenter noted, “the failure to take gender into consideration, at least when predicting recidivism risk, itself is unjust.” Melissa Hamilton, Risk–Needs Assessment: Constitutional and Ethical Challenges, 52 Am. Crim. L. Rev. 231, 255 (Spring 2015). Thus, if the inclusion of gender promotes accuracy, it serves the interests of institutions and defendants, rather than a discriminatory purpose. Id.

¶ 84 Additionally, Harris concluded that the defendant had not met his burden of proving by clear and convincing evidence that the circuit court actually relied on gender as a factor in imposing its sentence. 326 Wis.2d 685, ¶ 64, 786 N.W.2d 409. It explained that the “circuit court considered the proper factors—it evaluated the gravity of the offense, Harris’s character, and the public’s need for protection.” Id., ¶¶ 65, 67. “The circuit court
thoroughly explained its reasons for the sentence it imposed, and all of the potentially offensive comments flagged by both Harris and the court of appeals bear a reasonable nexus to proper sentencing factors.” *Id.*, ¶ 67.

¶ 85 Here, as in *Harris*, Loomis has not met his burden of showing that the circuit court actually relied on gender as a factor in imposing its sentence. The circuit court explained that it considered multiple factors that supported the sentence it imposed:

In terms of weighing the various factors, I’m ruling out probation because of the seriousness of the crime and because your history, your history on supervision, and the risk assessment tools that have been utilized, suggest that you’re extremely high risk to re-offend.

In addition to the COMPAS risk assessment, the seriousness of the crime and Loomis’s criminal history both bear a nexus to the sentence imposed. *See Gallion*, 270 Wis.2d 535, ¶ 46, 678 N.W.2d 197 (“we require that the court, by reference to the relevant facts and factors, explain how the sentence’s component parts promote the sentencing objectives.”). *See also Harris v. State*, 75 Wis.2d 513, 519, 250 N.W.2d 7 (1977) (relevant sentencing factors include past record of criminal offenses, history of undesirable behavior patterns, and results of presentence investigation).

¶ 86 We determine that COMPAS’s use of gender promotes accuracy that ultimately beneﬁts the beneﬁt of the justice system including defendants. Additionally, we determine that the defendant failed to meet his burden of showing that the sentencing court actually relied on gender as a factor in sentencing. Thus, we conclude that the use of the COMPAS risk assessment at sentencing did not violate Loomis’s right to due process.

VII

¶ 87 Next, we address the permissible uses for a COMPAS risk assessment at sentencing. Then we set forth the limitations and cautions that a sentencing court must observe when using COMPAS.

[15] ¶ 88 Although it cannot be determinative, a sentencing court may use a COMPAS risk assessment as a relevant factor for such matters as: (1) diverting low-risk prison-bound offenders to a non-prison alternative; (2) assessing whether an offender can be supervised safely and effectively in the community; and (3) imposing terms and conditions of probation, supervision, and responses to violations.49

¶ 89 First, COMPAS may be useful in identifying prison-bound offenders who are at low risk to reoffend for purposes of diverting them to non-prison alternatives and aids in the decision of whether to suspend all or part of an offender’s sentence.50

¶ 90 Second, risk assessment tools such as COMPAS can be helpful to assess an offender’s risk to public safety and can inform the decision of whether the risk of re-offense presented by the offender can be safely managed and effectively reduced through community supervision and services.51

¶ 91 Third, COMPAS may be used to inform decisions about the terms and con-


51. *Id.* at 9, 13–14.
Risk assessments can be useful in identifying low-risk offenders who do not require intensive supervision and treatment programs. Together with a need assessment, a risk assessment may inform public safety considerations related to offender risk management, and therefore may be used to provide guidance about the level of supervision and control needed for an offender placed on probation or released to extended supervision. Specifically, it may inform decisions such as reporting requirements, drug testing, electronic monitoring, community service, and the most appropriate treatment strategies.

Thus, a COMPAS risk assessment may be used to "enhance a judge's evaluation, weighing, and application of the other sentencing evidence in the formulation of an individualized sentencing program appropriate for each defendant." See Malenchik, 928 N.E.2d at 573. As the court of appeals explained in Samsa, "COMPAS is merely one tool available to a court at the time of sentencing and a court is free to rely on portions of the assessment while rejecting other portions." 359 Wis.2d 580, ¶ 13, 859 N.W.2d 149.

However, the use of a COMPAS risk assessment at sentencing must be subject to certain limitations. As noted above, the DOC already recognizes these limitations on the PSI, instructing that "[i]t is very important to remember that risk scores are not intended to determine the severity of the sentence or whether an offender is incarcerated." This is also the first "Guiding Principle" of the National Center for State Courts ("NCSC") report on using offender risk and needs assessment at sentencing, which instructs that:

Risk and need assessment information should be used in the sentencing decision to inform public safety considerations related to offender risk reduction and management. It should not be used as an aggravating or mitigating factor in determining the severity of an offender's sanction.

Additionally, we set forth the corollary limitation that risk scores may not be used as the determinative factor in deciding whether the offender can be supervised safely and effectively in the community. This is consistent with the second "Guiding Principle" of the National Center for State Courts.

The decision of the Indiana Supreme Court in Malenchik, 928 N.E.2d at 575, provides additional guidance here. It limited the use of risk assessments, explaining that they "are not intended to serve as aggravating or mitigating circumstances nor to determine the gross length of sentence, but a trial court may employ such results in formulating the manner in which a sentence is to be served."

Additionally, a COMPAS risk assessment was not designed to address all of the goals of a sentence. Its aim is addressing the treatment needs of an individual and identifying the risk of recidivism. Sentencing, on the other hand, is meant to address additional purposes. See State v. Dowdy, 2012 WI 12, ¶ 97, 338 Wis.2d 565, 808 N.W.2d 691 (Abrahamson, supra note 32, at 2).
C.J., dissenting) (“It is commonly understood that there are four main purposes of sentencing: (1) deterrence; (2) rehabilitation; (3) retribution; and (4) segregation.”).

¶ 97 Because of these disparate goals, using a risk assessment tool to determine the length and severity of a sentence is a poor fit. As scholars have observed, “[a]ssessing the risk of future crime plays no role in sentencing decisions based solely on backward-looking perceptions of blameworthiness, ... is not relevant to deterrence, ... and should not be used to sentence offenders to more time than they morally deserve.”

¶ 98 Thus, a sentencing court may consider a COMPAS risk assessment at sentencing subject to the following limitations. As recognized by the Department of Corrections, the PSI instructs that risk scores may not be used: (1) to determine whether an offender is incarcerated; or (2) to determine the severity of the sentence. Additionally, risk scores may not be used as the determinative factor in deciding whether an offender can be supervised safely and effectively in the community.

¶ 99 Importantly, a circuit court must explain the factors in addition to a COMPAS risk assessment that independently support the sentence imposed. A COMPAS risk assessment is only one of many factors that may be considered and weighed at sentencing.


60. A circuit court may order a presentence investigation pursuant to Wis. Stat. § 972.15(1). When filed with the court, any presentence investigative report that attaches or incorporates a COMPAS risk assessment must contain a written advisement listing the limitations. Additionally, this written advisement should inform sentencing courts of the following cautions as discussed throughout this opinion:

- The proprietary nature of COMPAS has been invoked to prevent disclosure of information relating to how factors are weighed or how risk scores are determined.
- Because COMPAS risk assessment scores are based on group data, they are able to identify groups of high-risk offenders—not a particular high-risk individual.
- Some studies of COMPAS risk assessment scores have raised questions about whether they disproportionately classify minority offenders as having a higher risk of recidivism.
- A COMPAS risk assessment compares defendants to a national sample, but no cross-validation study for a Wisconsin population has yet been completed. Risk assessment tools must be constantly monitored and re-normed for accuracy due to changing populations and sub-populations.
- COMPAS was not developed for use at sentencing, but was intended for use by the Department of Corrections in mak-
ing determinations regarding treatment, supervision, and parole.

¶ 101 It is important to note that these are the cautions that have been identified in the present moment. For example, if a cross-validation study for a Wisconsin population is conducted, then flexibility is needed to remove this caution or explain the results of the cross-validation study. Similarly, this advisement should be regularly updated as other cautions become more or less relevant as additional data becomes available.

VIII

¶ 102 We apply next the relevant permissible uses, limitations and cautions to an examination of the record in this case. Loomis argues that he is entitled to a resentencing hearing because the circuit considered the COMPAS risk assessment in imposing his sentence. According to Loomis, this is a violation of his due process rights because he argues that a COMPAS risk assessment should never be considered at sentencing.

¶ 103 Notably, Loomis does not argue that the other factors the court considered at sentencing were insufficient to support the sentence he received. In fact, at oral argument Loomis’s counsel acknowledged that he would not be challenging the sentence imposed if it were devoid of any reference to the COMPAS risk assessment. He argues instead that even if there are other bases for the circuit court’s sentence, this does not overcome the error of considering the COMPAS risk assessment.

¶ 104 As discussed above, if used properly with an awareness of the limitations and cautions, a circuits court’s consideration of a COMPAS risk assessment at sentencing does not violate a defendant’s right to due process. The circuit court here was aware of the limitations. Two limitations were set forth by the DOC in the PSI containing the COMPAS report. Thus, when Loomis was sentenced, the circuit court was aware that “risk scores are not intended to determine the severity of the sentence or whether an offender is incarcerated.” The third limitation, that a COMPAS risk assessment may not be determinative in deciding whether a defendant may be supervised safely and effectively in the community is a corollary limitation to those already set forth in the PSI.

¶ 105 With respect to the cautions this opinion requires, we intend that they be used to inform courts of due process implications. These cautions will enable sentencing courts to better assess the weight to be given to the COMPAS risk scores, circumventing potential due process violations. Here, however, the record reflects that although the circuit court referenced the risk assessment at sentencing, the court essentially gave it little or no weight.

¶ 106 At the post-conviction motion hearing, the circuit court explained that it used the COMPAS risk assessment to corroborate its findings and that it would have imposed the same sentence regardless of whether it considered the COMPAS risk scores:

I think it’s accurate and safe for this court to say that had there been absolutely no mention of the risk assessment tool in the Presentence Report, had the COMPAS not been attached to the presentence report, that the sentence would have been exactly the same because of the court’s evaluation of the sentencing factors that are required under the [ ] law.

¶ 107 The circuit court explained that it considered the COMPAS risk assessment as “an observation” to reinforce its assessment of the other factors it considered:
In other words, the factors that were cited by the court suggested low probability of success on supervision and serious crime. And that was reinforced by the fact that the risk assessment tool shows high risk in all areas . . .

The court identified factors that were apparent to Mr. Loomis’s history and the nature of the offenses. And then went to the COMPAS as an instrument, basically, that supported that evaluation.

¶ 108 This is consistent with the sentencing transcript, in which the circuit court explained that it was also considering the seriousness of the crime and Loomis’s criminal history and history on supervision in ruling out probation. A review of the sentencing transcript reveals that the circuit court also addressed and discussed the gravity of the offense, the character and rehabilitative needs of the defendant, and the need to protect the public. See Gal- lion, 270 Wis.2d 535, ¶ 13, 678 N.W.2d 197.

¶ 109 Thus, the record reflects that the sentencing court considered the appropriate factors and was aware of the limitations associated with the use of the COMPAS risk assessment. Ultimately, although the circuit court mentioned the COMPAS risk assessment, it was not determinative in deciding whether Loomis should be incarcerated, the severity of the sentence or whether he could be supervised safely and effectively in the community.

¶ 110 Additionally, although the circuit court was unaware of the cautions set forth above, those cautions are required in part to ensure that undue weight is not given to the COMPAS risk scores. As the circuit court explained at the post conviction hearing, it would have imposed the exact same sentence without it. Accordingly, we determine that the circuit court’s consideration of COMPAS in this case did not violate Loomis’s due process rights.

IX

[21] ¶ 111 As a final matter, Loomis argues that the circuit court improperly gave undue weight to read-in charges at sentencing. He asserts that not only did the circuit court appear to misunderstand the difference between dismissed and read-in charges, but it improperly assumed that the factual basis for the read-in charges was true.

¶ 112 In Frey, 343 Wis.2d 358, ¶ 61, 817 N.W.2d 436, this court clarified how the read-in procedure and dismissed charges fit into the plea bargaining process. The circuit court can consider uncharged or unproven offenses regardless of whether the defendant consented to having the charges read in or dismissed outright. Id., ¶ 47.

¶ 113 Frey explained that it is preferable for the circuit court to “acknowledge and discuss dismissed charges, if they are considered by the court, giving them appropriate weight and describing their relationship to a defendant’s character and behavioral pattern or to the incident that serves as the basis for a plea.” Id., ¶ 54. Open discussion of dismissed charges is consistent with the sentencing methodology set forth in Gallion and allows the defendant the opportunity to explain or dispute the charges. Id.

[22] ¶ 114 Additionally, read-in charges are expected to be considered at sentencing “with the understanding that the read-in charges could increase the sentence up to the maximum that the defendant could receive for the conviction in exchange for the promise not to prosecute those additional offenses.” Id., ¶ 68.

¶ 115 Loomis asserts that the circuit court appeared to misunderstand the difference between dismissed charges and those that are dismissed but read in. At
sentencing, the circuit court initially erred in its statement regarding dismissed and read-in charges when it stated that it could not consider the dismissed charges at all, but would consider the read-in charges as true. However, the circuit court took a break from the hearing to review *Frey* and continued the hearing under the proper framework.

¶ 116 Although the circuit court may have initially misstated that under *Frey* there is no distinction between read-in charges and dismissed charges, the circuit court’s consideration of the read-in charges was not an erroneous exercise of discretion. It subsequently clarified the proper use.

¶ 117 During the plea hearing, quoting directly from *Frey*, the circuit court advised Loomis of the proper legal standard regarding how it would consider the read-in offenses at sentencing. It allowed both sides to debate the merits of the charges and ultimately believed the State’s version of events was more credible.

¶ 118 At the post-conviction motion hearing, the circuit court reviewed the plea hearing transcript and the sentencing transcript and explained how it weighed the facts in addressing the read-in charges:

The Court had to give weight, greater weight or lesser weight to the facts that’s relating [sic] to the shooting. I felt Mr. Loomis’s explanation was inconsistent with the facts. The State’s version was more consistent with the facts and gave greater weight to the State’s version at sentencing.

¶ 119 Thus, the circuit court weighed the facts, assessed the credibility and the recognized legal standards for read-in offenses. Accordingly, we conclude that the circuit court’s consideration of the read-in charges was not an erroneous exercise of discretion.

X

¶ 120 Ultimately, we conclude that if used properly as set forth herein, a circuit court’s consideration of a COMPAS risk assessment at sentencing does not violate a defendant’s right to due process and that the circuit court did not erroneously exercise its discretion here.

¶ 121 We further conclude that the circuit court’s consideration of the read-in charges was not an erroneous exercise of discretion.

¶ 122 Accordingly, we affirm the order of the circuit court.

The order of the circuit court is affirmed.

PATIENCE DRAKE ROGGENSACK, Chief Justice. (concurring).

¶ 123 I agree with much of the majority opinion’s discussion and I concur in its result; however, I write to clarify that while our holding today permits a sentencing court to *consider* COMPAS, we do not conclude that a sentencing court may *rely* on COMPAS for the sentence it imposes. Because at times the majority opinion interchangeably employs *consider* and *rely* when discussing a sentencing court’s obligations and the COMPAS risk assessment tool, our decision could mistakenly be read as permitting reliance on COMPAS.¹ Therefore, I write to clarify for the reader.²

1. See, e.g., majority op., ¶¶ 8, 31, 48, 82, 85, 98–99.

2. Contrary to the manner in which the majority opinion sometimes employs “consider” and “rely,” they are not interchangeable. “Rely” is defined as “to be dependent” or “to place full confidence.” *Webster’s New Collegiate Dictionary* 977 (1974). Therefore, to permit circuit courts to rely on COMPAS is to
¶ 124 At sentencing, the circuit court is to consider three primary factors: gravity of the offense, character of the offender and the need to protect the public. *State v. Alexander*, 2015 WI 6, ¶ 22, 360 Wis.2d 292, 858 N.W.2d 662. A circuit court’s proper exercise of sentencing discretion includes an individualized sentence based on the facts of the case and may include explaining how the sentence imposed furthers the circuit court’s objectives. *Id.* (citing *State v. Harris (Landray M.*), 2010 WI 79, ¶ 29, 326 Wis.2d 685, 786 N.W.2d 409).

¶ 125 A sentencing court must articulate the factors that it considered at sentencing and how they affected the sentence it imposed. *State v. Harris (Denia)*, 119 Wis.2d 612, 623, 350 N.W.2d 633 (1984). It is through this articulation that we determine whether the circuit court properly exercised its sentencing discretion. *Id.* Defendants have a due process right not to be sentenced in reliance on improper factors such as on race or gender. *Harris (Landray M.*), 326 Wis.2d 685, ¶ 33, 786 N.W.2d 409.

¶ 126 The circuit court’s consideration of various sentencing factors is afforded a “strong presumption of reasonability because the circuit court is best suited to consider the relevant factors and demeanor of the convicted defendant.” *State v. Gallion*, 2004 WI 42, ¶ 18, 270 Wis.2d 535, 678 N.W.2d 197 (internal quotation marks omitted). Therefore, a circuit court’s sentencing decision is upheld unless it exhibits an erroneous exercise of discretion by sentencing based on irrelevant or improper factors. *Id.*, ¶ 17; *Harris (Landray M.*), 326 Wis.2d 685, ¶ 30, 786 N.W.2d 409. In addition, any reference to a potentially improper sentencing factor is reviewed in the context of the circuit court’s sentencing record as a whole. *Harris (Landray M.*), 326 Wis.2d 685, ¶ 45, 786 N.W.2d 409.

¶ 127 As the majority opinion aptly explains, the circuit court here appropriately considered numerous sentencing factors when imposing sentence and merely mentioned the defendant’s COMPAS risk assessment in passing. The circuit court detailed the three primary sentencing factors and explained how the facts of the case warranted the sentence imposed. Therefore, I agree with the majority opinion that circuit courts may consider a COMPAS risk assessment along with a multitude of other relevant factors at sentencing, as was done in this case.

¶ 128 However, one of my concerns is that the certified question frames the issue presented as “whether the right to due process prohibits circuit courts from relying on COMPAS assessments when imposing sentence.” The majority opinion concludes that “if used properly with an awareness of the limitations and cautions, a circuit court’s consideration of a COMPAS risk assessment at sentencing does permit circuit courts to depend on COMPAS in imposing sentence. On the other hand, ‘consider’ is defined as ‘to observe’ or to ‘contemplate’ or to ‘weigh.’” *Id.* at 241–42. Therefore, to permit circuit courts to consider COMPAS is to permit circuit courts to observe a COMPAS risk assessment and weigh it along with other relevant factors in imposing sentence.

3. *See State v. Gallion*, 2004 WI 42, ¶ 43 n. 11, 270 Wis.2d 535, 678 N.W.2d 197 which identifies numerous, supplemental sentencing factors that circuit courts may consider under the appropriate circumstances of each case.


5. *Id.*, ¶¶ 85, 104–10.


not violate a defendant’s right to due process.” I agree that “consideration” of COMPAS does not contravene defendant’s right to due process.

¶ 129 However, the question presented on certification is whether due process prohibits circuit courts from relying on COMPAS, and then the majority opinion’s answering that question in the negative, even though it employs the word “consideration,” may cause the majority opinion to be read as permitting circuit court reliance on COMPAS. Stated otherwise, rather than merely considering COMPAS as one of many factors relevant to sentencing, the majority opinion, due to its interchangeable use of “rely” and “consider,” together with the certified question, may be read to permit a circuit court to rely on COMPAS to determine the appropriate sentence. Reliance would violate due process protections. Accordingly, I write to clarify our holding in the majority opinion: consideration of COMPAS is permissible; reliance on COMPAS for the sentence imposed is not permissible.

SHIRLEY S. ABRAHAMSON, J. (concurring).

¶ 130 I join the majority opinion. It describes the salient issues raised by considering COMPAS at sentencing, and informs the bench and the bar of the limitations and cautions that should be observed in considering COMPAS in sentencing. It underscores that we are addressing the use of a research-based tool and that it is incumbent upon actors in the criminal justice system to recognize that additional research data may become available in the future and different, better tools may be developed.

¶ 131 I write separately to make two points:

1. First, I conclude that in considering COMPAS (or other risk assessment tools) in sentencing, a circuit court must set forth on the record a meaningful process of reasoning addressing the relevance, strengths, and weaknesses of the risk assessment tool.

2. Second, this court’s lack of understanding of COMPAS was a significant problem in the instant case. At oral argument, the court repeatedly questioned both the State’s and defendant’s counsel about how COMPAS works. Few answers were available.

¶ 133 Northpointe, the company that created COMPAS, sought to file an amicus brief in the instant case to discuss the history, accuracy, and efficacy of COMPAS, as well as the use of risk assessment tools like COMPAS throughout the criminal justice system.

¶ 134 The court denied (over my dissent and without comment) Northpointe’s motion to file an amicus brief. The denial was a mistake. The court needed all the help it could get. The majority opinion considers publications by Northpointe. Why could it not consider an amicus brief by Northpointe?

¶ 136 For these reasons, I write separately.

I

¶ 137 I would hold that a circuit court, in considering COMPAS (or another risk assessment tool) in sentencing, must evaluate on the record the strengths, weaknesses, and relevance to the individualized sentence being rendered of the evidence-based tool (or, more precisely, the research-based or data-based tool).

¶ 138 Such an explanation is needed, I think, because the use of risk assessment tools like COMPAS has garnered mixed
reviews in the scholarly literature and in popular commentary and analysis.

¶ 139 For example, although then-Attorney General Eric Holder endorsed the use of risk assessment tools in preparing and planning for the reentry of offenders into society, he cautioned against using risk assessment tools in sentencing. Attorney General Holder warned that using “static factors and immutable characteristics, like the defendant’s education level, socioeconomic background or neighborhood” in sentencing could have unintended consequences, including undermining our goal of “individualized justice, with charges, convictions, and sentences befitting the conduct of each defendant and the particular crime he or she commits.”1


Wisconsin law also recognizes the need for individualized sentences. See State v. Gal lion, 2004 WI 42, ¶ 48, 270 Wis.2d 535, 678 N.W.2d 197 (recognizing that individualized sentencing “has long been a cornerstone to Wisconsin’s criminal justice jurisprudence.”).

University of Wisconsin Law Professor Cecelia Klingele summarized the challenges inherent in using these tools in The Promises and Perils of Evidence-Based Corrections, 91 Notre Dame L. Rev. 537, 576–78 (2015).

2. See Jeff Larson et al., How We Analyzed the COMPAS Recidivism Algorithm, Pro Publica (May 23, 2016), https://www.propublica.org/article/how-we-analyzed-the-compas-recidivism-algorithm; see also Julia Angwin et al., Machine Bias, Pro Publica (May 23, 2016), https://www.propublica.org/article/machine-bias-risk-assessments-in-criminal-sentencing (reviewing the findings of Pro Publica’s study and discussing numerous anecdotal examples of individuals whose risks of recidivism were incorrectly assessed).

3. See, e.g., Sheldon X. Zhang et al., An Analysis of Prisoner Reentry and Parole Risk Using COMPAS and Traditional Criminal History Measures, 60 Crime & Delinquency 167, 187 (2014) (finding that a model assessing just four static variables—gender, age, age of first arrest, and number of prior arrests—performed just as well as COMPAS in predicting prior arrests); Jennifer L. Skeem & Jennifer Eno Louden, Assessment of Evidence on the Quality of Correctional Offender Management Profiling for Alternative Sanctions (COMPAS) 28 (2007), http://www.cdc.ca.gov/adult_research_branch/Research_Documents/COMPAS_Skeem_EnoLouden_Dec_2007.pdf (last visited July 1, 2016) (stating that “there is little evidence that the COMPAS predicts recidivism,” and “there is no evidence that the COMPAS assesses risk state, or change over time in criminogenic needs.”); but see Sharon Lansing, New York State COMPAS-Probation Risk and Need Assessment Study: Examining the Recidivism Scale’s Effectiveness and Predictive Accuracy, N.Y. Div. Crim. Justice Servs., Office of Justice Research & Performance, at i (Sept. 2012) (concluding that COMPAS’s “Recidivism Scale worked effectively and achieved satisfactory predictive accuracy,” namely 71% accuracy); Tim Brennan et al., Evaluating the Predictive Validity of the COMPAS Risk and Needs Assessment System, 36 Crim. Just. & Behavior 21, 30 (2009) (determining, in a study by three individuals for Northpointe, the company that markets COMPAS, that COMPAS’s risk models are “satisfactorily predictive . . .”).

¶ 140 Attorney General Holder’s concerns have been echoed in other studies.2 Additionally, studies differ regarding the accuracy of COMPAS’s recidivism (and especially violent recidivism) scores.3 The circuit court has to show its awareness of and consideration of these issues.

¶ 141 I recognize that the demands on circuit courts are many and their resources relatively few, but making a record, including a record explaining consideration of the evidence-based tools and the limitations and strengths thereof, is part of the long-standing, basic requirement that a circuit court explain its exercise of discretion at sentencing.

¶ 142 Such a process increases the likelihood that circuit courts will remain abreast
of new developments in evidence-based decision making and cognizant of the qualities of the tools utilized. Such a process also provides appellate courts with a meaningful record to review and provides the State, the defendant, and the public with a transparent and comprehensible explanation for the sentencing court’s decision.

II

¶ 143 With evidence-based decision making on the rise, amicus briefs evaluating the research and data will, in all likelihood, become more important. As Judge Richard Posner has written, “[m]ost judges are generalists, and increasingly we are confronted by complexities that most of us have difficulty understanding.” 4 One way of addressing these complexities is taking a more expansive view toward accepting amicus briefs.

¶ 144 The court denied Northpointe’s motion to file an amicus brief over my dissent. See Attachment A. COMPAS is proprietary, and Northpointe considers COMPAS’s algorithms trade secrets. As a result, Northpointe does not disclose how COMPAS determines individual risk scores or how it weighs various factors in arriving at a risk score.

¶ 145 Northpointe has an obvious financial and proprietary interest in the continued use of COMPAS. The court could have taken Northpointe’s interests into account in weighing Northpointe’s amicus brief.

¶ 146 This court’s orders accepting and rejecting amicus briefs have generally not explained the court’s decision, and the orders have not been consistent. Perhaps Northpointe’s brief was rejected because Northpointe had an interest in the use of its tool.

¶ 147 In contrast, in another order denying a motion to file an amicus brief (Attachment B), the amicus had no legally cognizable interest in the case.

¶ 148 Yet in Thompson v. Craney, 199 Wis.2d 674, 546 N.W.2d 123 (1996), the court accepted an amicus brief filed by then-Assembly Speaker David T. Prosser arguing that the legislative enactment at issue in that case was constitutional.

¶ 149 In a recent case addressing similar issues to those raised in Thompson, the court permitted an amicus to file a brief and raise issues that the parties did not address. See Coyne v. Walker, No. 2013AP416, unpublished orders dated Sept. 22, 2015 and October 1, 2015.

¶ 150 Without providing an explanation for the court’s acceptance or denial of amicus briefs, we provide no guidance to lawyers and other interested persons wishing to file amicus briefs in future cases. The court should, in my opinion, take a more expansive view toward granting motions to file amicus briefs.

¶ 151 For the reasons set forth, I concur and write separately.

March 11, 2016

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You are hereby notified that the Court has entered the following order:

No. 2015AP157-CR  
State v. Loomis  
L.C.#2013CF98

The court having considered the motion of Norpointe Inc. for leave to file a non-party brief amicus curiae;

IT IS ORDERED that the motion is denied.


¶  The court issues an order denying the motion. I would grant the motion.
Once again, the court offers no explanation of its order to assist this movant or future movants.

Northpointe, Inc. states that it wishes to file an amicus brief because it developed COMPAS, the sentencing tool at issue in the instant case. Northpointe argues that it is uniquely positioned to discuss the history, accuracy, and efficacy of COMPAS, as well as the use of actuarial risk needs assessments across the criminal justice continuum, and may bring to the court's attention certain issues and points of law that may assist the court in reaching its decision on the merits.

I recognize that the court may be denying this motion because, as the developer of COMPAS, Northpointe, Inc. would have an interest in promoting its product and might benefit or be harmed financially by the court's writing on COMPAS in State v. Loumos. Northpointe does not, however, appear to have a specific interest in the circuit court's decision about the sentence to be imposed on this particular defendant, Eric Loumos.

In addition to Northpointe's financial interest, it claims the software is proprietary information.

I would not necessarily deny a motion to file an amicus brief because the movant has a financial or other interest in the subject matter of the case or because of the claim of the software's proprietary nature. Amici generally have a strong interest in a case or an important stake in an outcome. Why else would a person or entity take the time and trouble to seek amicus status?

The propriety of using COMPAS and risk assessment instruments to reach evidence-based decisions is an emerging area of the law. COMPAS risk assessment instruments present issues that are novel, technical, and complex. The court's decision in the instant case may affect far more people than the parties.

The briefs of both parties cite to reference materials relating to COMPAS, risk-need assessment, and evidence-based sentencing. Why cannot an amicus brief by Northpointe play the same role as the citations in the briefs to reference books or articles by Northpointe or about Northpointe's COMPAS? The court knows of Northpointe's financial and proprietary interests and can take these into account in evaluating Northpointe's amicus brief.

Judges across the country disagree regarding the merits of amicus briefs or the approach a court should take to requests to file amicus briefs. Compare, e.g., Judge Richard Posner's views expressed in Velez v. Choice Cnty. Med. Ctr., 339 F.3d 542, 545 (7th Cir. 2003) (generally viewed as hostile to amicus briefs), with then-Judge Samuel Alito's views expressed in Rosario v. Ashcroft, 393 F.3d 128, 133 (3d Cir. 2005) (generally viewed as more friendly toward amicus briefs).
STATE v. LOOMIS

Cite as 881 N.W.2d 749 (Wis. 2016)

Page 3
March 11, 2016


12 My analysis of this court's orders accepting and rejecting amicus briefs over the years is that they generally do not explain the court's decisions; they do not guide lawyers and other interested persons in filing amicus briefs in future cases; and they do not provide the benefit of reasoned decisions so that the court can be thoughtful and consistent in its approach to amicus briefs.

13 The court should, in my opinion, take a more expansive view to granting motions to file an amicus brief. A court can use all the help it can get. An amicus may have particular expertise and may present a perspective that the parties cannot or will not advocate. I agree with Judge Samuel Alito (now Supreme Court Justice Samuel Alito) in writing that requiring amici to be limited to persons or entities that are impartial or disinterested "is contrary to the fundamental assumption of our adversary system that, when (but this advocacy on behalf of opposing views promotes sound decision making)." Neapolitan Assocs., 293 F.3d at 131.

14 The court knows of Northpointe's financial and proprietary interests. If the amicus brief proves useless to the court, the court can easily set it aside.

15 In closing, I write to object once again to unilateral directives imposed by one member of the court on a justice's separate writings. For my prior writings objecting to this practice, see my dissent to the December 4, 2015 unpublished order of four justices setting a deadline for motions to intervene in the John Doe trilogy; my concurrence/dissent to the January 12, 2016 unpublished order of four justices granting the motion of three district attorneys to intervene in the John Doe trilogy; my separate writings in the unpublished orders granting review in three cases, State v. Finley, No. 2014AP2488-DR; Wis. Carver v. City of Madison, No. 2015AP146; and Regency West Apts. v. City of Racine, No. 2014AP204; my concurrence/dissent to the court's decision to the March 8, 2016 order denying judicial notice in Clark's Wisconsin Co., No. 2014AP77.
¶16 As I have often written, I favor deadlines for writings of justices and staff. But deadlines should be imposed by the court and uniformly and consistently applied.

¶17 For the reasons set forth, I dissent and would grant the request to file an amicus brief.

Prosser, J., dissents and would grant the motion.

________________________________________

Diane M. Fienege
Clerk of Supreme Court
May 19, 2016

To:

Hon. Richard J. Sankovitz
Milwaukee County Circuit Court Judge
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Milwaukee, WI 53233

Donald H. Carlson
Criminal District Attorney
710 N. Plankinton Ave., Ste. 500
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Milwaukee, WI 53226

*Additional Parties listed on Page Three

You are hereby notified that the Court has entered the following order:


The court having considered the motion of Charles F. Dykman for leave to file non-party brief amicus curiae;

IT IS ORDERED that the motion is denied.

DAVID T. PROSSER and REBECCA G. BRADLEY, JJ., did not participate.

SHIRLEY S. ABRAHAMSON, J. (dissenting). The court issues an order denying
Charles Dykman’s motion to file an amicus brief under Wis. Stat. § 809.19(7). I would grant the
motion and would grant the Brenner's request to respond to the amicus brief.

Once again, the court offers no explanation of its order to assist this movant or future
movants.

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Wis. 881 NORTH WESTERN REPORTER, 2d SERIES

Brenner v. National Casualty Company, L.C. #3012CV12446


That Charles Dykman has no legally cognizable interest in the case does not bar him from filing an amicus brief. Indeed sometimes such an interest may be a barrier to filing an amicus brief. See State v. Samuels, No. 2015AP157-CR, unpublished order dated Mar. 11, 2016 (Abrahamson, J., dissenting).

I recognize that the amicus brief would raise issues that the parties did not address. We recently allowed such an amicus brief in Coyne v. Walker, No. 2013AP416. See unpublished order dated Sept. 22, 2015; see also unpublished order dated Oct. 1, 2015.

Judges across the country disagree regarding the merits of amicus briefs or the approach a court should take to requests to file amicus briefs. Compare, e.g., Judge Richard Posner’s views expressed in Voices for Choice v. Ill. Bell. Tel. Co., 539 F.3d 542, 545 (7th Cir. 2008) (generally viewed as hostile to amicus briefs), with then-Judge Samuel Alito’s views expressed in Napolitano v. A.P.A., v. C.I.R., 293 F.3d 128, 133 (3d Cir. 2002) (generally viewed as more friendly toward amicus briefs).

My analysis of this court’s orders accepting and rejecting amicus briefs over the years is that the orders generally do not explain the court’s decision; they do not guide lawyers and other interested persons in filing amicus briefs in future cases; and they do not provide the benefit of reasoned decisions so that the court can be thoughtful and consistent in its approach to amicus briefs.

The court should, in my opinion, take a more expansive view to granting motions to file an amicus brief. A court can use all the help it can get. An amicus may have particular expertise and may present a perspective that the parties cannot or will not advocate.

KLISMET’S 3 SQUARES INC. v. NAVISTAR, INC.

Cite as 881 N.W.2d 783 (Wis.App. 2016)

Page Three
May 19, 2016
No. 2014AP2376

KLISMET’S 3 SQUARES INCORPORATED, Plaintiff–Respondent,
v. NAVISTAR, INC., Defendant–Appellant.
No. 2014AP1830.

Court of Appeals of Wisconsin.
Submitted on Briefs May 15, 2015.
Opinion Filed May 5, 2016.

Background: Purchaser of truck brought action against manufacturer, alleging violation of Lemon Law. Following a grant of partial summary judgment in favor of purchaser, the Circuit Court, Waupaca County, Raymond S. Huber, J., entered judgment in favor of purchaser after a trial. Manufacturer appealed.

Holdings: The Court of Appeals, Sherman, J., held that:

1. Accord and satisfaction did not bar Lemon Law claim;
2. Lemon Law permitted use of 300,000 as denominator in formula for determining reasonable allowance for use;
3. Trial court’s calculation of allowance for use was reasonable; and
4. Purchaser did not intentionally prevent manufacturer from issuing refund within 30–day statutory period.

Affirmed.

1. Appeal and Error ○842(9)

The Court of Appeals’ review of a circuit court’s determination regarding ac-
Remedies for Robots

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Bryan Casey
Stanford Law School

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Working Paper Series
Paper No. 523

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Remedies for Robots

Mark A. Lemley & Bryan Casey

Engineers training an artificially-intelligent self-flying drone were perplexed. They were trying to get the drone to stay within a predefined circle and to head towards its center. Things were going well for a while. The drone received positive reinforcement for its successful flights, and it was improving its ability to navigate towards the middle quickly and accurately. Then, suddenly, things changed. When the drone neared the edge of the circle, it would inexplicably turn away from the center, leaving the circle.

What went wrong? After a long time spent puzzling over the problem, the designers realized that whenever the drone left the circle during tests, they had turned it off. Someone would then pick it up and carry it back into the circle to start again. From this pattern, the drone’s algorithm had learned—correctly—that when it was sufficiently far from the center, the optimal way to get back to the middle was to simply leave it altogether. As far as the drone was concerned, it had discovered a wormhole. Somehow, flying outside of the circle could be relied upon to magically teleport it closer to the center. And far from violating the rules instilled in it by

1 © 2018 Mark A. Lemley and Bryan Casey.
2 William H. Neukom Professor, Stanford Law School; partner, Durie Tangri LLP.
3 Lecturer in Law, Stanford Law School; Legal Fellow, Center for Automotive Research at Stanford (CARS).
4 This example comes from a presentation at the June 2014 Stanford Ecommerce Best Practices Conference. As far as we know it has not been previously described in print.
its engineers, the drone had actually followed them to a T. In doing so, however, it had discovered an unforeseen shortcut—one that subverted its designers’ true intent.

What happens when artificially intelligent robots misbehave, as the drone did here? The question is not just hypothetical. As robotics and artificial intelligence (AI) systems increasingly integrate into our society, they will do bad things. Sometimes they will cause harm because of a design or implementation defect: we should have programmed the self-driving car to recognize a graffiti-covered stop sign but failed to do so. Sometimes they will cause harm because it is an unavoidable byproduct of the intended operation of the machine. Cars, for example, kill thousands of people every year, sometimes unavoidably. Self-driving cars will too. Sometimes the accident will be caused by an internal logic all of its own—one that we can understand but that still doesn’t sit well with us. Sometimes they will do the things we ask them to (minimize recidivism, for instance) but in ways we don’t like (such as racial profiling). And sometimes, as with our drone, robots will do unexpected things for reasons that doubtless have their own logic but which we either can’t understand or predict.

These new technologies present a number of interesting substantive law questions, from predictability, to transparency, to liability for high stakes decision making in complex computational systems. A growing body of scholarship is beginning to address these types of questions. Our focus here is different. We seek to explore what remedies the law can and should provide once a robot has caused harm.

The law of remedies is trans-substantive. Where substantive law defines who wins legal disputes, remedies law asks, “What do I get when I win?” Remedies are sometimes designed to make plaintiffs whole by restoring them to the condition they would have been in “but for” the wrong. But they can also contain elements of moral judgment, punishment, and deterrence. For instance, the law will often act to deprive a defendant of its gains even if the result is a windfall to the plaintiff, because we think it is unfair to let defendants keep those gains. In other instances, the law may order defendants to do (or stop doing) something unlawful or harmful.

Each of these goals of remedies law, however, runs into difficulties when the bad actor in question is neither a person nor a corporation but a robot. We might order a robot—or, more realistically, the designer or owner of the robot—to pay for the damages it causes. (Though, as we will see, even that presents some surprisingly thorny problems.) But it turns out to be much harder for a judge to “order” a robot, rather than a human, to engage in or refrain from certain conduct. Robots can’t directly obey court orders not written in computer code. And bridging the translation gap between natural language and code is often harder than we might expect. This is particularly true of modern AI techniques that empower machines to learn and modify their decision making over time, as the drone in the opening example did. If we don’t know how the robot “thinks,” we won’t know how to tell it to behave in a way likely to cause it to do what we actually want it to do.


6 More on this below.
One way to avoid these problems may be to move responsibility up the chain of command from a robot to its human or corporate masters—either the designers of the system or the owners who deploy it. But that too is easier said than done. Robot decision making is increasingly likely to be based on algorithms of staggering complexity and obscurity. The developers—and certainly the users—of those algorithms won’t necessarily be able to deterministically control the outputs of their robots. To complicate matters further, some systems—including many self-driving cars—distribute responsibility for their robots between both designers and downstream operators. For systems of this kind, it has already proven extremely difficult to allocate responsibility when accidents inevitably occur.7

Moreover, if the ultimate goal of a legal remedy is to encourage good behavior or discourage bad behavior, punishing owners or designers for the behavior of their robots may not always make sense—if only for the simple reason that their owners didn’t act wrongfully in any meaningful way. The same problem affects injunctive relief. Courts are used to ordering people and companies to do (or stop doing) certain things, with a penalty of contempt of court for noncompliance. But ordering a robot to abstain from certain behavior won’t be trivial in many cases. And ordering it to take affirmative acts may prove even more problematic.

In this paper, we begin to think about how we might design a system of remedies for robots. It may, for example, make sense to focus less of our doctrinal attention on moral guilt and more of it on no-fault liability systems (or at least ones that define fault differently) to compensate plaintiffs. But addressing payments for injury solves only part of the problem. Often

7 See infra notes __ - __ and accompanying text.
we want to compel defendants to do (or not do) something in order to prevent injury. Injunctions, punitive damages, and even remedies like disgorgement are all aimed, directly or indirectly, at modifying or deterring behavior. But deterring robot misbehavior too is going to look very different than deterring humans. Our existing doctrines often take advantage of “irrational” human behavior like cognitive biases and risk aversion. Courts, for instance, can rely on the fact that most of us don’t want to go to jail, so we tend to avoid conduct that might lead to that result. But robots will be deterred only to the extent that their algorithms are modified to include sanctions as part of the risk-reward calculus. These limitations may even require us to institute a “robot death penalty” as a sort of specific deterrence against certain bad behaviors. Today, speculation of this sort may sound far-fetched. But the field already includes examples of misbehaving robots being taken offline permanently\(^8\)—a trend which only appears likely to increase in the years ahead.

Finally, remedies law also has an expressive component that will be complicated by robots. We sometimes grant punitive damages—or disgorge ill-gotten gains—to show our displeasure with you. If our goal is just to feel better about ourselves, perhaps we might also punish robots simply for the sake of punishing them. Christina Mulligan half-jokingly suggests that we should have the right to punch a robot.\(^9\) But if our goal is to send a slightly more nuanced signal than that through the threat of punishment, robots will require us to rethink many of our current doctrines.

\(^8\) See infra notes ___ - ___ and accompanying text.

In Part I, we discuss the development of robots and learning AIs, as well as the sorts of robot wrongdoing that will increasingly draw the attention of the legal system. In Part II, we outline the basic principles of remedies law and consider how those remedies will work—or not work—when applied to robots and AIs. Finally, in Part III, we consider how we might remake remedies law with robots in mind.

I. Bad Robots

A. Rise of the Machines

“Robots again.” When Judge Kozinski opened his dissent in *Wendt v. Host International* with this line, he could count on it fetching an ironic grin because it was, well, ironic.10 *Wendt* prominently featured an animatronic version of two television personas,11 much like another case the jurist had overseen some three years prior.12 And in the late 1990s, suits of this sci-fi-esque variety represented such a novelty that the judge’s reference was unmissable. Robots again? Sure. But only because two cases in three years involving robots felt, at the time, like a freak recurrence.

Fast forward just two decades to the present, and Judge Kozinski’s quip appears quaint by comparison. Nowadays, robots are ubiquitous. Industries as far flung as finance, transportation, defense, and healthcare regularly invest billions in the technology. Patent filings

11 *Wendt v. Host Int’l*, Inc., 125 F.3d 806, 809 (9th Cir. 1997).
12 The case referred to here is *White v. Samsung Elec. Am, Inc.*, 971 F.2d 1395 (9th Cir. 1992), cert. denied, 508 U.S. 951 (1993) which involved an animatronic version of Vanna White, a television game show persona.
for robotics and AI applications have skyrocketed.\textsuperscript{13} Even octogenarian Senators can be heard fumbling over phrases once confined exclusively to computer science departments, such as “botnet,” “machine learning algorithm,” and “deep neural network.”\textsuperscript{14} Robots again, indeed.

Comparing these two moments—separated by just twenty years—puts on full display the field’s breathtaking progress. Today, technological feats that read like pages torn from sci-fi novels have become regular fixtures of the news. Robots have driven millions of miles on U.S. roadways,\textsuperscript{15} humbled human professionals at the pinnacle of their fields,\textsuperscript{16} and even performed high-stakes surgical procedures on cardiac patients.\textsuperscript{17} And as innovators continue to compete against each other in increasingly diverse domains, “robots” themselves are taking on new and expansive forms.\textsuperscript{18} Gone are the days of robots confined to assembly lines or warehouse floors.\textsuperscript{19} With each passing week, robots infiltrate deeper into our public spaces, places of work, and even bedrooms.\textsuperscript{20}


\textsuperscript{16} See infra notes ___ - ___ and accompanying text.


\textsuperscript{19} And not just because they sometimes escape. See Holbrook v. Prodomax Automation, Ltd., complaint 17-219, (W.D. Mich. 2017) (wrongful death suit alleging a robot escaped from its work area at a Michigan auto parts factory and killed a woman).

\textsuperscript{20} See infra notes __.
The disruptive forces unleashed by this ascendant technology are challenging long-held assumptions about the limits of machine capabilities—forcing the rest of society to adapt not only economically and politically, but also legally. In the last few years alone, autonomous robots have killed and maimed our fellow citizens, helped determine who goes to prison and who stays there, spouted racist and homophobic remarks on our social media platforms, and even shaped the course of our national elections. Far from anomalous, all signs suggest that these types of events are destined to become the new normal as robots continue to their march into the social mainstream in the decades ahead.

In the view of many leading experts, the challenges posed by this impending “robot revolution” could precipitate a jurisprudential revolution of similar magnitude. And though numerous scholars have begun to explore the ramifications robots pose for our substantive legal


25 See Charles Duhigg, The Case Against Google, N.Y. TIMES (Feb. 20, 2018), https://www.nytimes.com/2018/02/20/magazine/the-case-against-google.html (noting that prominent lawmakers and critics have accused Google of “creating an automated advertising system so vast and subtle that hardly anyone noticed when Russian saboteurs co-opted it in the last election”).

26 See Andrew Berg et al., Should We Fear the Robot Revolution? (The Correct Answer is Yes), INT’L MONETARY FUND (May 21, 2018) (arguing that global society is on the cusp of a second industrial revolution thanks to advances in robotics and artificial intelligence).

27 See infra note __ and accompanying notes.
rules, comparatively little attention has been paid to the rules governing remedies. Our goal is to change that. But in order to understand the impact that robots may have on this area of law, it is helpful to first review the technology’s defining characteristics, as well as the ways legal issues will most likely arise.

A. Defining “Robot”

Though “robot” has appeared in common parlance for nearly a century, the term is still notoriously resistant to definition. For many outside of computer science circles, it continues to evoke 1950s-era stock images of ironclad humanoids adorned with flashing lights, accompanied by the obligatory monotone voice. More recently, though, “robot” and its derivative “robotics” have come to take on more exacting definitions within broader expert communities.

Among legal scholars, efforts have been made to define robots by their so-called “essential qualities.” Such qualities refer to the fundamental, legally-pertinent “characteristics that distinguish [robots] from prior or constituent technology such as computers or phones.”

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28 See infra note ___ and accompanying notes.
31 See id. at 514.
One leading scholar, Ryan Calo, argues that robots exhibit at least three “essential qualities”: namely, “embodiment,”\textsuperscript{32} “emergence,”\textsuperscript{33} and “valence.”\textsuperscript{34} In Calo’s telling:

Robotics combines, arguably for the first time, the promiscuity of information with the [embodied] capacity to do physical harm. Robots display increasingly emergent behavior, permitting the technology to accomplish both useful and unfortunate tasks in unexpected ways. And robots, more so than any technology in history, feel to us like social actors—a tendency so strong that soldiers sometimes jeopardize themselves to preserve the "lives" of military robots in the field.\textsuperscript{35}

In light of these qualities, Calo argues that “robots are best thought of as artificial objects or systems that sense, process, and act upon the world to at least some degree.”\textsuperscript{36} Thus, “a robot in the strongest, fullest sense of the term exists in the world as a corporeal object with the capacity to exert itself physically.”\textsuperscript{37}

As innovation in robotics continues to advance apace, however, the sharp dividing lines of even these recently established “essential qualities” are rapidly blurring. Nowadays, disembodied systems that exist purely as bits and bytes regularly go by the monikers of “bot,” “chatbot,” “crawler bot,” “spam bot,” “social bot,” and so forth. When systems of these types

\textsuperscript{32} Calo describes “embodiment” as the “capacity to act physically upon the world [and], in turn, to the potential to physically harm people or property.” Calo, \textit{Robotics and the Lessons of Cyberlaw supra} note __ at 534.

\textsuperscript{33} Calo describes “emergence” as the ability to “do more than merely repeat instructions but adapt to circumstance.” Calo, \textit{Robotics and the Lessons of Cyberlaw supra} note __ at 538.

\textsuperscript{34} Calo describes “social valence” as the heightened emotion response triggered in humans due to our tendency to anthropomorphize them. \textit{See} Calo, \textit{Robotics and the Lessons of Cyberlaw supra} note __ at 538.

\textsuperscript{35} \textit{Id.} at 515.

\textsuperscript{36} \textit{Id.} at 535.

\textsuperscript{37} \textit{Id.}
operate in parallel, the collective is often referred to by the ominous title of “botnet.” And when gaming or strategy robots run metaphorical circles around human champions in the likes of Go 38 or DOTA 39 they do so in entirely ethereal forms with the capacity to exert themselves only digitally.

Thus, unlike some technologies that have stabilized as their commercial and social presence has increased, robots appear to have done the opposite. As Jack Balkin recently observed, a similar phenomenon occurred in the cell phone industry. 40 According to the scholar, “Thirty years ago people might have argued that an essential characteristic of a cell phone was its ability to make a phone call outside of one’s home. . . . But this feature of cell phones is by no means the primary way that people use them today.” 41 So, too, it seems is true of the “essential qualities” of yesteryears’ robots. Already, those that Calo enumerated less than five years read like relics of a bygone era—a testament to the field’s engine of innovation firing on all cylinders. 42

Today, the terms “robotics” and “artificial intelligence” are often used interchangeably, referring to both embodied and disembodied systems that affect the physical and digital worlds alike. And while there are important technical distinctions to be made between the two

38 Cade Metz, In a Huge Breakthrough, Google’s AI Beats a Top Player at the Game of Go, WIRED (Jan. 27, 2016), https://www.wired.com/2016/01/in-a-huge-breakthrough-googles-ai-beats-a-top-player-at-the-game-of-go/. “Go” is an ancient Eastern strategy game that is comparable to chess, though far more computationally complex. Id.

39 Tom Simonite, Can Bots Outwit Humans In One Of The Biggest Esports Games?, WIRED (Jun. 25, 2018), https://www.wired.com/story/can-bots-outwit-humans-in-one-of-the-biggest-esports-games/. DOTA is one of the internet’s most popular real time strategy games and is more difficult for AI systems than Go or chess.


41 See id.

42 See supra note ___ - ___ and accompanying text. See also, e.g., Balkin (stating he does “not think it is helpful to speak in terms of ‘essential qualities’ of a new technology that we can then apply to law”).
concepts, we adopt the convention of construing “robot” to encompass both robots in Calo’s “essentialist” sense and artificially intelligent systems embodied only in software. Our goal is to include any hardware or software system exhibiting intelligent behavior.

1. What Makes Robots Smart?

But what, then, does it mean for a robot to be “intelligent?” Experts operating at the cutting edge of the field describe “artificial intelligence”—in somewhat circular fashion—as the “science of making machines smart.” And though the definition may be wanting for precision, it is this singular feature—the ability to execute complex behaviors such as planning, language processing, or object recognition—that differentiates a robot from a barren hunk of metal, plastic, or bits.

Robots exhibit their “smart[s]” by executing “algorithms.” Although the term has a certain cerebral ring to it, it actually describes a simple concept. Algorithms are merely sequences of instructions for performing a given task. When translated into software, these instructions can be simplified further still. In fact, all commands given to a computational system are reducible

43 See Kamal Ahmed, Google’s Demis Hassabis—Misuse of Artificial Intelligence ‘Could do Harm’, BBC NEWS (Sept. 16, 2015), http://www.bbc.com/news/business-34266425. While some scholars have suggested that “there is a continuum between ‘robots’ and ‘artificial intelligence,’” Jack B. Balkin, The Path of Robotics Law, 6 CALIF. L. REV. CIRCUIT 45 (2015), the distinction is actually artificial (if you’ll pardon the expression). Without the ability to exhibit intelligent behavior, any so-called robot would be little more than an inanimate composite of metal, plastic, or bits. Accordingly, AI is better understood as a component feature of any robotics system, rather than an entity separate from it.


45 See id.
to one of three logical operators: AND, OR, and NOT.\textsuperscript{46} If chained together in the right way, these basic operators can produce behaviors of breathtaking complexity. Yet at bottom, even the most sophisticated algorithms are comprised of simple, logic-based building blocks.

For much of AI’s history as a scientific field, the prevailing paradigm of system design involved explicitly encoding the algorithms that governed robots.\textsuperscript{47} This approach—sometimes termed the “classic,” “symbolic,” or “GOFAI” approach (short for “Good Old-Fashioned AI”)—required that scientists or engineers hand-code robot behaviors through “explicit, logical representation of facts about the world.”\textsuperscript{48} The expression \textit{dogs have four legs}, for example, might be represented as:\textsuperscript{49}

\[ \forall x \left( \text{is\_a\_dog}(x) \Rightarrow \text{number\_of\_legs}(x) = 4 \right) \]

In plain English, this statement translates to: \textit{For every entity, if that entity is a dog, it has four legs.}

The precision and austerity of the GOFAI approach has obvious appeal. Among other features, explicitly encoded algorithms are inherently predictable and explainable. And robots programmed using this approach are still capable of exhibiting astonishingly complex behaviors,

\textsuperscript{46} See id.

\textsuperscript{47} See id.


\textsuperscript{49} This example derives from David Auerbach’s piece. See id.
ranging from mathematical calculations far surpassing human capabilities, to conquering world chess champions.50

But GOFAI also has its limits. How, for example, is an AI system embedded with a four-legged representation of dogs to categorize the small fraction that do not have four legs, either through accident or genetics? Without prospectively accounting for these types of outliers, hand-coded machines have no means of learning such distinctions on the fly.

In many instances, programmers can teach their robots how to handle these types of “edge cases”51 by prospectively encoding fail-safe measures that anticipate them. But even robust GOFAI approaches that account a wide array of edge cases are often no match for amorphous and ambiguous real-world environments.

Take, for example, the task of navigation. Classically encoded robots have long excelled at getting from point A to point B in warehouses or factories—whether traversing a floor on four wheels or a three-dimensional space with an articulated arm.52 This aptitude owed to the fact that warehouses and factories are, by and large, tightly controlled environments. As such, “programmers could anticipate the range of scenarios a [robot] may encounter, and c[ould] program if-then-else-type decision algorithms accordingly.”53


51 An “edge case” is a technical term that refers to scenarios which occur at the extremes of a given operating parameter—whether expected or unexpected.


53 See id.
On a smooth, clearly demarcated surface with little chance of encountering obstacles (much less inclement weather) the number of uncertainties and edge cases presented was reduced to manageable proportions. But translating a similar navigation task to a bustling city street was another matter entirely. Because the number of uncertainties a robot might encounter in most uncontrolled environments approaches infinity, navigating using a GOFAI approach requires a commensurate number of \textit{a priori} if-then-else statements. Hand-coded algorithms, in other words, simply do not scale.

In the AI field’s earliest years, this inherent limitation of GOFAI—what Pedro Domingo terms the “knowledge acquisition bottleneck”\textsuperscript{54}—went largely unnoticed. At the time, microprocessing technology itself was in its infancy, meaning that roboticists typically curbed their enthusiasm.\textsuperscript{55} But as Moore’s law took hold, and computer scientists began expanding their ambitions, the shortcomings of GOFAI became increasingly apparent.

By the 1980s, it was clear a new approach would be necessary to move the field forward.\textsuperscript{56} But for decades, none appeared—leading to a painful period of stagnation that came to be known as the “AI Winter.”\textsuperscript{57} Thanks to recent breakthroughs in an innovative approach known as “machine learning,” however, the AI winter is emphatically over.\textsuperscript{58}

\textsuperscript{54} See DOMINGO, supra note __.

\textsuperscript{55} See Auerbach, supra note __ (noting a “lack of computational processing ability” limited AI’s potential in its early years).


\textsuperscript{57} See id.

\textsuperscript{58} See RAY KURZWEIL, THE SINGULARITY IS NEAR: WHEN HUMANS TRANSCEND BIOLOGY (Viking Press, 2006) (writing "the AI winter is long since over").
2. How Do Machines Learn?

Machine learning refers to a subfield of AI that turns the GOFAI approach to algorithmic design on its head. Rather than laying out a specific set of instructions for the robot follow, engineers instead specify a goal or set of goals for the robot to achieve when tackling a given problem, often referred to as an “optimizing function.” Having established the desired goal, the robot is then left to author its own algorithms for achieving it, which it does by practicing on illustrative examples of the problem at hand.

At the outset, the robot usually just flails around in the dark—trying things essentially at random without a good idea of what will or won’t work. But each time its experimental efforts move it closer to the goal specified by its designers, the robot receives positive feedback and uses statistical techniques to improve its algorithms accordingly.59 Thus, instead of repeatedly executing an unchanging set of instructions, machine learning approaches enable robots to iteratively write their own instructions as they go.60 And if given enough examples to train on, these systems can prove remarkably adept at solving staggeringly complex tasks that admit of no obvious GOFAI solutions.

Therein lies the promise of machine learning. In situations where the endless fine-tuning of algorithmic instructions would be impossible to do by hand, machines themselves are able to successfully navigate the “knowledge acquisition bottleneck.”61 The program, thus, becomes the

59 And when it performs poorly, vice versa.
60 See DOMINGO, supra note __.
61 See id.
programmer—obviating the need for engineers to anticipate a near-infinite number of edge cases.

When embedded in a broader software or hardware application, the possibilities created by this powerful approach are seemingly endless. Indeed, many leading experts now view machine learning as one among a rarified number of “general purpose technologies” (GPTs), the likes of which include the modern engine, the internet, and electricity.62 Such technologies are distinguished by their ability to “significantly enhance productivity or quality across a wide number of fields or sectors.”63 Paul David’s canonical study established three criteria of GPTs that machine learning appears to possess in abundance: “they have pervasive application across many sectors; they spawn further innovation in application sectors, and they themselves are rapidly improving.”64

Today, companies as diverse as Walmart, Facebook, and General Motors are adopting machine learning systems at “unprecedented rates . . . due to their ability to radically improve data-driven decision making at a cost and scale incomparable to that of humans.”65 It is this engineering approach that allows autonomous vehicles, self-flying drones, and warehouse


64 See id. (citing Paul A. David, The Dynamo and the Computer: An Historical Perspective on the Modern Productivity Paradox, 80 AM. ECON. REV. 355, 355–361 (1990)).

“fetching” robots to function with seeming ease in unimaginably complex environments. And beyond these robots of the more “essentialist” variety, machine learning also powers a vast array of entities classified as “cyber-physical systems” (e.g. Internet of Things devices), as well as disembodied digital systems often classified as software “bots.”

B. When Robots Do Harm

Machine learning is not without its limitations, however. By breaking from the GOFAI paradigm, robots powered by this technique must also embrace a higher degree of uncertainty than their classically-encoded counterparts. Because machines share in the task of writing their algorithms, using machine learning requires sacrificing some degree of fine-grained control over a machine’s algorithms. Accordingly, designers seeking to implement this powerful approach also understand that it can produce robots which are difficult to predict, tricky to debug, and hard or even impossible to understand.

For many years, this engineering reality limited the most successful machine learning applications to domains with high degrees of fault tolerance. After all, it is one thing for a song recommendation engine to miss its mark 20% of the time. But it is quite another for an autonomous vehicle’s LIDAR system to miss oncoming vehicles at a similar clip.


68 See DOMINGO, supra note __.
In the last decade, however, advances in the field have enabled engineers to dramatically improve the accuracy, predictability, and performance of numerous machine learning applications—thus, enabling them to entrust robots with positions of greater decision making authority than ever before. It is these advances that have allowed for the introduction of high-stakes robotics systems including self-driving cars, medical diagnostic robots, and even experimental autonomous passenger drones. Yet, even the most performant of these systems remains imperfect—much like the human decision makers they seek to emulate.

Accepting imperfection means also accepting the possibility that robotics systems will sometimes cause harm to others. Indeed, robots acting in harmful, occasionally catastrophic, ways are already a regular fixture of modern life. Robotic cars, aircraft, and manufacturing systems have killed and maimed third-parties; robots tasked with making online purchases have


been “arrested” for illicitly buying narcotics on the dark web;\(^73\) and robots powering our largest social media platforms have even influenced the course of national elections.\(^74\)

How is the legal system to remedy the harms caused by these, and countless other, robots? The easy cases will be those involving identifiable defendants who deliberately use robots against others. But all signs suggests that such cases will be the exception, not the rule. Far more often, robots comprised of complex amalgamations of software and hardware, designed by vast numbers of contributors, operating along diffuse causal chains, and executing algorithms that range from enigmatic to outright inscrutable will take actions that hurt others. In such instances, it may be hard to tell who owns the robot, who operates it, who trained it, whether it operated as intended, whether the harm could have been avoided, and perhaps even who the victims are. It is these types of scenarios that will pose the greatest challenges for remedies law in the years and decades ahead.

The following sections survey some of the harms complex robotics systems are likeliest to cause, providing contemporary examples of each.

1. **Unavoidable Harms**

Many robots operating free from software bugs, hardware errors, or failures of engineering precaution will nevertheless harm others. Some dangers, after all, are inherent to a


product or service. In such instances, calling for the total elimination of the danger is tantamount to calling for a prohibition on a product or service itself.

Harms of this variety are often referred to as “unavoidable harms” or, in some tort circles, as “comment k harms.” Conceptually, the notion of such harms tends to evoke products such as cigarettes, pharmaceuticals, alcohol, or knives. But as Robert Peterson notes, virtually no product or service is perfectly “safe,” whether it is a peanut butter jar or a tea cozy—much less a complex robotics application.

An illustrative example of the types of unavoidable harms that robots will cause can be found in the autonomous vehicle (AV) context. Ever since the transition from the horse drawn buggy to the modern automobile, vehicular transportation has entailed error-prone humans, strapped to hulking masses of steel, navigating highly complex environments at highly dangerous speeds. Accordingly, “[f]or more than a century, safety professionals have begun with the assumption that cars would crash, and focused their efforts on reducing the damage.” Experts too numerous to list have convincingly argued that this same assumption will also hold for cars

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76 See Welge v. Planters Lifesavers Co., 17 F.3d 209 (7th Cir. 1994).

77 See Peterson, supra note __.

driven by robots as opposed to humans.\textsuperscript{79} For even superhumanly safe self-driving systems are subject to the laws of physics. And if AVs driven by such systems unexpectedly encounter an individual or object without sufficient time or distance to prevent a collision, harm of some variety may be unavoidable.\textsuperscript{80}

2. Deliberate Least-Cost Harms

A close relative of the “unavoidable harms” detailed above involves “deliberate least-cost harms.” These harms are similar to unavoidable ones insofar as they are foreseeable by designers and, in some sense, cannot be avoided. But unlike their entirely unavoidable counterparts, deliberate least-cost harms fall into a grey area where there is sufficient forewarning to meaningfully react to an impending harmful event, but no way to avoid the harm entirely. The question, thus, becomes one of triage: Which of the harmful outcomes is the least costly?\textsuperscript{81}

\textsuperscript{79} Today’s human-driven car accidents can cause unavoidable injuries to drivers, passengers, bystanders, and property. But there is an important difference between contemporary cars and the robocars of the future. Injury from a car crash today is typically the result either of the design of the car or, far more commonly, the behavior of the humans. The law distinguishes those two types of harm, holding manufacturers responsible for injuries caused by product design and human drivers responsible for the injuries they cause.\textsuperscript{79} But self-driving cars, as the name implies, drive themselves. The “design” of the product, in other words, is also responsible for its behavior on the road.

\textsuperscript{80} See, e.g., Noah Goodall, \textit{Ethical Decision Making During Automated Vehicle Crashes}, J. OF THE TRANSP. RESEARCH BD. (Dec. 2014), doi:10.3141/2424-07 (noting that “[w]hile any engineering system can fail, it is important to distinguish that, for automated vehicles, even a perfectly-functioning system cannot avoid every collision”).

\textsuperscript{81} Not in strictly monetary terms.
This type of lesser-of-evils dilemma, where injury is both inevitable and variable, was canonized by the philosopher Judith Thomson in a thought experiment known as the “trolley problem.” In its most popular formulation, the trolley problem proceeds as follows:

[A]n observer is witness to a runaway trolley car barreling toward five unwitting workers on the tracks ahead. The observer, however, is standing at a switch. If pulled, it will divert the trolley onto another track where only one unlucky worker awaits. Tragedy, of some kind, is foreordained. But the observer holds the proverbial power to steer fate: Turn the trolley, killing the one or refrain from turning the trolley, killing the five?

Ever since the introduction of experimental AVs to U.S. roadways, scenarios involving killer robocars thrust into trolley problem-like dilemmas have captured the public and academic imagination. But situations of this kind will likely be the exception, not the rule, when it comes to deliberate least-cost harms. Far likelier, albeit subtler, scenarios involving least-cost harms


83 Thomson’s original experiment asked subjects to imagine themselves as the trolley driver rather than as an outside observer at a switch.


85 See, e.g., WENDELL WALLACH & COLIN ALLEN, MORAL MACHINES: TEACHING ROBOTS RIGHT FROM WRONG, 16 (Oxford U. Press 2009); Joel Achenbach, Driverless Cars Are Colliding With the Creepy Trolley Problem, WASH. POST (Dec. 29, 2015) (arguing “we’re suddenly in a world in which autonomous machines, including self-driving cars, have to be programmed to deal with Trolley Problem-like emergencies in which lives hang in the balance); John Markoff, Should Your Driverless Car Hit a Pedestrian to Save Your Life, N.Y. TIMES (June 23, 2016), https://www.nytimes.com/2016/06/24/technology/should-your-driverless-car-hit-a-pedestrian-to-save-your-life.html (discussing the “dilemma of robotic morality” and its implications for engineers designing robotic decision making systems); Matt Simon, To Make Us All Safer, Robocars Will Sometimes Have to Kill, WIRED (Mar. 13, 2017) (The “trolley problem . . . illustrates a strange truth: Not only will robocars fail to completely eliminate traffic deaths, but on very, very rare occasions, they’ll be choosing who to sacrifice—all to make the roads of tomorrow a far safer place.”).

86 One curious approach is to ignore the problem altogether. German law simply forbids consideration of the trolley problem in programming AVs, saying that an AV headed for an accident cannot alter its
will involve robots that make decisions with seemingly trivial implications at an individual level, but which result in non-trivial impacts at scale.  

Self-driving cars, for example, will rarely face a stark choice between killing a child or killing two elderly people. But thousands of times a day, they will have to choose precisely where to change lanes, how closely to trail another vehicle, when to accelerate on a freeway on-ramp, and so forth. Each of these decisions will entail some probability of injuring someone. And making the “right” decision will require weighing the probability of causing harm, exploring what alternatives exist, and specifying how the car should value the different types of harms that will foreseeably impact different stakeholders.

Consider, for example, the seemingly trivial engineering choice of how much buffer to provide a cyclist. Suppose that a vehicle were programmed to give an extra inch or two of room to any cyclists it passed, out of an abundance of caution. From any single cyclist’s perspective the change would be scarcely perceptible. The vehicle would overtake them at a distance that appeared identical to any other self-driving cars programmed to not provide the extra distance.

But if that same design choice scaled to an entire fleet of vehicles that regularly encountered hundreds of thousands—or even millions—of cyclists, even a difference of such minuscule proportions could be expected to impact cyclist collision rates. Given this reality, providing the additional buffer room may seem like a no-brainer.

behavior to prefer one life over another. See Dave Gershgorn, Germany’s Self-Driving Car Ethicists: “All Lives Matter,” QUARTZ, Aug. 24, 2017. That does leave open the question of what the AV should do in an unavoidable accident situation, though. “Nothing” may often be the worst response.

See Casey, Amoral Machines, supra note ___ (discussing how minute differences in how individual vehicles operate could have profoundly consequential macroscopic effects).
But not so fast. The same inch that benefits the cyclists might have the opposite effect for the vehicles’ passengers, putting them at a marginally higher risk of head-on collisions due to the vehicles’ position closer to the center of the roadway. Once again, the seemingly infinitesimal uptick in risk implicated by such a decision would be all but imperceptible during the course of any individual journey. But when viewed at scale, decisions of this kind will carry a profound ethical and legal weight—requiring designers to grapple with complex, highly fraught tradeoffs inherent to deliberate least-cost harms.

3. **Defect-Driven Harms**

One of the more obvious ways robots will cause harm is through traditional hardware or software “defects.” Harms of this variety occur when a software bug, hardware failure, or insufficient level of precaution by designers causes a robot to injure others. For much of the field’s history, these types of defect-driven harms have been relatively easy to define and identify. They typically occur when designers intend a robot to work in a certain way, but screw up, causing it to behave differently, as was recently alleged in a case involving a robot that “escaped” from its section of a trailer hitch assembly plant, “entered [a technicians] work area, surprise[ed] her, and crushed her head between hitch assemblies.”

As robots continue take on increasingly sophisticated forms, however, defining and identifying these types of “defects” will likely become more challenging. Is a self-driving car to be

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88 This piece does not discuss substantive tort law distinctions found in modern tort doctrine.

deemed “defective” if it brakes more slowly than a human driver? What if it brakes faster than humans, but not as fast as other self-driving cars? Or as fast as other self-driving cars, but not as fast as it might possibly brake if reprogrammed?

   Additional legal wrinkles involving defect-driven harms will also arise in systems involving “humans-in-the-loop,” where responsibility for controlling a robot is distributed between algorithmic and human decision makers. A boundary-pushing example of this phenomenon recently occurred in Tempe, Arizona, when a self-driving car deployed by Uber fatally struck a pedestrian. Although the vehicle was capable of autonomy under certain design parameters, it also relied on a backup driver to take control in the event of an emergency. Yet one night, when a pedestrian unexpectedly walked out in front of one such vehicle, neither the backup driver nor the self-driving system took steps to avoid the collision. As a result, the vehicle collided with the pedestrian at speeds in excess of 30mph without breaking or swerving. Should the backup driver be held responsible for failing to take over? Or was it unreasonable for Uber to put the operator in such a position to begin with? Does it matter how the car was programmed?


92 See id.


94 See id.
How the legal system will eventually resolve controversies involving these types of “moral crumple zones”\textsuperscript{95} remains an open question, even among experts.\textsuperscript{96} But none question the reality that robots exhibiting increasingly complex design defects will continue to harm individuals for the foreseeable future.

4. Misuse Harms

Sometimes, people will misuse robots in a manner that is neither negligent nor criminal but nevertheless threatens to harm others. Given the unpredictable nature of machine learning systems, and the nearly infinite variety of ways humans can interact with modern robotics applications, these types of harms are particularly difficult to guard against. Already, media reports are rife with examples of individuals attempting to manipulate robot behaviors, deceive or “trick” robot perception systems, probe robots for safety or security vulnerabilities, or deploy robots in ways that adversely impact others.\textsuperscript{97} Whether such forms of meddling are deemed to have been preventable by manufacturers, or to have fallen within the scope of the robot’s intended design, will have significant implications for the substantive legal doctrines that will govern the ultimate outcomes and for who bears the resulting liability.


\textsuperscript{96} Whether these types of questions will, ultimately, be resolved under the umbrella of negligence, breach of warranty, enterprise liability, or traditional product “defect” remains unclear.

A now infamous example of robot misuse comes from Microsoft’s Twitter chatbot, “Tay.” Unlike chatbots designed to maintain a static internal state upon deployment, Tay’s system updated itself in real time by learning from interactions with users. Within hours of going live, however, hundreds of Twitter users began intentionally tweeting “misogynistic, racist, and Donald Trumpist remarks” at the robot. Thanks to this barrage of unforeseen misuse, “Tay rapidly morphed from a fun-loving bot . . . into an AI monster.” Tay lasted a mere sixteen hours on the platform before Microsoft intervened. After initially declining to comment, the company eventually noted that a “coordinated effort by some [Twitter] users to abuse Tay’s commenting skills” led it to shut the robot down.

One notable feature of the Tay example is that Microsoft itself did not engage in misuse. Nor is there any reason to think that Tay’s design was defective. Rather, the robot’s rogue conduct resulted from the input of third-parties. But owners, too, will misuse robots, or at least use them in ways we may not expect. Drone owners, for example, might use them to spy on neighbors or invade their privacy. Similarly, self-driving car owners might modify their vehicles to protect occupants at all costs, even if doing so imposes greater risks on bystanders. And


99 But we repeat ourselves.

100 Misconduct from the perspective of Microsoft, at least.

predictive learning algorithms that might decide everything from the cost of your life insurance to where you end up in an emergency room queue to whether you are granted parole are all dependent on the training data they are fed. And that training is only as good as the (often imperfect) data users feed the robot.  

5. Unforeseen Harms

Many harms attributable to robots will be neither defect-driven, unavoidable, nor the result of misuse, but will simply be unforeseen by those who designed them. Harms of this variety are by no means unique to the field of robotics. Indeed, unpredictability is part and parcel of any sufficiently complex system. It’s why your computer periodically crashes and perhaps why new typos seem to pop up in our writing even though we’ve read through a draft at least 30 times.

But if the last decade of progress in the field of robotics has taught us anything, it is that robotics systems using machine learning techniques can be extremely hard to predict, rendering them particularly susceptible to causing unforeseen harms. This phenomenon owes, in large part, to the fact that machine learning systems “enter[] into a social world already in motion, with an existing set of assumptions and expectations about what is likely and unlikely, possible

102 We discuss this problem in more detail infra notes ___-___ and accompanying text.

103 Either because of resource constraints involving safety testing or because they were genuinely unforeseeable.


105 OK, maybe not that last one.
and impossible.” Yet because such systems are, by definition, empowered to learn with limited direct human intervention, the behaviors that they develop can also be unconstrained by the norms, assumptions, and expectations that implicitly govern humans.

Sometimes, this lack of constraint can lead to astonishing, utterly unintuitive results. Robots deployed using machine learning techniques, for example, have devised wholly new tactics for conquering strategy games, have inadvertently set off wars of proliferation with bots on online platforms (leading to bizarre pricing decisions), and have even invented “codewords” to communicate with other AI systems that were indecipherable by their designers. Because of this unpredictability, many complex robots will carry an enormous range of unforeseeable risks—even where numerous precautions are taken in advance of deployment.

106 See Balkin, The Path of Robotics Law, supra note __.
107 See Domingo, supra note __.
108 See Balkin, The Path of Robotics Law, supra note __.
109 See David Silver et al., Mastering the Game of Go Without Human Knowledge, 555 NATURE 354 (Oct. 19, 2017); Nicola Twilley, Artificial Intelligence Goes to the Arcade, NEW YORKER (Feb. 25, 2015), https://www.newyorker.com/tech/elements/deepmind-artificial-intelligence-video-games (writing that “without any human coaching, [an AI system designed to play arcade games] not only became better than any human player but [] also discovered a way to win that its creator never imagined”).
To be clear, the unpredictability inherent to machine learning is also one of its greatest strengths. An AI that just engages in rote calculation of equations we already know the answer to might get to the result faster than humans can, but it won’t be any better at understanding or predicting outcomes than humans. We want AIs to do unpredictable things, so long as those things lead to good results. If an AI can reliably conclude that butterfly population variance in Tibet affects the weather in Indonesia, it will be better than humans at predicting the weather. And if a self-driving car can conclude from subtle changes in the velocity of the cars surrounding it that a crash is imminent, it offers greater hope of avoiding such crashes than a human driver might.\footnote{See Rob Ludacer, \textit{Watch a Tesla Predict an Accident and React Before It Even Happens}, BUS. INSIDER (Dec. 29, 2016), http://www.businessinsider.com/tesla-avoids-accident-before-happens-2016-12 (showing a video of Tesla’s Autopilot doing just that).}

But the unpredictability of the path that robots will take to their goals means that they may do things that make perfect sense given what they were asked to maximize, but which turn out to reflect either poorly specified goals or flawed training data. The introduction’s example of a drone learning to intentionally sabotage its flight path provides just one of the now countless documented instances of unforeseen robot behaviors. Another comes from the healthcare domain.

In the 1990’s, a pioneering multi-institutional study sought to use machine learning techniques to predict health-related risks prior to hospitalization.\footnote{B. Buchanan et al., \textit{An Evaluation of Machine-learning Methods for Predicting Pneumonia Mortality}, 9 ARTIFICIAL INTELLIGENCE IN MED., 107 (1997); R. Ambrosino et al, \textit{The Use of Misclassification Costs to Learn Rule-Based Decision Support Models for Cost-Effective Hospital Admission Strategies} in PROCEEDINGS OF THE ANNUAL SYMP. ON COMP. APPLICATION IN MEDICAL CARE (1995).} After ingesting an enormous quantity of data covering patients with pneumonia, the system learned the rule:
The colloquial translation being “that patients with pneumonia who have a history of asthma have lower risk of dying from pneumonia than the general population.”\textsuperscript{114}

The machine-derived rule was curious, to say the least. Far from being protective, asthma can seriously complicate pulmonary illnesses, including pneumonia. Perplexed by this counterintuitive result, the researchers dug deeper. And what they found was troubling.

They discovered that “patients with a history of asthma who presented with pneumonia usually [had been] admitted not only to the hospital but directly to the Intensive Care Unit (ICU).”\textsuperscript{115} Once in the ICU, asthmatic pneumonia patients went on to receive more aggressive care, thereby raising their survival rates compared to the general population.\textsuperscript{116}

The rule, in other words, reflected a genuine pattern in data. But the machine had confused correlation with causation—"incorrectly learn[ing] that asthma lowers risk, when in fact asthmatics have much higher risk.”\textsuperscript{117}

Thankfully, the relative simplicity of the machine learning model deployed by the researchers in this instance allowed them to detect, reverse engineer, and remedy the situation

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\textsuperscript{114} Rich Caruana et al., \textit{Intelligible Models for HealthCare: Predicting Pneumonia Risk and Hospital 30-day Readmission} in \textsc{Proceedings of the 21th ACM SIGKDD International Conference on Knowledge Discovery and Data Mining} (2015).
\textsuperscript{115} See Buchanan et al., \textit{supra} note \_\_.
\textsuperscript{116} \textit{id}.
\textsuperscript{117} \textit{id}.
\end{flushright}
before any harmful behavior resulted. Indeed, the algorithm taught humans something about the flaws in existing care techniques. But that is a luxury which will not be afforded to all robot designers. Indeed, as Marc Canellas et al. have convincingly argued, the likelihood of these types of unpredictable events actually tends to rise alongside the complexity of computational models, even though the overall likelihood of an abnormal event may remain constant. This phenomenon owes to the highly leptokurkic failure curves often observed in complex systems, where a “reduced likelihood of failure in a general sense” tends to be accompanied by “an increase[d] likelihood of more severe failures.”

118 See Caruana, supra note __.
119 IMB’s Watson, for example, was recently reported as displaying “multiple examples of unsafe and incorrect treatment recommendations.” Jennings Brown, IBM Watson Reportedly Recommended Cancer Treatments That Were ‘Unsafe and Incorrect’, GIZMODO (Jul. 25, 2018), https://gizmodo.com/ibm-watson-reportedly-recommended-cancer-treatments-tha-1827868882.
121 Leptokurkic distributions show higher peaks around mean values and higher densities of values at the tail ends of the probability curve.
122 Canellas et al., supra note __ at 41.
6. Systemic Harms

People have long assumed that robots are inherently “neutral” and “objective,” given that robots simply intake data and systematically output results. But they are actually neither. Robots are only as “neutral” as the data they are fed and only as “objective” as the design choices of those who create them. When either bias or subjectivity infiltrates a system’s inputs or design choices, it is inevitably reflected in the system’s outputs. Accordingly, those responsible for overseeing the deployment of robots must anticipate the possibility that algorithmically biased applications will cause harms of this systemic nature to third-parties.

Robots trained on poorly curated data sets, for example, run the risk of simply perpetuating existing biases by continuing to favor historical *haves* against *have-nots*. In such

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instances, different outcome distributions in the data reflecting racial, ethnic, social, or economic disparities can become self-fulfilling prophecies—leaving already marginalized groups at the mercy of past injustices.

Similarly, the algorithmic goals and sub-goals that define robot behavior can also lead to biased results. After all, each decision in the process of developing an algorithm necessarily reflects the values of its designers. And when designers fail to consider particular stakeholders, or fail to specify goals that accurately map onto their desired outcomes, their robots may unfairly privilege certain individuals or groups over others. Hence, Cathy O’Neil’s provocative description of an algorithm as an “opinion embedded in mathematics.”

Instances of bias or subjectivity infiltrating robotics systems are already well documented. A recent example comes from the car insurance industry. U.S. law obliges all car owners to purchase insurance for their vehicles. But not all premiums are created equal. A recent study by Consumer Reports found that contemporary premiums depended “less on driving habits and increasingly on socioeconomic factors,” including an individual’s credit scores. After analyzing “2 billion car insurance price quotes from more than 700 companies,” the study found that “[c]redit scores . . . factored into [insurance] algorithms so heavily that perfect drivers with low credit scores often paid substantially more than terrible drivers with high scores.” The study’s findings raised widespread concerns that AI systems used to generate these quotes could “create

See id.

A credit score “summarizes an individual’s credit history and financial activities in a way that informs the bank about their creditworthiness.” See Lydia T. Liu et al., supra note ___.
negative feedback loops that are hard to break.”

According to one expert, “Higher insurance prices for low-income people can translate to higher debt and plummeting credit scores, which can mean reduced job prospects, which allows debt to pile up, credit scores to sink lower, and insurance rates to increase in a vicious cycle.” Similar examples of robotics systems causing, or threatening to cause, systemic harms have been documented in the domains of predicting policing, criminal sentencing, targeting advertising, search optimization, and facial recognition, among many others.

To be sure, all advantages are comparative. AI may replicate bias in existing legal systems. But it also has the potential to reduce that bias by replacing human instinct with actual metrics. But it is important that those new objective measures don’t simply replicate the problems of their subjective predecessors.


128 See id. (quoting Cathy O’Neil, a data scientist and author of Weapons of Math Destruction: How Big Data Increases Inequality and Threatens Democracy).


7. **Collateral Harms**

As we continue to invite robots into our homes, personal lives, and places of work, the types of collateral risks they pose to our privacy, security, environment, and even livelihoods will also grow in kind. Some harms, after all, simply arise as a byproduct of pervasiveness. And the threat of these types of harms emerging will be especially true in modern robots, given that they often combine the uncertainties of machine learning, the “promiscuity of data,”\(^\text{131}\) the inherent security risks of computational systems, and the threat of physically affecting the real world.

Take, for example, the now commonplace phenomenon of inviting “Internet of Things”\(^\text{132}\) (IoT) devices, such as an Amazon Echo or Google Home, into our homes to monitor our every utterance. For many (ourselves included), the convenience of simply issuing a voice command to set a cookie timer, play a song, or order a cab can be too good to pass up. Yet, in exchange for the capabilities offered by these powerful voice recognition bots, we must also accept the reality of their 24-7 surveillance of our most intimate settings.

All signs suggest that the invasiveness of robotics applications like these will only increase in the years ahead. As the capabilities and price points of home security bots, robo vacuums, office assistants, and even “robomaids” improve with time, so too will the scope and the granularity of the data they capture. Data collection practices of this magnitude will not only present legal oversight challenges to those tasked with gathering it, but they will also present novel challenges for those seeking to secure robots against external threats. As James

\(^{131}\) This phrase comes from the scholar Ryan Calo and refers to the fact that digital information “faces few natural barriers to dissemination.” See Calo, *Robotics and the Lessons of Cyberlaw*, supra note __ at 532.

\(^{132}\) Internet of Things refers to the embedding of networked devices in everyday objects, thereby allowing them to gather, send, and receive data.
Grimmelmann notes, “the more opportunities for innovation, the more possible targets for hacking.” Accordingly, the very same applications that now gather unprecedented amounts of data from users are also likely to pose unprecedented risks in the event that such data gets into the wrong hands.

Even if they aren’t hacked, the mere presence of these devices can change human behavior. People act differently when they think they are being watched or listened to, even if the thing doing the watching is only a picture of a pair of eyes taped to the computer. And if a robot is in your house, you’re not just imagining it: it probably is watching and listening to you.

Add to this brave new reality the awesome power of cloud computing and networking technologies, and the threat of collateral harms is only exacerbated. Armies of robots linked through networking technologies will enable single, centralized systems to impact our physical and digital environments in profound new ways. Seemingly microscopic design choices within systems controlling fleets of tens of thousands of autonomous vehicles, for example, could produce macroscopic effects including changes to traffic patterns, transportation pricing, congestion, and even energy grid usage. We may, for example, wake up one morning to discover that Google Maps has routed highway traffic through our quiet neighborhood streets. Such a decision harms people who never use Google Maps or self-driving cars. But so might its opposite.

134 Ryan Calo, People Can Be So Fake: A New Dimension to Privacy and Technology Scholarship, 114 Penn St. L. Rev. (2010); Margot E. Kaminski et al., Averting Robot Eyes, 76 Md. L. Rev. 983 (2017) (noting this problem and offering design principles to minimize it).
Suppose, instead, that the same routing algorithm avoided residential areas entirely, causing greater congestion on highways and interstates than was socially optimal.

Finally, some of the collateral harms presented by robots may not feel like traditional “harm” at all, but will be the unintended economic effects of certain behaviors, including net positive ones. Robots, for example, displace jobs. And though delivery drones, manufacturing robots, and driverless trucks may serve as the usual suspects in this regard, many other less obvious applications pose similar threats. A more accurate parole prediction algorithm, for example, could result in a smaller incarcerated population. As a consequence, cities and towns across rural America may need fewer prison guards and fewer construction workers to build their prisons. In the long term, algorithms like these will almost certainly prove to be a net benefit to society. But their short-term negative consequences may be especially pronounced for discrete segments of society—raising new questions surrounding the law’s role in remedying them.136

II. Remedies and Robots

The injuries we described in the last part will lead to lawsuits of various types. Indeed, they already have.137 We don’t intend to discuss all the ways courts might apply the substantive

136 For discussions of the net effects of robots on jobs, which are likely to be complex, see Jason Furman & Robert Seamans, AI and the Economy (working paper May 29, 2018); Mark A. Lemley, IP in a World Without Scarcity, 90 N.Y.U. L. REV. 460, 510-15 (2013).

law to those legal harms. There is a growing literature doing just that.\textsuperscript{138} Rather, our focus is on the practical end game of these coming lawsuits: the law of remedies. Having identified a wrong, courts try to make it right by applying various remedies. But as we will see, when the defendant is a robot (or its owner) that can be easier said than done.

### A. The Law of Remedies

A remedy, broadly defined, is anything that a judicial body can do for an individual who has been harmed or is threatened with harm. Remedies are the means by which substantive law is given its actual effect. Once a plaintiff is adjudged to have suffered harm under the laws governing primary rights and duties, the law must provide a remedy for those rights and duties to have meaning. Without a remedy, lawfulness and unlawfulness are rendered merely nominal distinctions—or, as it is often more pithily phrased, “No right without a remedy.”\textsuperscript{139}

There are two fundamental kinds of remedies: those that are “compensatory” and those that are “preventative.”\textsuperscript{140} Compensatory remedies aspire to address the wrongs suffered by an individual through monetary transfers between plaintiff and defendant, compensating the


\textsuperscript{139} Frederick Pollock, \textit{The Continuity of the Common Law}, 11 Harv. L. Rev. 423, 424 (1898) (noting the phrase already functioning as a “maxim” in the 19\textsuperscript{th} century).

\textsuperscript{140} DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES 3-7 (Aspen Publishers 4th ed. 2011).
plaintiff for the injury suffered. Preventative remedies, meanwhile, aspire to avoid this transfer entirely. They seek to discourage, avert, or literally undo harm, rather than retrospectively compensating victims once harm has occurred. Some preventative remedies accomplish this aim by threatening lawbreakers with damages, specific performance, or restitution in an effort to deter unlawful conduct. But sometimes courts seek to prevent harm more directly by enjoining individuals from acting or, less commonly, ordering them to take affirmative steps to avoid violating the law.141

One goal of remedies law is to make plaintiffs whole by restoring them to the condition they would have been in “but for” the wrong—what Doug Laycock calls restoring the “plaintiff’s rightful position.”142 Traditionally, this compensatory goal has focused on the plaintiff in the dispute—presumably a legal person.143 Compensation is normally accomplished through the award of legal damages.

141 Id. at 11.
142 Id. at 11-15.
143 It is possible to imagine robot plaintiffs. Robots can certainly be injured by humans. You might run a stop light and hit my self-driving car, for example. Or people might attack a robot. See, e.g., Isobel Hamilton, People Kicking These Food Delivery Robots is an Early Insight Into How Cruel Humans Could be to Robots, BUS. INSIDER (Jun. 9, 2018), https://www.businessinsider.com/people-are-kicking-starship-technologies-food-delivery-robots-2018-6?r=US&IR=T (the headline says it all); Russ Mitchell, Humans Slapped and Shouted at Robot Cars in Two of Six DMV Crash Reports This Year, L.A. TIMES (Mar. 5, 2018), http://www.latimes.com/business/autos/la-fi-hy-human-attacks-robot-cars-20180305-story.html; Silicon Valley Security Robot Attacked by Drunk Man—Police, BBC NEWS (Apr. 26, 2017), https://www.bbc.com/news/world-us-canada-39725535. The robot itself presumably won’t have a right to sue, at least for the foreseeable future. But the owner of the robot might sue for damages. That doesn’t seem to present significant remedies issues different from ordinary property damages cases, though. Valuing the loss of an individual robot or AI that has learned in ways that differ from factory settings may present difficulties akin to the valuation of any unique asset. But that’s likely to be rare, since people will presumably back up their unique AIs periodically.
But remedies law also focuses substantial attention on defendants. Equitable restitutionary remedies such as unjust enrichment, disgorgement, and constructive trust are designed not to compensate plaintiffs but to deprive defendants of the benefit of wrongful acts. These remedies are designed not to make the plaintiff whole, but to make the defendant “whole” (in the sense that he is no better off than he would have been but for the wrongdoing).

Injunctive relief can serve the purpose of putting either the plaintiff or the defendant in their rightful position. Injunctions order the defendant not to act (or, less commonly, to take some affirmative act). Generally, injunctions are designed to prevent a future harm or stop an ongoing one. But they can also aim to make affirmative changes in the world, by seeking to change existing structures that have led to past injuries.¹⁴⁴

Remedies law also contains many elements of moral judgment, punishment, and deterrence. For instance, the law will often act to deprive the defendant of gains, even if the result is a windfall to the plaintiff, because we think it is unfair to let the defendant keep those gains. Courts may also enhance damages beyond what is necessary to compensate plaintiffs or deprive defendants of profits in order to punish behaviors we deem reprehensible.

Most of these non-compensatory remedies laws were explicitly designed to change the behavior of people. But the remedial mechanisms used to shape human behavior cannot be relied upon to do the same when machines, not people, engage in harmful conduct. The remainder of this Part considers some of the complications that robots bring to various remedies rules.

B. The Nature of Remedies

1. Normative Versus Economic Perspectives

The choice of remedy for a given legal violation often stems from fundamental assumptions regarding the nature of the substantive law itself. Two views predominate. A "normative" view of substantive law sees it as a prohibition against certain conduct, with the remedy being whatever is prescribed by the law itself. The defendant, on this view, has engaged in a wrongful act that we would stop if we could. But because it is not always possible to do so—commonly because the act has already occurred—remedies law seek to do the next best thing: compensate the plaintiff for the damage done. This view is consistent with laws enforced by property rules.¹⁴⁵

An alternative view of substantive law, however, conceptualizes the role of remedies differently. Under this "economic" view, the substantive law alone forbids nothing. Rather, it merely specifies the foreseeable consequences of various choices, with the available remedies simply signaling the particular penalties associated with particular conduct. Damages, on this view, are simply a cost of doing business—one we want defendants to internalize but not

necessarily to avoid the conduct altogether. This approach is more commonly associated with liability rather than property rules.

To help illustrate the difference between these two views, consider an everyday encounter with a traffic light. Under the normative view, a red light stands as a prohibition against traveling through an intersection, with the remedy being a ticket or fine against those who are caught breaking the prohibition. We would stop you from running the red light if we could. But because policing every intersection in the country would be impossible, we instead punish those we do catch in hopes of deterring others.

Under the economic view, however, an absolute prohibition against running red lights was never the intention. Rather, the red light merely signals a consequence for those who do, in fact, choose to travel through the intersection. As in the first instance, the remedy available is a fine or a ticket. But under this view, the choice of whether or not to violate the law depends on the willingness of the lawbreaker to accept the penalty.

In one of his more arresting turns of phrase, Oliver Wendell Holmes’ famously described the economic view of substantive law as that of a “bad man.” According to Holmes:

If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.

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146 See Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 YALE L.J. 1027 (1995); see also Louis Kaplow & Steven Shavell, Do Liability Rules Facilitate Bargaining? A Reply to Ayres and Talley, 105 YALE L. J. 221 (1995) (responding the Ayres’s and Talley’s argument that, when bargaining is imperfect, “liability rules possess an ‘information-forcing’ quality” that “may induce both more contracting and more efficient contracting than property rules).

147 See Calabrese & Melamed, supra note __.

148 Oliver Wendell Holmes, Jr., The Path of the Law, 10 HARV. L. REV. 457, 458-459 (1897).
The measure of the substantive law, in other words, is not to be mixed up with moral qualms, but is simply coextensive with its remedy—no more and no less.

While some law and economics scholars accept this precept as fundamental, in many behavioral contexts it does not tell the entire story. Although the actual consequences associated with lawbreaking play a substantial role in much of human decision making, many individuals nonetheless view law as having distinctly normative underpinnings. As Doug Laycock notes, “It is certainly true that some individuals will obey the law only if the consequences of violation are more painful than obedience. . . . [But the fact that] some individuals are unmoved does not eliminate the statement’s moral force for the rest of us.”149

An illustrative example of this phenomenon in action comes from the Ohio case, French v. Dwiggins, involving a fatal motorcycle accident.150 At issue was a recently passed statute expanding the avenues of recovery available to plaintiffs who pursued wrongful death claims. The court wrote that, although the expansion of remedies coincided with the timing of the accident, the defendant “could not be reasonably expected to conduct his affairs any differently” than under the prior regime. The court reasoned that when it came to this life and death matter, the marginal differences in available remedies played no role in the defendant’s decision making leading up to the accident.

149 Laycock, Modern American Remedies, supra note __ at 7. See also Yuval Feldman, The Law of Good People: Challenging States’ Availability to Regulate Human Behavior (Cambridge Univ. Press forthcoming 2018) (arguing that we should focus legal rules on the signals they send to good people rather than just constraining the behavior of bad people).

Holmes, himself, could hardly have been said to disagree with the court’s reasoning.\textsuperscript{151} Despite his provocative use of the “bad man” metaphor to clarify the role of the legal rules for those acting out of pure self-interest, he understood the complex—oftentimes competing—roles that normative concerns play in everyday decision making.

2. \textit{Bad Men and Good Robots}

People are rarely forced to grapple with the distinctions between the normative or economic view of substantive law.\textsuperscript{152} But robots, or at least their programmers, are afforded no such luxury. Sure, robots can be prohibited from engaging in certain types of conduct, assuming their designers understand and control the algorithm by which they make decisions. But implementing a legal remedy via computer code necessarily involves adopting either a normative or economic view of the substantive law.

That’s because a true “prohibition” can only be communicated to a computer system in one of two basic ways: \textit{IF, THEN}\textsuperscript{153} statement that prevents a robot from engaging in particular types of conduct, or it can be coded as a negative weight for

\textsuperscript{151} See, e.g., Marco Jimenez, \textit{Finding the Good in Holmes’s Bad Man}, 79 FORD. L. REV. 2069, 2069 (observing that “a careful reading of Holmes suggests that he was himself well aware of the intimate relationship between law and morality, and seems to have recognized, somewhat surprisingly, that only by engaging in an analytical separation of these two concepts can they then be normatively reunited in an intellectually consistent and satisfying manner”).

\textsuperscript{152} Corporations are more likely to do so. Because we can’t put a corporation itself in jail, corporate compliance—even with penalties designed to stop conduct rather than just internalize costs—might nonetheless be viewed as a cost of doing business for the corporation.

\textsuperscript{153} An IF, THEN statement—or “if-then-else statement”—refers to an expression that conditionally executes a statement or group of statements.
engaging in that same conduct. An IF, THEN statement operates like an injunction, while a weight in a decision-making algorithm operates like a liability rule.

Returning to the example of the red light, a programmer seeking to prohibit a robot from breaking the law could do so with an IF, THEN statement along the lines of: “If the robot encounters a red light, then it will not travel into the intersection.” Similarly, a programmer seeking to achieve that same prohibition in a probabilistic system could do so by assigning an infinitely high negative consequence to traveling into the intersection when the light is red.

An IF, THEN statement is an absolute rule. If a triggering event occurs, then a particular consequence must inexorably follow. As a practical matter, so is an infinitely negative weight.154 Both achieve the functionally equivalent result of prohibiting the unlawful conduct—the goal of a normative vision of substantive law. But in order to achieve this normative vision, the prohibition must be implemented without regard for the cost of a ticket.

Because the law is encoded as an absolute in its programming, the robot will always obey the law. That’s not true of people. If we want legal rules to be self-executing, the ability to impose perfect obedience may be a good thing.

By contrast, if the underlying theory of a remedy is economic, the machine’s decisionmaking calculus is fundamentally different. Once more, the example of the traffic light helps to clarify this distinction. To an economist, the substantive law and its remedy do not signal a “self-executing refusal never run a red light” but instead an understanding that “running a red light is associated with a small chance of a modest fine and a somewhat increased chance of a

154 No matter how improbable, any non-zero probability multiplied negative infinity returns negative infinity.
traffic accident which will damage the car and may require the payment of damages to another.”

Under this view, the remedy, and its risks, are both expressed in stochastic terms. They translate into probabilistic costs within the robot’s overall decisionmaking calculus. Those costs won’t be infinite, unless perhaps the penalty is death. They will instead reflect a “price” for running a red light that the algorithm might decide to pay depending on what benefits light-running offers.

Thus, under the economic view, the choice of whether or not to obey a law is, of necessity, the choice of a Holmesian “bad man.” Normative views of substantive law—which we know shape certain aspects of human behavior—cannot be expected to translate cleanly into the robotics context with their associated remedies intact. If we want robots to adopt normative views of the law, prohibitions against unlawful conduct will need to be embedded in robots without regard to their economic remedies, requiring outright prohibitions of the type that famously got Asimov’s robots into so much trouble. After all, it’s hard to operate a robot with too many absolute prohibitions. And this will be particularly true of machine learning systems that develop their own algorithms, making it difficult for engineers to reliably predict how encoded prohibitions will interact with other rules.

Encoding the rule “don’t run a red light” as an absolute prohibition, for example, might sometimes conflict with the more compelling goal of “not letting your driver die by being hit by

155 And probably not even then, unless the robot’s algorithm preferences its own survival over most other outcomes (which it probably won’t).

156 ISAAC ASIMOV, THE REST OF THE ROBOTS 43 (1964) (remarking “[t]here was just enough ambiguity in the Three Laws [of robotics found in his works] to provide the conflicts and uncertainties required for new stories, and, to my great relief, it seemed always to be possible to think up a new angle out of the sixty-one words of the Three Laws”).

157 “Don’t become Skynet” does seem like a good one to include, though. See Genetic Algorithms Tip: Always Include This in Your Fitness Function, XKCD https://xkcd.com/534/.
an oncoming truck.” Humans know that “don’t run a red light” doesn’t really mean “don’t ever run a red light.” Rather it translates, roughly, to “don’t run a red light unless you have a sufficiently good reason and it seems safe.” Likewise, even weightier normative prohibitions, such “though shalt not kill,” come with an implied “unless . . .” But designers can’t put that in an IF, THEN statement unless they understand and specify all the exceptions to the rule.

More plausibly, robots operating in the real world will have to adopt algorithmic approaches to almost all complex problems that weigh particular actions against various goals and risks. As a result, the role of remedies in discouraging socially detrimental conduct will need to be reimagined in terms of cost internalization, as opposed to normative sanction or punishment. Deterrence makes sense where we are trying to affect individual behavior. But the logical way to "deter" a machine is to put the actual costs into the calculus it uses to make the decision. In practice, that translates into quantifying, and then operationalizing, the price we want robots to have to pay if they take certain actions we want to deter. 158 And under the broadest interpretation of the economic view, even doctrines seemingly designed to prevent or deter conduct—like injunctions or prison sentences—could simply be construed as costs, albeit very high ones.

That said, we think it makes more sense to distinguish between remedies designed to internalize costs and those designed to enjoin, deter, or punish behavior. While some defendants faced with the latter may treat punitive damages or even prison sentences as mere costs of doing

158 See Casey, Amoral Machines, supra note __.
business, the remedy’s ultimate intent is to deter unlawful conduct, not to simply internalize its social costs.

For the vast majority of applications, legal remedies will likely be incorporated into machines through their “economic” formulation—resulting in robots that, by design, adopt this view of substantive law exclusively. Unless specifically programmed otherwise, distinctions between normative and economic goals will be utterly lost on robots. Thus, while it may be true to say that it is the rare “individual [who] will obey the law only if the consequences of violation are more painful than obedience,”¹⁵⁹ this will be definitionally true of robots. And for reasons made clear in virtually every sci-fi plot line featuring robots, it will only be on the rarest of occasions that it actually makes sense to completely bar robots from engaging in certain types of conduct.

It, thus, appears that Holmes’s archetypical “bad man” will finally be brought to corporeal form through, ironically, not as a man at all. And if Holmes’s metaphorical subject is truly “morally impoverished and analytically deficient,” as some accuse, it will have significant ramifications for robots.¹⁶⁰

C. Teaching Robots to Behave

Each of the major types and purposes of remedies we identified in section A will face challenges as applied to robots and AI. In this section we consider each in turn.

¹⁵⁹ Laycock, Modern American Remedies, supra note __ at 7.
¹⁶⁰ See CHRISTOPH BEZEMEK, BAD FOR GOOD - PERSPECTIVES ON LAW AND FORCE, THE FORCE OF LAW REAPPLIED 1 (Springer Bezemek/Ladavac eds. 2016).
1. **Who Pays?**

The first purpose of damages—to compensate plaintiffs for their losses and so return them to their rightful position—is perhaps the easiest to apply to robots. True, robots don’t have any money, so they can’t actually pay damage awards themselves. In fact, the European Union Parliament specifically cited this fact in its recommendation against giving robots personhood, noting that they are not fully functioning members of society that could afford to pay their debts.\(^{161}\)

But this problem is hardly insurmountable. The law will rise to challenge. Someone built the robots, after all. And someone owns them. So if a robot causes harm, it may make sense for the company behind it to pay, just as when a defective machine causes harm today.

But it’s not that easy. Robots are composed of many complex components, learning from their interactions with thousands, millions, or even billions of data points, and often designed, operated, leased, or owned by multiple different companies. Which party is to internalize these costs? The one that designed the robot or AI in the first place? The one that collected and curated the data set used to train its algorithm in unpredictable ways? The users who bought the robot and deployed it in the field? Sometimes all of these roles will be one in the same, falling upon individuals operating in a single company, as was arguably the case when a self-driving Uber car killed a pedestrian in Tempe, Arizona.\(^{162}\)

\(^{161}\) See Amanda Wurah, *We Hold These Truths to Be Self-Evident, That All Robots Are Created Equal*, J. OF FUTURE STUD., DOI:10.6531/JFS.2017.22(2).A61.

\(^{162}\) See Wakabayashi, *surpra* note __.
In such instances, assigning responsibility may be easy. But often the chain of legal responsibility will be more complicated. Is a self-flying passenger drone an inherently dangerous product? If so, one set of rules might apply depending on whether it is the passenger or, instead, a third-party who is injured. Is the injury caused by this hypothetical drone the result of a design defect? If so, it may be the designer who should bear the risk. But suppose instead that it was the result of a software defect that a different designer introduced through an aftermarket modification. Here, the law commonly shifts responsibility away from the manufacturer, if the modification was one that it didn’t intend. Indeed, companies regularly void warranties when third-parties modify their products or use them in unexpected ways. Things will get even more complicated if, as seems likely, some or all of the robot code is open source, raising the question of who ultimately is responsible for the code that goes into the car.

Robot designers, owners, operators, and users will, of course, fight over who bears true legal responsibility for causing the robot to behave the way it did. And these complex distinctions don’t even account for the role of third-parties causing robots to behave in adverse ways, as recently happened when Microsoft’s chatbot, Tay, turned into a proverbial Nazi after interacting with trolls on Twitter.

165 See Lothar Determann & Bruce Perens, Open Cars, 32 BERKELEY TECH. L.J. 915 (2017); Bryan Casey, Open Source Robots (working paper 2018).
166 See Vincent, supra note __. In retrospect, this event probably should have been a wake-up call for 2016.
These problems can, and will, eventually be resolved by the courts. But long before any consensus is reached, we should expect no shortage of finger-pointing, as different companies and individuals clamor to shift responsibility for harms to others in the causal chain—whether just to minimize their costs or because there are legitimate disputes about how the behavior of different actors in the chain interacted to cause the harm. And if the AI is self-learning, we may really never know who is to blame.

2. **Law as Action: Shaping the Behavior of Rabota Economicus**

The second prong of the remedies triad—damage awards and equitable remedies designed to internalize costs and deter socially unproductive behavior—will likely prove even more problematic. If we want to deter a robot, we need to make sure that it is programmed to account for the consequences of its actions. Embedding this type of decision making in robots often means quantifying the various consequences of actions and instructing the robot to maximize the expected net monetary benefits of its behavior.

This might sound like heaven to an economist. Finally, we will have a truly rational *homo economicus* (or, more accurately, a *rabota economicus*)\(^ {167}\) who will internalize the social costs of its actions (at least insofar as those costs are accurately calculated in the courts) and modify its behavior accordingly. And if machine learning systems estimate these costs correctly, robots will

be Learned indeed—presumably deciding to do harm only when it is socially optimal (i.e. when $B \lt PL$).\(^{168}\)

But not so fast. Things are more complicated. Robots won’t reflexively care about money. They will do whatever we program them to do. We can align robot incentives with social incentives by properly pricing, punishing, or deterring the companies that design, train, own, or operate robots. Those companies, in turn, should internalize the relevant costs of their robots’ actions. It might be reasonable to assume that corporations and people want to maximize their rational self-interest and will, thus, program their robots accordingly. But not all will, either intentionally or unintentionally. There are at least three potential problems.

First, the goal of cost internalization through legal liability can only be accomplished by proxy. And it isn’t clear who the proxy will be. All the problems we noted in the prior section about assigning responsibility to compensate victims will return in spades as we try to force robots to account for the costs of their conduct. Even truly rational, profit maximizing companies with perfect information about the costs of their actions won’t internalize those costs unless they expect the legal system to hold them liable. If they are wrong, either in fearing liability when none exists or in believing someone else will foot the bill, their pricing will not accurately reflect reality.

Second, we are unlikely to have anything resembling “perfect” information about the potential harms robots may cause. As noted in Part I, robots operating in complex environments can do a wide variety of harmful things. Some of those things we want to stop altogether. Some

\(^{168}\) United States v. Carroll Towing Co., 159 F.2d 169, 171-73 (2d Cir. 1947) (the case in which Judge Learned Hand first expressed his canonical negligence formula).
we want to discourage except in unusual circumstances. Some we want to outright permit but still price appropriately to account for externalities imposed on others. And some we want to permit despite their costs to society because the alternatives are worse.

Getting robots to make socially beneficial, or morally “right,” decisions means we first need a good sense of all the things that could go wrong. Unfortunately, we’re already imperfect at that. Then we’d need to decide whether the conduct is something we want to ban, discourage, tax, or simply permit. Having done so, we would then need to decide who in the chain of robot design, training, ownership, and operation should be responsible for the harm, if anyone. Then, we would need to figure out how likely each adverse outcome is in any given situation. Finally, we would need to assign a price to those potential harms—even the amorphous ones, such as a reduction in consumer privacy. And we’d want to balance those harms against reasonable alternatives to make sure the decision the robot made was the right one, even if it did cause harm.

Our entire system of tort law has been trying to accomplish this feat for centuries. And it hasn’t worked very well. Indeed, most of tort is composed of standards, as opposed to hard and fast rules, for good reason. Standards give us the leeway to reserve judgement for later, when we might have a better idea of the actual facts leading up to an event.

Tort law, for example, requires us to value injury, and—if we are to deter conduct—to decide on a multiplier to that value that serves as an optimal deterrent. While there are some circumstances in which we calculate these values formulaically,\textsuperscript{169} the primary way we do so is

\textsuperscript{169} See, \textit{e.g.}, H. Laurence Ross, \textit{Settled Out Of Court} (2d ed. 1980) (discussing the routinization of negligence and insurance compensation formulas for auto accidents).
by leaving it to juries to pick the right number after an injury has already occurred. Effective
deterrence in robots would, therefore, require accurate predictions about how juries might
assess specific harmful events, not to mention a host of other computationally complex
considerations. Scholars already find these types of predictions difficult, if not impossible, in the
human context.\textsuperscript{170} And we know virtually nothing of how juries will react to harmful events
caused by robots, particularly those exhibiting behaviors they can’t understand because the
algorithm is inscrutable.\textsuperscript{171} As we discuss below,\textsuperscript{172} this reality on the ground may even lead to
feedback loops, in which the very act of trying to price harms in a decision-making algorithm
changes the jury’s view of the robot’s responsibility.\textsuperscript{173}

The problem is even more complex than that, though, because robots don’t necessarily
care about money. They will maximize whatever they are programmed to. If we want them to
internalize the costs of their behavior, we will need to put those costs in terms robots can
understand—for example, as weights that go into a decision-making algorithm. That’s all well
and good for robots already designed to maximize profit in purely monetary terms—say, a day-
trading AI. But lots of robots will be designed with something other than money in mind. A
policing or parole algorithm might minimize the likelihood that a released offender commits
another crime. A weather-prediction system may maximize successful prediction outcomes. A

\textsuperscript{170} See LAYCOCK, supra note ___ at 165-6 (discussing multiple studies showing disagreement among juries
“over how to convert severity of injury into dollars”).

\textsuperscript{171} See infra notes ___ - ___ and accompanying text.

\textsuperscript{172} See infra notes ___ - ___ an accompanying text.

\textsuperscript{173} See, e.g., Malcom Gladwell, The Engineer’s Lament: Two Ways of Thinking About Automotive Safety,
The New Yorker (May 4, 2015), https://www.newyorker.com/magazine/2015/05/04/the-engineers-lament (describing jurors’ horror at internal memos that seemed to callously weigh the value of human lives against business considerations).
surgery robot might maximize success in the surgery without considering certain side effects down the road. And a self-driving car might minimize time to destination subject to various constraints like generally obeying traffic laws and reducing the risk of accidents. But to build deterrence into those algorithms, we must convert certain divergent values into a common metric, whether it be money or something else.

A final complexity involving *rabota economicus* emerges for economic costs that are not directly reflected by legal remedies. The cost of any given decision, after all, is not just a function of the legal system. In many instances, extralegal forces such as ethical consumerism, corporate social responsibility, perception bias, and reputational costs will provide powerful checks on profit maximizing behaviors that might, otherwise, be expected to produce negative societal externalities.\(^{174}\) By pricing socially unacceptable behavior through the threat of public backlash, these and other market forces help to fill some of the gaps left by existing remedies regimes. But they may open up other holes, creating rather than internalizing externalities. In fact, in certain circumstances, these factors may end up utterly swamping the costs of actual legal liability. For instance, if I make it clear that my car will kill its driver rather than run over a pedestrian if the issue arises, people might not buy my car. The economic cost of lost sales may swamp the costs of liability from a contrary choice. [In the other direction, car companies could run into PR problems if their cars run over kids]. Put simply, it is aggregate profits—not just profits related to legal sanctions—that will drive robot decision making.

\(^{174}\) See Casey, *Amoral Machines*, supra note ___ at fn 69 (discussing “the warped incentive signals conceivably sent [to robots] by transaction costs, first- and third-party insurance intermediaries, administrative costs, technical limitations, agency costs, information costs, detection costs, judgement proofing, human error and incompetence, consumer psychology, potential media backlash, and judicial and regulatory uncertainty”).
Further, even when a profit maximizing corporation is wholly responsible for the conduct of a robot, incentives may misalign for other reasons. Corporations might want robots that maximize the long-term value of their brand even if doing so imposes unnecessary hidden costs. Or, conversely, they may task their robots with creating content that goes viral and, therefore, maximizes short-term visibility—even if it is divisive and potentially contrary to the corporation’s long-term interest. Corporations may also decide that first-mover advantages are worth the risk of causing some injury in order to capture a long-term market. “Move fast and break things” is a slogan in Silicon Valley, one that has served many disruptive tech companies well. But this same slogan can take on somewhat more sinister cast when it is self-driving cars that are literally moving fast and breaking things.

Corporations are also likely to be siloed in ways that interfere with effective cost-internalization. Machine learning is a specialized programming skill, and programmers aren’t economists. Even those who are employed by profit maximizing companies interested in effectively internalizing their legal costs may see no reason to take the law into account, or may not be very good at it even if they try to. They may resent constant interference from the legal department in their design decisions. And agency costs mean that different subgroups within companies may be motivated by different incentives—as when sales divisions, manufacturing


176 At least not most of them.
divisions, and service departments all get compensated based on different and potentially conflicting metrics.¹⁷⁷

Further, designers aren’t the only people whose motivations we need to worry about. What a self-learning robot will maximize depends not only on what it is designed to do—the default optimizing function or functions that it starts with—but also how it learns. To efficiently deter behavior we must be able to predict it. But if we don’t know how the robot will behave because it might discover novel ways of achieving the goals we specify, simply pricing in the cost of bad outcomes might have unpredictable effects. And even if it doesn’t, we once again have to confront the possibility that not all engineers will design their robots to maximize profit. Even if the designer of my self-driving car defaults to an algorithm that appropriately balances the risks to everyone associated with driving, I might personally prefer a car that protects its passengers at the expense of pedestrians. And if I (or, more realistically, a car company that wants to market to me) instructs the car accordingly, simply pricing the social cost of accidents into the algorithm won’t modify behavior in the way we hope.

This complex relationship between deterrence, responsibility, and financial liability does not, alone, differentiate robots from corporations or people. Deterrence is imperfect among humans, too, because humans aren’t motivated entirely by money and because they can’t always pay for the harm they cause. But what is different here is that the possibility of deterrence working at all will depend entirely on the robot’s code. A robot programmed to be indifferent to

money won’t be deterred by any level of legal sanction. And while making the responsible legal party pay\textsuperscript{178} might encourage that party to design robots that do take adequate care, the division of responsibility between component makers, software designers, manufacturers, users, owners, and third-parties means that the law must be careful about who exactly it holds accountable.\textsuperscript{179}

\textbf{C. Deterrence Without Rational Actors: Is There Still a Role for Morality and Social Opprobrium in Robot Remedies?}

\textbf{1. Equitable Monetary Relief and Punishment}

So far, we have focused on internalizing the costs of accidents or other injuries that result from otherwise socially desirable activities, such as driving cars. But we also need to worry about genuinely “bad” behavior by robots that may merit prohibition. Many of our equitable monetary remedies are aimed at this sort of conduct. Their goal is not to make defendants internalize costs—to put a price on socially valuable behavior because of the costs it imposes—but to prevent the behavior. If you steal my car, the law says that you don’t get to keep it even if you value it more than me. Rather, you hold it in constructive trust for me.\textsuperscript{180} If you make profits by infringing my copyright or trade secret (but not my patent), the law will require you to disgorge those profits, paying me the money you made even if I never would have made it myself.\textsuperscript{181} We

\textsuperscript{178} Or face time behind bars.

\textsuperscript{179} As it gets easier to design AIs, these entities will be increasingly judgement-proof. That will make us want to look upstream past the owner/user to the manufacturer. A second and more significant category of circumstances where a robot might depart from purely profit maximizing behavior involves instances where the chain of legal responsibility running from the robot to the manufacturer is intermediated by a downstream user.

\textsuperscript{180} See LAYCOCK, supra note ___ at 699-711.

\textsuperscript{181} Id. at 655-63.
require defendants to give up such “unjust enrichment,” not because we think we need to do so to compensate the plaintiff, but because we don’t want the defendant to have the money.\textsuperscript{182}

These equitable rules share some similarities with the cost-internalization measures discussed in the last section. But there are two key differences: (1) the money a defendant must pay is not limited to what is needed to compensate the plaintiff, and (2) the defendant must give up all gains, making the entire activity unprofitable. The focus here is not on the plaintiff’s rightful position but on the defendant’s rightful position. And in the class of cases in which we often use these remedies, the defendant’s rightful position is one in which she didn’t engage in the activity at all.\textsuperscript{183}

From an economic perspective, depriving defendants of their gains is simply a matter of coming up with a number. It might be greater than, equal to, or less than the damages we would otherwise impose to internalize the costs of unlawful conduct or to restore the plaintiff’s rightful position. But there is something psychologically effective about taking away a defendant’s gains altogether. Indeed, in certain contexts, it might be a better means of deterring humans than the threat of paying compensatory damages, even if those damages turn out to be higher than a disgorgement remedy would. When it comes to robots, however, there is little reason to think that the notion of taking “all your profits” will have the same psychological effects. True, if you set “profit = 0,” a profit maximizing AI would not engage in the conduct. But that same logic would apply with equal force if the damages award made the activity unprofitable too.

\textsuperscript{182} \textit{Id.}
\textsuperscript{183} \textit{Id.}
Remedies focused on the defendant’s rightful position do have one significant economic advantage over damages remedies intended strictly as *ex ante* deterrents: we can calculate them after the fact once we have all the necessary information. If we want to use the threat of damages to deter conduct, we need to predict the likelihood and severity of the harm that the conduct will cause.\(^{184}\) But if we care only about depriving the defendant of benefits on the theory that that doing so will deter her, we just need to wait to set the number until the parties get to court and figure out how much the defendant actually gained. That often won’t be trivial. The benefit of stealing a trade secret, for example, can be as amorphous as a “quicker time to market” or a “more competitive product.”\(^{185}\) But it’s still likely to be easier than predicting in advance who will be injured and by how much.

This same calculus doesn’t work for injuries that are the byproduct of productive behavior. It doesn’t make sense to say that a self-driving car that hits a pedestrian should disgorge its profits. It likely didn’t profit from hitting the pedestrian. And we don’t want to force defendants to disgorge all the value they make from driving. But defendant-focused equitable monetary remedies, like disgorgement or constructive trust, may have advantages for robot torts for which our goal is to stop the conduct altogether, not to simply to price it efficiently.

\(^{184}\) See *supra* notes __ - __ and accompanying text.


For examples, see K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 474 (9th Cir. 1974) (“We are satisfied that the appropriate duration for the injunction should be the period of time it would have taken Head, either by reverse engineering or by independent development, to develop its ski legitimately without use of the K-2 trade secrets.”); Winston Research Corp. v. Minn. Mining & Mfg. Co., 350 F.2d 134, 145–46 (9th Cir. 1965) (discussing injunction protection for a machine company); Verigy US, Inc. v. Mayder, No. C-07-04330 RMW, 2008 WL 564634, at *9, *11 (N.D. Cal. Feb. 29, 2008) (granting a five-month injunction to account for the lag time defendant would have faced in getting to market absent misappropriation).
2. Detection, Deterrence, and Punitive Damages

The fact that robots won’t be affected by the psychological impact of certain remedies also has consequences for how we should think about the threat of detection. For a robot to be optimally deterred by remedies like disgorgement—which rely on human psychology to maximize their effects—we must also detect and sanction the misconduct 100% of the time.¹⁸⁶ That, in turn, leads us to the problem of robots (or their masters) that hide misconduct.

To be sure, many robot harms will be well publicized. The spate of autonomous vehicle accidents covered by media in recent years provides one stark example. But countless robot harms will be of far subtler, so-called “blackbox,”¹⁸⁷ varieties and will, therefore, be much harder to detect.¹⁸⁸

Makers and trainers of robots may have incentives to hide their behavior, particularly when it is profitable but illegal. If a company’s parole algorithm concludes (whether on the merits of the data or not) that black people should be denied parole more often than similarly situated white people, it might not want the world to know. And if you, as an owner, tweaked the algorithm on your car to run over pedestrians rather than put your own life at risk, you might


¹⁸⁷ This term refers to algorithms that are inscrutable to outsiders, either by virtue of complexity, lack of technical fluency, or trade secrets protection.

seek to hide that too. We have already seen remarkable efforts by companies conspiring to cover up wrongdoing, many of which succeeded for years.189 Often such conspiracies are brought down by sheer virtue of their scale—i.e. the fact that many people know about and participate in the wrongdoing. This same property may be less true of future robotics firms, which may require fewer people to participate and cover up unlawful acts.190

Further, robots that teach themselves certain behaviors might not know they are doing anything wrong. And if their algorithms are sophisticated enough, neither may anyone else for that matter.191 Deterrence will work on a robot only if the cost of the legal penalty is encoded in the algorithm. A robot that doesn't know it will be required to disgorge its profits from certain types of conduct will not accurately price those costs and so will optimize for the wrong behaviors.

The economic theory of deterrence responds to the improbability of getting caught by ratcheting up the sanctions when you are caught, setting the probability of detection times the penalty imposed equal to the harms actually caused.192 Proportionality of punishment makes


190 Desai and Kroll argue for protections for whistleblowers who identify flaws in robotic design in an effort to reduce the risk of such cover-ups. Desai & Kroll, supra note __, at 3.

191 Pricing algorithms may effectively replicate the anticompetitive effects of a cartel by predicting the behavior of their rivals, for instance. See Kellie Lerner & David Rochelson, How Do you Solve a Problem Like Algorithmic Price Fixing, ANTITRUST & TRADE REG. DAILY (BNA), Feb. 7, 2018.

sense here. As the chance of detection goes down we want the damage award to go up. And machines can do this math far better than humans can. Indeed, this idea may be tailor-made for robots. Becker’s “high sanctions infrequently applied” approach seems unfair in many humans contexts because it can have widely varied interpersonal effects: even if we get equal deterrence from a 100% chance of a year in prison or a 10% chance of 10 years in prison, the lottery system that punishes a few very harshly seems intuitively unfair. We want our laws to protect both victims and wrongdoers against some forms of moral bad luck (whereas Becker’s approach exacerbates it). But robots will internalize the probability of punishment as well as its magnitude, so we may be able to encourage efficient behavior without worrying about treating all robots equitably. Further, we are unlikely to feel bad for harshly-punished robots in the ways that we might for human beings.

Even if we decide to heed Becker’s advice, getting the numbers right presumes that we have a good estimate of the proportion of torts committed by robots that go undetected. That’s tough to do, especially for newly introduced technologies. And it also requires programmers to predict the multiplier and feed those calculations into the algorithm, something that might not be a straightforward undertaking for any of the variety of reasons covered in the last section (not to mention the possibility that we get the numbers wrong, which will either over- or under-deter certain behaviors).


193 High sanctions, for example, “may lead juries to be less likely to convict defendants, or may induce individuals to engage in greater efforts to avoid detection.” Polinsky & Shavell, supra note ___ at ___ (citing James Andreoni, Reasonable Doubt and the Optimal Magnitude of Fines: Should the Penalty Fit the Crime?, 22 RAND J. OF ECON. 385 (1991); Arun Malik, Avoidance, Screening and Optimum Enforcement, 21 R. AND J. OF ECON. 341 (1990)).
Maybe society will, instead, be able to force corporations to internalize their costs through non-legal mechanisms—e.g. by voting with their wallets when a company’s robots engage in misconduct. But this, too, is easier said than done, particularly for the types of “systemic harms” described in Part I. In the era of big data and even bigger trade secrets, structural asymmetries often prevent meaningful public engagement with the data and software critical to measuring and understanding the behavior of complex machines. Because private companies retain almost exclusive control over both the proprietary software running the machines and their resultant data, barriers to accessing the information necessary to understand the reasons behind particular machine decisions can often be insurmountable. What’s more, even in circumstances where the information is available, evidence of unlawful decision making can still be notoriously difficult to detect. As the AI Now Institute notes, “[u]nintended consequences and inequalities [of sophisticated computational systems] are by nature collective, relative and contextual, making measurement and baseline comparisons difficult” and creating the “potential for both over- and under-counting biases in measurement of distributions given the limits on observable circumstances for individuals, problems with population gaps and possible measurement errors.”

Current trends in AI appear likely to only exacerbate this problem. As Bryce Goodman and Seth Flaxman observe, even after “putting aside any barriers arising from technical fluency [and]
ignoring the importance of the training model,” modern machine learning techniques pose significant “tradeoff[s] between the representational capacity of a model and its interpretability.”¹⁹⁶ Systems capable of achieving the richest predictive results tend to do so through the use of aggregation, averaging, or multilayered techniques which, in turn, make it difficult to determine the exact features that play the largest predictive role.¹⁹⁷ Thus, even more so than with the past generation of algorithms governing machines, understanding how modern robots arrive at a given decision can be prohibitively difficult, if not technically impossible—even for the designers themselves.¹⁹⁸ As a result, potentially unlawful or defective decision making within such systems can often only be demonstrated in hindsight, after measuring the unevenly distributed outcomes once they have already occurred. And as systems get more complex, maybe not even then.

The risk presented by this combination of factors is not so much that corporations will intentionally build bad robots in order to eke out extra profits, but that bad “effects [will] simply happen, without public understanding or deliberation, led by technology companies and governments that are yet to understand the broader implications of their technologies once they are released into complex social systems.”¹⁹⁹ Indeed, much of the misconduct that tomorrow’s designers, policymakers, and watchdogs must guard against might not be intentional at all. Self-learning machines may develop algorithms that take into account factors we may not want them

¹⁹⁶ See Bryce Goodman & Seth Flaxman, European Union Regulations on Algorithmic Decision-Making and a “Right To Explanation”, ICML WORKSHOP ON HUMAN INTERPRETABILITY IN MACHINE LEARNING (2016).
¹⁹⁷ Id.
¹⁹⁸ Id.
to, like race or economic status. But on some occasions, taking precisely those factors into
account will actually get us to the ultimate result of interest.

For this reason, we think AI transparency is no panacea.\textsuperscript{200} Transparency is a desirable
goal in the abstract. But it may inherently be at odds with the benefits of certain robotics
applications. We may be able to find out \textit{what} an AI system did. But, increasingly, we may not be
able to understand \textit{why} it did what it did.\textsuperscript{201} Calls for transparency are useful to the extent that
they identify bad behavior, defective designs, or rogue algorithms. But mostly what people want
when they talk about transparency is an explanation they can understand. \textit{Why} was my loan
application denied? \textit{Why} did the car swerve in the way it did? For some robots, we simply won’t
know the answer. Even if we see how the algorithm comes to a conclusion, we won’t necessarily
be able to understand how it derived a relationship between, say, butterfly populations in
Mongolia and thunderstorms in Ethiopia, or why it thinks the precise time of day and year should
affect the speed at which it proceeds through an intersection.\textsuperscript{202}

Are we right to be bothered by this? Should we have a right to understand the \textit{mens rea}
of robots? Or to impute explanations so we can appropriately channel opprobrium? Our punitive
and deterrence remedies are based on identifying and weeding out bad behavior. The search for

\textsuperscript{200} See, e.g., Frank Pasquale, \textit{The Black Box Society: The Secret Algorithms That Control Money and Information.} (Cambridge, MA: Harvard University Press 2015); Katyal, \textit{supra note} __.

\textsuperscript{201} See Deven R. Desai & Joshua A. Kroll, \textit{Trust But Verify: A Guide to Algorithms and the Law,} 31 Harv. J. L. & Tech. 1 (2016) (arguing that the push for transparency is misguided because it misunderstands the
nature of the algorithms at stake).

\textsuperscript{202} We made these examples up. The real ones are likely to be even weirder. The whole point is that they
are inexplicable to humans. Even today, AI is making decisions humans struggle to understand. Dave
Some companies are studying the decisions of their own AIs to try to unpack how they are made. See
that bad behavior is much of what drives the “intuitive appeal of explainable machines.” But our intuitions may not always serve us well. The question is whether the demand for an explanation is actually serving legitimate purposes (Preventing Skynet? Stopping discrimination?) or just making us feel that we’re the ones in charge. The punitive and equitable monetary side of remedies law wants to understand the “why” question because we want to assign blame. But that might not be a meaningful question when applied to a robot. More on this later.

3. Inhuman, All Too Inhuman

a. Punishing Robots for Responding to Punishment

Even economic forms of deterrence—both legal and extralegal—will look different than they currently do when people or corporations are being deterred. Deterrence of people often takes advantage of cognitive biases and risk aversion. People don’t want to go to jail, for instance, so they will avoid conduct that might lead to that result. But robots can be deterred only to the extent that their algorithms are modified to include external sanctions as part of the risk-reward calculus. Once more, we might view this as a good thing—the ultimate triumph of a rational law and economics calculus of decision making. But humans who interact with robots may

204 See infra note ___ and accompanying text.
205 See Peter M. Asaro, Punishment, Reinforcement Learning, and Machine Agency, http://peterasaro.org/writing/cosmopolis.globalist.it%20%20Punishment,%20Reinforcement%20Learning%20&%20Machine%20Agency.htm (“a key intuitive difference between humans . . . and machines is that when a human misbehaves, you punish it, whereas when a machine does, you fix it. On our present theory, however, it becomes clear that punishing and fixing are essentially the same: punishing is a clumsy, external way of modifying the utility function.”).
demand a non-economic form of moral justice even from entities that lack the human capacity to understand the wrongfulness of their actions (a fact that anyone who has ever hit a malfunctioning device in frustration can understand).\textsuperscript{206}

Indeed, the sheer rationality of robot decision making may itself provoke the ire of humans. Any economist will tell you that the optimal number of deaths from many socially beneficial activities is more than zero. Were it otherwise, our cars would never go more than five miles an hour. Indeed, we would rarely leave our homes at all.

Effective deterrence of robots requires that we calculate the costs of harm caused by the robots interacting with the world. If we want a robot to take optimal care, we need it to figure out not just how likely a particular harm is but how it should weight the occurrence of that harm. The social cost of running over a child in a crosswalk is high. But it isn’t infinite.\textsuperscript{207}

Even today, we deal with those costs in remedies law unevenly. The effective statistical price of a human life in court decisions is all over the map.\textsuperscript{208} The calculation is generally done ad hoc and after the fact. That allows us to avoid explicitly discussing politically fraught concepts


\textsuperscript{208} “Global variation in estimates of the value of life range from $70,000 to $16.3 million.” See Deborah L. Rhode et al., \textit{Legal Ethics} 645 (U. Casebook Series, 7th ed. 2016) (citing Eric A. Posner & Cass R. Sunstein, \textit{Dollars and Death}, 72 U. CHI. L. REV. 537 (2005); Binyamin Appelbaum, \textit{As U.S. Agencies Put More Value on a Life, Businesses Fret}, N.Y. TIMES (Feb. 17, 2011)). “In the United States, federal agencies operate with figures generally ranging from roughly $6 to $9 million—but tort awards for wrongful death are typically a fraction of that, and even agency estimates tend to shift with the political winds.” See Rhode et al., \textit{supra} note ___ at 645.
that can lead to accusations of “trading lives for cash.” And it may work acceptably for humans, because we have instinctive reactions against injuring others that make deterrence less important. But, in many instances, robots will need to quantify the value we put on a life if they are to modify their behavior at all. Accordingly, the companies that make robots will have to figure out how much they value human life, and they will have to write it down in the algorithm for all to see (at least after extensive discovery).

The problem is that people strongly resist the idea of actually making this calculus explicit. They oppose the seemingly callous idea of putting a monetary value on a human life, and juries punish companies that make explicit the very cost-benefit calculations that economists want them to. Human instincts in this direction help explain why we punish intentional conduct more harshly than negligent conduct. A deliberate decision to run over a pedestrian strikes us as worse than hitting one by accident because you weren’t paying attention. Our assumption is that, if you acted deliberately, you could have chosen not to cause the harm, thereby making you a bad actor who needs to modify your behavior. But that assumption often operates even when causing that harm was the socially responsible thing to do, or at least was justified from cost-benefit perspective.

Things are more complicated, of course. We do try to create justifications and excuses in the law, even for intentional conduct that we think is socially acceptable. But juries often have a

visceral desire to hold someone responsible when bad things happen. And they are inclined to treat killing or injuring a human being as a bad act even if it was (statistically) inevitable. They will rebel against treating it as a mere cost of doing business. Thinking about it in such terms offends many people’s sense of human decency.

b. **Punishment as Catharsis: Punching Robots**

Punishment may serve other, non-monetary purposes as well. We punish, for instance, to channel social opprobrium. That can set norms by sending a message about the sorts of things we won’t tolerate as a society. And it may also make us feel better. We have victim allocation in court for good reason, after all. It may provide useful information to courts. But it also helps people to grieve and to feel their story has been heard.

Our instinct to punish is likely to extend to robots. We may want, as Christina Mulligan puts it, to punch a robot that has done us wrong.212 Certainly people punch or smash inanimate objects all the time.213 Juries might similarly want to punish a robot, not to create optimal cost internalization but because it makes the jury and the victim feel better. It’s already quite easy to think of robots as humans.214 We naturally anthropomorphize.215 That instinct is likely to get stronger over time, as companies increasingly deploy “social robots” that intentionally pull on

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212 See Mulligan, *supra* note __.
213 See *supra* note ___ and accompanying text.
215 See Calo, *Robotics and the Lessons of Cyberlaw supra* note ___ at 538 (terming this phenomenon “social valence”).
Humans will expect human-like robots to act, well, human. And we may be surprised, even angry, when they don’t. Our instinct may increasingly be to punish humanoid robots as we would a person—even if, from an economic perspective, it’s silly. Making us feel better may be an end unto itself. But hopefully there is a way to do it that doesn’t involve wanton destruction of or damage to robots.

D. Ordering Robots to Behave

All these problems with monetary remedies as deterrents seem to point in the direction of using injunctive relief more with robots than we currently do with people. Rather than trying to encourage robot designers to build in correctly priced algorithms to induce efficient care, wouldn’t it be easier just to tell the robot what to do—and what not to do?

1. Be Careful What You Wish For

First, the good news: injunctions against robots might be simpler than against people or corporations, because they can be enforced with code. A court can order a robot, say, not to take race into account in a processing an algorithm. Likewise, it can order a self-driving car not to exceed the speed limit. Someone will have to translate that injunction, written in legalese, into code the robot can understand. But once they do, the robot will obey the injunction. This virtual

216 Like Asimov’s fiction, Westworld’s days as pure fantasy may be numbered.

217 It’s an open question whether we will react differently to a self-learning AI that isn’t in corporeal form and doesn’t act in human-like ways.

guarantee of compliance seems like a significant advantage over existing injunctions. It is often much harder to coerce people (and especially groups of people in corporations) to comply with similar court orders—even when the consequences are dire.

But, once again, not so fast. As the adage goes (and as legions of genies in bottles have taught us): be careful what you wish for. Automatic, unthinking compliance with an injunction is a good idea only if we’re quite confident that the injunction itself is a good idea. Now, obviously the court thinks the injunction improves the world. Otherwise, it wouldn’t issue it. But the fact that injunctions against people aren’t self-enforcing offers some potential breathing room for parties and courts to add a dose of common sense when circumstances change. This is a common problem in law. It’s a major reason we have standards rather than rules in many cases.219 And it’s the reason that even when we do have rules, we don’t enforce them perfectly. To a person (and even to a police officer), “don’t exceed the speed limit” implicitly means “don’t exceed the speed limit unless you’re rushing someone to the emergency room or it would be unsafe not to.” “Don’t cross the double yellow line” implicitly means “don’t cross the double yellow line unless you need to swerve out of the lane to avoid running over a kid.” No cop is going to ticket you for such a maneuver. Similarly, even if an injunction says “don’t cut lumber on this property,” a court isn’t going to hold you in contempt for taking down the one rotten tree that’s about to fall on your neighbor’s house. That’s because people understand that rules and injunctions come with the implied catchall “unless you have sufficient justification for departing from the rule” exception.

219 See supra note ___ - ___ and accompanying text.
Try telling that to a robot, though. Machines, unlike at least some humans, lack common sense. They operate according to their instructions—no more, no less. If you mean “don’t cross the double yellow line unless you need to swerve out of the lane to avoid running over a kid” you need to say that. Meanwhile, Av should probably avoid adults too, so better put that in the algorithm. . . . And maybe dogs. . . . And deer and squirrels, too. Or maybe not: crossing into oncoming traffic is dangerous, so while we might do it to avoid hitting a kid even if it raises the risk of a head-on collision we shouldn’t do it to avoid a squirrel unless the risk of a head-on collision seems low. (Sorry, squirrels). If you want the self-driving car to do all that, you need to tell it exactly when to swerve and when not to swerve. That’s hard. It’s more plausible to give each outcome weights—killing squirrels is bad, but head-on collisions are much worse, and killing a kid is (Probably? Maybe?) worse still. But then we’re back to deterrence and cost internalization, not injunctions.

Further, even if we can specify the outcome we want with sufficient precision in an injunction, we need to be extremely careful about the permissible means a robot can use to achieve that result. Think back to our example from the introduction. The drone did exactly what we told it to. The problem is that we weren’t sufficiently clear in communicating what we wanted it to do. We wanted it to head to the center of the circle without shutting down and without human intervention. But we didn’t say that, because we didn’t anticipate the possibility of the drone doing what it did. ²²

²² Former Secretary of Defense Donald Rumsfeld famously described these types of foreseeability concerns:

There are known knowns. These are things that we know we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. There are things we don’t know we don’t know. And if one looks
The “be careful what you wish for” problem is a major one for robotics and AI. Tim Urban of Wait But Why tells the hypothetical story of Turry, a self-learning AI that is designed to mimic handwritten greeting cards. If you don’t specify the things it can’t do, or at least impose cost weights, an AI could literally take over all the resources of the world and devote them to producing handwritten greeting cards. Computer programmers will, we hope, be aware of this problem and be extremely careful about phrasing their instructions to a robot in just the right way, with precise caveats and limiting conditions to prevent them turning into Skynet or Turry. But judges aren’t computer programmers, and they are unlikely to be as knowledgeable or as careful in what they order robots to do or not do. And even if we could do it, an injunction of this sort represents a pretty significant intrusion into the product design process, something courts have been unwilling to do in other circumstances. Whether or not courts are right to shy away throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones.


222 This is a variation on Eliezer Yudkowsky’s and Nick Bostrom’s famous “paper clip maximizer” thought experiment.

223 Search King, Inc. v. Google Technology, Inc., No. CIV-02-1457-M, 2003 WL 21464568, at *4 (W.D. Okla. May 27, 2003) (ruling that Google’s page rankings were “subjective result[s]” that constituted “constitutionally protected opinions . . . entitled to full constitutional protection”); Langdon v. Google, Inc., 474 F. Supp. 2d 622, 629–30 (D. Del. 2007) (refusing to affirmatively order Google and Microsoft to rank certain search results prominently); United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001) (applying balancing test to judge whether new product is predatory); United States v. Microsoft Corp., 147 F.3d 935 (D.C. Cir. 1998) (deferring to a company’s claims of product improvement to avoid emmeshing the court in design decisions); Allied Orthopedic Appliances, Inc. v. Tyco Health Care Grp., 592 F.3d 991, 998–99 (9th Cir. 2010) (permitting companies to introduce any product that constitutes “improvement” over predecessors).
from telling companies how to design products generally, we think that’s a good instinct when it comes to robotics, at least in the early stages of the industry.

To issue an effective injunction that causes a robot to do what we want it to do (and nothing else) requires both extreme foresight and extreme precision in drafting it. If injunctions are to work at all, courts will have to spend a lot more time thinking about exactly what they want to happen and all the possible circumstances that could arise. If past experience is any indication, they are unlikely to do very well at it. That’s not a knock on courts. Rather, the problem is twofold: Words are notoriously bad at conveying our intended meaning,\footnote{Dan Burk & Mark Lemley, \textit{Fence Posts or Sign Posts? Rethinking Patent Claim Construction}, 157 U. PENN. L. REV. 1743 (2009) (detailing the fraught history of “parties and courts [being] unable to agree on what particular patent claims mean” due to “plausible disagreements over the meanings of the words” in the claims) (citing, among other cases, Phillips v. AWH Corp., 415 F.3d 1303 (Fed. Cir. 2005) (en banc); N. Am. Vaccine, Inc. v. Am. Cyanamid Co., 7 F.3d 1571, 1581 (Fed. Cir. 1993); Kustom Signals, Inc. v. Applied Concepts, Inc., 264 F.3d 1326, 1331 (Fed. Cir. 2001); Chef Am., Inc. v. Lamb-Weston, Inc., 358 F.3d 1371, 1374 (Fed. Cir. 2004); Cybor Corp. v. FAS Techs., Inc., 138 F.3d 1448, 1459 (Fed. Cir. 1998) (en banc); Toro Co. v. White Consol. Indus., Inc., 199 F.3d 1295, 1300-02 (Fed. Cir. 1999); Sage Prods., Inc. v. Devon Indus., Inc., 126 F.3d 1420, 1430-31 (Fed. Cir. 1997)).} and people are notoriously bad at predicting the future.\footnote{These two facts combine to provide the plot line of virtually every Isaac Asimov novel. ISAAC ASIMOV, \textit{THE REST OF THE ROBOTS} 43 (1964) (remarking “[t]here was just enough ambiguity in the Three Laws [of robotics found in his works] to provide the conflicts and uncertainties required for new stories, and, to my great relief, it seemed always to be possible to think up a new angle out of the sixty-one words of the Three Laws”).} And if we fall into either of these traps, the consequences of drafting the injunction incompletely may be quite severe.

2. “What Do You Mean You Can’t?!”

Courts that nonetheless persist in ordering robots not to do something may run into a second, more surprising problem: it may not be simple or even possible to comply with the
injunction. Just as robots don’t have money, they also don’t read and implement court opinions. And they aren’t likely to be a party to the case in any event. Enjoining a robot, in other words, really means ordering someone else to implement code that changes the behavior of the robot.

The most likely party to face such an injunction is the owner of the robot. They are the ones who will likely have been determined to have violated the law, say by using a discriminatory algorithm in a police profiling decision or operating a self-driving car that has behaved unsafely. But most owners won’t have the technical ability, and perhaps not even the right, to modify the algorithm their robot runs. The most a court could order may be that they ask the vendor who supplied the robot to make the change, or perhaps to take the robot off the market as long as it doesn’t comply with the injunction.

Even if the developer is a party to the case, perhaps on a design defect theory, the self-learning nature of many modern robots makes simply changing the algorithm more complicated still. A court may, for instance, order the designer of a robot that makes predictions about recidivism for parole boards not to take race into account. But that assumes that the robot is


227 More on this below when we consider the robot death penalty. See infra notes __-__ and accompanying text.

228 Far from hypothetical, courts have considered these types of arguments on multiple occasions in recent years. See, e.g., State v. Loomis, 881 N.W.2d 749, 767 (Wis. 2016); Malenchik v. State, 928 N.E.2d 564 (Ind. 2010).
simply doing what it was originally programmed to do. That may be less and less common as machine learning proliferates. Ordering a robot to “unlearn” something it has learned through a learning algorithm is much less straightforward than ordering it to include or not include a particular function in its algorithm. Depending on how the robot learns it might not even be possible.

Life gets easier if the courts can control what training information is fed to robots in the first place. At the extremes, a court might order a company to take badly-trained robots out of service and to train new ones from scratch. But as the example in the introduction indicates, the effects of training material on robots are not always predictable. And the results of training are themselves unpredictable, so even controlling the training dataset is no guarantee that a robot, once trained, will behave as the court wants it to.

Further, the future may bring robots that are not only trained in complicated ways but that train themselves in ways we do not understand and cannot replicate. Ordering such a robot to produce or not produce a particular result, or even to consider or not consider a particular factor, may be futile. If we don’t understand how the robot makes decisions we can’t effectively guide those decisions. It is one thing to look at a transparent algorithm written by programmers and see whether it includes the race of the parolee as a factor. It is quite another to try to untangle whether a robot has learned that race matters by looking at the data and how that learning is implemented in an always-changing algorithm that doesn’t itself explicitly include race. An algorithm that is simply told to minimize the risk of recidivism but not to take race directly into account might end up generating proxies that are correlated with race instead. That’s fine if those proxies are in fact the variable of interest. If, say, the fact that members of a
minority group commit disproportionately more crimes results from the fact that they are poorer than average, an algorithm that gets to the same result by considering family poverty instead of race may solve the problem. But if the algorithm has really just found a proxy for race (say, the street you grew up on in a segregated neighborhood) we aren’t any better off. And it is much harder to tell a robot not to consider “race or anything that serves as a proxy for race.”

Courts are used to telling people to do something and having them do it. They may have little patience for the uncertainties of machine learning systems. And they are quite likely to have even less patience with lawyers who tell them their “client” can’t comply with the court’s order.

3. Unintended Consequences

Even when the injunction is simple and clearly identifies who should change the algorithm and how, ordering a robot to change how it “thinks” is likely to have unintended consequences. Consider two examples.

(1) We don’t want self-driving cars to hit pedestrians. But just brute-forcing that result might lead to other problems, from taking crowded freeways instead of less-crowded surface streets to running into other cars. Some of those consequences could be worse, either because a head-on collision kills more people than running over the pedestrian would or, more likely, because instructing the car to act in a certain way may cause it to avoid a very small chance of killing a pedestrian by avoiding surface streets altogether (even though the collective cost of traffic jams might be quite great). This is a version of the same problem we saw in damages: we

229 Whether we want to disproportionately punish poor people is another matter, of course, but doing so isn’t race discrimination.
need to assign a cost to various outcomes if we want an algorithm to weigh the alternatives. But here the injunction effectively sets the cost as infinite. That’s fine if there really is nothing to balance on the other side. But that will rarely be true.

(2) The case against algorithmic bias seems one of the strongest, and easiest to enjoin, cases. And if that bias results simply from a bad training set, it may be straightforward to fix. But if an algorithm takes account of a prohibited variable like race, gender, or religion because that variable matters in the data, simply prohibiting consideration of that relevant information can have unanticipated consequences. One possible consequence is that we make the algorithm worse at its job. We might be fine as a society with a certain amount of that in exchange for the moral clarity that comes with not risking discriminating against minorities. But where people are in fact different, insisting on treating them alike can itself be a form of discrimination. Being male, for example, is an extremely strong predictor of criminality. Men commit many more crimes than women, and male offenders are much more likely to reoffend. We suspect police and judges know this and take it into account, consciously or unconsciously, in their arrest, charging, and sentencing decisions, though they would never say so out loud. But a robot won’t conceal what it’s doing. A court that confronts such an robot is likely to order the it not to take gender into

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230 It is possible a company will simply factor the cost of contempt into the algorithm, but that seems unlikely. And if they do, courts will probably not be happy about it.

231 To the extent that the algorithms are transparent to third-parties, of course. Yet, even detecting bias within a system can be less straightforward than may initially appear. See Corbett-Davies et al., Algorithmic Decision Making and the Cost of Fairness, https://arxiv.org/pdf/1701.08230.pdf (pushing back on Julia Angwin’s claim that the COMPAS criminal sentencing algorithm was biased).

232 See supra notes ___ - ___ and accompanying text. See also, e.g., Reuters Staff, New Zealand Passport Robot Tells Applicant of Asian Descent to Open Eyes, REUTERS (Dec. 7, 2016) (reporting on facial recognition software failure that resulted from an evidently unrepresentative training set).
account, since doing so seems a rather obvious constitutional violation. But it turns out that if you order pretrial sentencing algorithms to ignore gender entirely, you end up discriminating against women, since they get lumped in with the heightened risks of recidivism that men pose.\footnote{See Matthew DeMichele et al, The Public Safety Assessment: A Re-Validation and Assessment of Predictive Utility and Differential Prediction by Race and Gender in Kentucky, ARNOLD FOUNDATION (2018), https://www.arnoldfoundation.org/wp-content/uploads/3-Predictive-Utility-Study.pdf,}

Ordering a robot not to violate the law can lead to additional legal difficulties when injunctions are directed against discrete subsystems within larger robotics systems. These types of injunctions seem likeliest to be granted against newly introduced subsystems within a tried and true application—given that older systems will, by definition, have a longer track record of success. Not only could targeting one component of a larger system change it in unpredictable and often undesirable ways, doing so could also discourage innovation. With the field of AI improving by leaps and bounds, maybe we should be less protective of tried-and-true approaches and more willing to experiment. Even though some of those experiments will fail, the overall arc is likely to bend towards better systems than we have now. But we won’t get there if courts are too quick to shut down new systems while leaving established but imperfect procedures in place. If the alternative to a flawed predictive policing algorithm is the gut instincts of a large number of cops, some of whom are overtly racist and others of whom are subconsciously biased, we might be better off with the robots after all.

III. Rethinking Remedies for Robots
We’ve seen that robots and AI pose a number of challenges to the law of remedies as it is currently applied. In this section, we offer some preliminary thoughts about how we might redesign the law for the world that is fast approaching. We don’t intend this to be the last word on how to design remedies for robots. Much more remains to be done. Rather, we hope it marks the beginning of a conversation on these issues. The suggestions we outline below will help align the law of remedies with what we know about the behavior of robots.

A. Compensation, Fault, and the Plaintiff’s “Rightful” Position

Compensation is the easiest remedy to translate to robots because its focus is on the (presumably human or corporate) plaintiff. The harm is to plaintiffs, not robots, and the same valuation measurement problems arise here that always do in calculating damages. But as we have seen, robot defendants do introduce some complications. Who is responsible when a robot misbehaves? The designer? The manufacturer? The owner? Under current tort law the answer may depend on whether the harm resulted from a design defect, a problem in training, or an

234 A different issue arises when the robot is itself the injured party. What would it mean to put a robot in its rightful position? What that likely means, at least until we recognize robot rights, is putting the robot’s owner or operator in its rightful position. While there are issues here, we think they are likely to be more straightforward than most of the ones we have discussed. If a robot is damaged or destroyed through negligence or vandalism, we will normally treat that as we would damage to any other property. It’s easy enough to replace parts for pre-programmed bots, but if the algorithms learned from unique, one-off interactions and cannot be recovered, robots might not be so easy to replace. Hopefully emergent AI will be backed up regularly, though, so it could still be replaced.

We can imagine deliberately unique robots, though. Technologies like block chain are now being used to impose scarcity (e.g. crypto kitties, digital cats you can raise and trade via the blockchain. Because cats. And blockchain). We could see this same phenomenon transposed to robot personalities, so as to artificially impose scarcity. Tay, for instance, was a unique chat bot deployed by Microsoft. Like too many people, when exposed to the Internet, Tay quickly became a fascist. See supra note __. When Microsoft shut her down, her “learning” was gone and could not be replaced. Few would lament that in this specific case, but we can imagine valuation difficulties if a tortious or malicious act destroys a unique AI personality.
error in operation. But learning AIs will blur this line; the designer might not be the one training
the AI in ways that caused it to subsequently do harm.

Many (though not all) of the problems with compensating plaintiffs for robot injury come
from tort law’s focus on fault as a prerequisite to responsibility. We generally hold people
responsible for accidental injuries only if they are negligent. The focus on fault may make sense
where people are concerned, but it is much less meaningful as applied to a robot. What does it
mean for a robot to be negligent? This isn’t really a remedies question, though it may be a
causation question. But it’s not obvious that it is a question worth asking. True, we might want
to single out certain design or implementation choices that we think are problematic and
discourage them. But in many environments in which robots operate there are more direct
regulatory means to do so. NHTSA, for instance, approves or mandates the introduction of many
vehicle safety technologies. So, too, does the FAA for aircraft. If we think a particular design
shouldn’t be on the market at all, some regulatory bodies will be able to simply prohibit it.

Tort law does, as noted above, also serve to raise the cost of products that cause harm
and therefore deter the deployment of inefficient ones. In theory, tort law makes that calculus
directly by setting \( B < P_L \) or demanding some other risk-utility test. But in doing so, the law
makes a threshold judgment as to whether there should be any liability for costs imposed on
others. An alternative formulation would require an actor to pay for any harm it causes, negligent
or not. That shifts the focus of deciding whether \( B \) is less than \( P_L \) to the company that makes the
product rather than to the courts.

Perhaps we just want someone to pay the costs of any harm robots cause, even if that occurred without a wrongful or illegal act. We often use negligence as a proxy for whether the defendant’s conduct was justified despite the costs it imposes, but that will be harder to do with robots. And maybe we don’t want to ask a jury to decide who was at fault if programmers can actually code in a standard of care that internalizes the harm the robot imposes on others.

Existing remedies laws might get us there, though not without modification. We do impose strict liability in some circumstances.\textsuperscript{236} That’s easier when the plaintiff is a passive victim like someone injured by pollution from a factory or from a product that unexpectedly exploded. It’s more problematic when both the plaintiff and the defendant might have contributed to the cause of the injury. When two cars collide, one reason we try to decide who was at fault (or whether both were in part) is to fairly allocate the cost of injury to the party who was best positioned to avoid it. Allocating that fault will raise new challenges when a robot-driven car gets into an accident because its driving capabilities and the sorts of evidence it can provide will be different than human drivers. We can’t cross-examine the robot to interrogate its state of mind. On the other hand, AVs are likely to record every aspect of the accident, giving us a better record than fallible human memory currently does. A second reason we focus on blame is that we need to worry that the parties might lie about what happened. But self-driving cars are likely to keep clear records and video that may make it easier to figure out what happened.\textsuperscript{237} And it may make

\textsuperscript{236} Albeit, not in the case of defective products.

\textsuperscript{237} See, e.g., Francesca M. Favaro, \textit{Examining Accident Reports Involving Autonomous Vehicles in California}, PLoS ONE. https://doi.org/10.1371/journal.pone.0184952 (reconstructing autonomous vehicle accidents through the data collected by onboard recording devices).
less sense to try to assess fault when two robotic cars collide, though we expect that will be a much rarer occurrence.238

Yet another reason we assess fault against people is that blame for wrongdoing can encourage more careful behavior. As we discussed in Part II, that isn’t likely to work, or at least to work in the same way, with robots. Without the element of moral culpability that underlies much remedies law, we might be better off looking to insurance schemes or no-fault liability regimes to internalize the costs robots impose rather than using existing legal rules in a fruitless quest to get robots to act morally. As robots and AI take on more responsibility in our society, the law should move away from efforts to assess blame and towards a system that internalizes the costs those machines impose on those around them. Doing so will make the problem of coding effective care easier. And it may increasingly mean tort cases involving robots don’t show up in the legal system at all, but in some sort of regulatory compensation system.239

That might incline us towards some sort of a no-fault system as self-driving cars and self-flying planes increasingly share space with their human-operated counterparts.240 While we


239 See, e.g., Kenneth Abraham & Robert Rabin, A New Legal Regime For a New Era (arguing for a no-fault accident compensation regime once autonomous vehicles have reached sufficient market penetration); Katherine Wallis, New Zealand’s 2005 ‘No-Fault’ Compensation Reforms and Medical Professional Accountability For Harm, 126 New Zealand Med. J. 33 (2013) (detailing New Zealand’s “taxpayer funded accident compensation scheme to provide compensation for medical injury”).

could assess the overall safety of an autonomous vehicle and—assuming it was safer than the human standard—deny liability altogether in crashes, 241 we think the determination of what AV behavior falls below the standard of care is likely to be hard for the foreseeable future. Adding in the metric of fault doesn’t make much sense, and depriving injured parties of any remedy might not make sense either. The simplest way to train AVs to avoid doing unnecessary harm is to make them responsible for the harm they cause whether or not they were “negligent.”

That doesn’t solve all problems with AVs, particularly when they interact with humans, because we still must decide when an AV “causes” an accident with a human driver. While occasional fatal crashes have dominated the headlines, most AV-human car accidents involve humans running into AVs, often because the AV did something legal and presumably safe but unexpected, like driving the speed limit or coming to a complete stop at an intersection. 242 While that may suggest that we want to program AVs to behave in a more predictable way, it’s hard to fault the AV for being rear-ended because it came to a complete stop at an intersection. Without the addition of a contributory negligence defense (which functions a lot like plain old B<PL from a fault perspective), innovators would end up disproportionately bearing costs, human drivers wouldn’t be priced off the roads as quickly as they should, and companies would also be apt to

241 For a suggestion along these lines, see Mark A. Geistfeld, A Roadmap for Autonomous Vehicles: State Tort Liability, Automobile Insurance, and Federal Safety Regulation, 105 CALIF. L. REV. 1611, 1612 (2017). Geistfeld would leave an exception for cars that were designed or manufactured defectively and for those that were hacked.

spend less on safety from a competitive perspective, since no amount of investment could get them off the liability hook when people, themselves, created the hazards.\textsuperscript{243}

Thus, while we think moral fault makes little sense in accidents involving AVs, and perhaps any consideration of blame is problematic when considering accidents between two AVs,\textsuperscript{244} we will still need to compare the behavior of humans and AVs in order to make sure that we give proper incentives to human drivers. Comparative negligence may still matter for robot drivers, therefore. But it is the idealized cost-internalization vision of negligence reflected in Learned Hand’s formula, not consciousness of fault or state of mind, that we should care about.

\textbf{B. Punishment, Deterrence, and the Human Id}

Deterrence, unlike compensation, is forward-looking. We want robots to internalize the costs of their actions even apart from compensation of particular victims. The good news is that cost internalization has the potential to work better with robots than it does with people.\textsuperscript{245} Robot algorithms may allow us to internalize costs further down the causal chain than tort law normally does, for example by accounting for the social cost of pollution or other nebulous injuries to society as a whole. But these must be priced, again requiring fraught social tradeoffs to be made explicit. And the pricing should be cost-based. We should minimize the

\textsuperscript{243} For a more detailed discussion of these issues, see Bryan Casey, working paper.

\textsuperscript{244} Even then we might want to assess liability against the AV that is using an outdated or less-safe algorithm, to encourage the development of better safety technology in AVs.

psychologically-driven aspects of deterrence (jail, disgorgement of ill-gotten gains) and replace them with more rational measures of cost.

Doing so is at odds with many of the mechanisms we have for deterrence, however. Often those mechanisms are directed at showing moral opprobrium or at punishing people in ways we expect them to react to psychologically. Christina Mulligan’s idea of punching robots who wrong us\textsuperscript{246} sounds silly, but there is a serious idea behind it. Much of our law of remedies, including our search for fault (but also the way in which we punish), is designed not to compensate plaintiffs or even to internalize costs for defendants but to make us feel better. This sometimes involves “sending a message,” but often the defendant isn’t the target of the message. Perhaps it is society as a whole; large punitive damage awards or harsh criminal penalties can signal the things we won’t tolerate as a society, and overly lenient sentences can do the opposite. That is a broader social conversation, albeit one usually carried out in the context of legal remedies.\textsuperscript{247} But often, remedies are purely cathartic: we want someone to blame to make ourselves feel better for the bad thing that happened to us. When there is no obvious candidate for blame, we go to considerable lengths to find one.\textsuperscript{248} Punishment in this sense is a form of psychological compensation—the very act of punishing the defendant is the compensation.

\textsuperscript{246} Mulligan, supra note ___ at ___.

\textsuperscript{247} The recent controversy that erupted over a Stanford University swimmer’s six-month sentence for sexual assault provides just one examples. See The judge Who Sentenced Brock Turner to Six Months in Stanford Rape Case is Fighting a Recall, ASS’D PRESS (May 18, 2018), http://www.latimes.com/local/lanow/la-me-persky-recall-20180518-story.html.

\textsuperscript{248} For instance, we have relaxed the rules of causation in remedies law in order to compensate indirect victims of large oil spills. Oil Pollution Act, 33 U.S.C. § 2701 (2006).
This seems socially wasteful. Punishing robots, not to make them behave better but just to punish them, is kind of like kicking a puppy that can’t understand why it’s being hurt. The same might be true of punishing people to make us feel better, but with robots the punishment is stripped of any pretense that it is sending a message to make the robot understand the wrongness of its actions.

We don’t deny that there is a real phenomenon at work here, or even that it may benefit the victim psychologically. But it might not make sense to serve those goals when suing robots. Is there a way to make us stop? To channel that instinct into other areas than the legal system where it might be more productive? Should we just abandon the signaling function of remedies altogether? Perhaps, but we probably won’t, human nature being what it is.

Rather, if we want to rationalize remedies for robots, we might need to take human decision makers (especially untrained ones like juries) out of the remedies equation in some cases (or at least closely constrain the remedies they can order and the reasons that justify those remedies). Juries are likely to have an instinct to punish bad behavior by robots. But punishment makes sense only if we think compensation for damages is inadequate and so defendants will take insufficient precautions or engage in socially harmful behavior we want them to stop. A robot that calculates the cost of its various decisions accurately will make bad

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249 One day, we may even want to go further by putting robots in charge of remedies decisions. See, e.g., Eugene Volokh, Chief Justice Robots, PULSE LUNCH TALK (JAN. 24, 2018), https://law.ucla.edu/news-and-events/4096/2018/1/24/pulse-lunch-talk-c--professor-eugene-volokh/ (discussing possibility of automating such legal decisions).

250 It might be, for various reasons. We cut off liability with proximate cause before we have traced all the harm from wrongful acts. See Pruitt v. Allied Chem. Corp., 523 F. Supp. 975 (E.D. Va. 1981) (denying relief for indirect injury from pollution); Lemley, Fruit of the Poisonous Tree, supra note __. We are bad at valuing pain and suffering and do so in idiosyncratic ways that will sometimes undercompensate plaintiffs. And we have imposed caps on liability in many circumstances that undercompensate for actual injuries.
decisions if we add in data on the likelihood of punitive damages that exceed those costs. And if the robot is being punished precisely because it is calculating how many people it’s ok to kill, the problem becomes recursive and we will undo the purpose of optimal deterrence and cost internalization.

C. Reeducating Robots

Injunctions, as we have seen, are both important and problematic remedies for robots. Can courts order a robot to do better—to change its programming? Perhaps we can require changes in design, or we might compel some sorts of modifications to learning algorithms.

Courts in general favor injunctions that preserve the status quo and prohibit parties from changing things (so-called prohibitory injunctions). They are traditionally more reluctant to order parties to do affirmative things to change the state of affairs (mandatory injunctions). It does happen, particularly in impact litigation after a final finding of liability. But courts tend to shy away from involving themselves in the details of running a business or designing a product if they can avoid it. With robots, though, there’s no avoiding it—whether the injunction is mandatory or prohibitory. An order for a robot to do something and an order for it to not do something both

See Michael Kang, Don’t Tell Juries About Statutory Damage Caps: The Merits of Nondisclosure, 66 U. Chi. L. Rev. 469 (1999) (noting “[i]t has become increasingly common for Congress and state legislatures to enact statutory limits on the amount of money damages that a plaintiff can recover in a jury trial). But if we are not compensating plaintiffs properly, the solution is to compensate them properly, not to add a damages multiplier to awards whether or not they are actually compensatory.

251 See supra notes ___-__ and accompanying text (discussing this problem).

252 See supra notes ___-__ and accompanying text (discussing this phenomenon in antitrust context).
require redesigning the product. Courts should take care when and how they grant those injunctions.

In light of this reality, what exactly will courts order robots to do? One likely compromise is not to order the code to be written in a specific way, but rather to order the company to find a way to achieve a specific result. As we saw in Part II, that by no means solves the problems with injunctions against robots. But it does offer some flexibility to the company that needs to rewrite their code, ideally without introducing other problems in the process.

One way to increase that flexibility is to give companies time to comply. Courts generally expect their orders to be obeyed quickly. But writing quick code often means writing bad code, particularly in an ever-changing, complex machine learning system. Courts and regulators should be patient. Self-driving cars go through years of testing before we are comfortable that they will drive safely. We shouldn’t just rewrite that code and put it on the streets without testing. So courts should delay implementation of their orders against robots to enable the defendant to develop and test a solution that doesn’t cause more problems than it solves. Regulators have so far shown admirable restraint in not rushing to mandate particular rules for AVs.253

Turning that results-oriented goal into an injunction runs into legal problems, though. Obviously we don’t want cars to run over kids, but a judge can’t simply order that. Court orders can’t just say “obey the law";254 they must give clear notice of what the defendant must do. So


254 FED. R. Civ. P. 65(b) (“Every order granting an injunction and every restraining order shall set forth the reasons for its issuance; shall be specific in terms; [and] shall describe in reasonable detail . . . the act or acts sought to be restrained.”); Burton v. City of Belle Glade, 178 F.3d 1175, 1201 (11th Cir. 1999) (rejecting
an injunction might say “stop the car if the likelihood that a pedestrian will imminently enter the intersection is greater than 0.2%.”

In some cases, orders might require robots to make their algorithms worse. An injunction preventing the police from taking gender into account in predicting criminality may make it harder to predict who will commit crimes. We might nonetheless want to order it, either to counteract existing bias reflected in the training data or simply because recognizing gender differences in criminality violates a constitutional norm even if the differences are real. But in doing so we are departing from the real world, ordering companies to train their robots to make decisions based on the society we would like to have rather than the one we do have.

One compensating advantage to robot injunctions is that the orders involve rewriting code, and in a connected world these changes can often be shipped out retroactively. Tesla updates the software periodically in cars it has already sold. Unlike traditional products, where an injunction is generally limited to the sale of products in the future, court orders against robots can affect existing robots already in the hands of consumers. That makes the injunction much

an injunction that simply forbade future discrimination); Hughey v. JMS Dev. Corp., 78 F.3d 1523 (11th Cir. 1996) (overturning injunction that forbade discharge of waste in violation of the Clean Water Act).

more effective, though it also may raise due process concerns on the part of owners not a party to the case whose robot suddenly behaves differently or stops working altogether.\textsuperscript{256}

D. The Robot Death Penalty?

One area of remedies that becomes easier when the defendant is a robot is criminal law. We worry about the consequences of depriving people of liberty even when they have done something wrong. We worry even more about depriving them of life. It is an adage that we put a heavy thumb on the scale in favor of innocence, allowing the guilty to go free before punishing the innocent.\textsuperscript{257} We require guilt to be proven beyond a reasonable doubt, and we have special protections before imposing the death penalty.\textsuperscript{258} Some states and most countries have in fact abolished the death penalty altogether.

But robots aren’t people, and we might worry less about robot liberty.\textsuperscript{259} True, robots will be entitled to due process, if for no other reason than that they are owned by people or companies that would lose valuable property if their robots disappeared. But one new and significant form of remedy becomes available against robots that isn’t available against people in most circumstances: the robot death penalty. If a robot is causing unjustified harm and we can’t

\textsuperscript{256} Cf. Hassell v. Bird, ___ Cal.4\textsuperscript{th} ___ (2018) (stressing that “the courts’ power to order people to do (or to refrain from doing) things is generally limited to the parties in the case”).


\textsuperscript{259} For a suggestion that robots can be held liable for crimes just as people can, see Gabriel Hallevy, \textit{Dangerous Robots—Artificial Intelligence vs. Human Intelligence}, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3121905.
stop it, either because we don’t understand how it works or because the harm is inextricably bound up with its programming, we might simply shut it down.260 Turning off malfunctioning robots is a simple and effective, if blunt, instrument to enforce an injunction. And removing the robot from commercial deployment may allow us to figure out what went wrong by engaging in the sorts of testing we couldn’t do without jeopardizing operational function.

_Should_ we shut down misbehaving robots? In some cases the answer is yes. Corporations do it all the time.261 And essentially any time you change the code you are changing the robot, replacing it with a new and (hopefully) improved one.

Whether courts can order a robot shut down over the objections of its owner is a slightly harder question, but the answer is still probably yes. Courts kill pets that repeatedly attack others and can order other types of machines shut down if they are unreasonably dangerous.262 If robot can be replaced by others with competing algorithms, we probably want to shut it down if it is operating below the standard of care. One way learning algorithms improve is through natural selection,263 and shutting down the bad ones is just a form of that process. But if an AI has developed unique attributes as a result of its own learning, we have the problem of dual-use

260 We distinguish this from the case where humans use robots to commit crimes. A human can use a drone to fire missiles, for instance, or to spy on people. See Amanda McAllister, _Stranger than Science Fiction: The Rise of A.I. Interrogation in the Dawn of Autonomous Robots and the Need for an Additional Protocol to the U.N. Convention Against Torture_, 101 MINN. L. REV. 2527 (2017). If the robot is the instrument of the crime but not its cause it is the human, not the robot, that should face criminal penalties.

261 See, e.g., Perez, _supra_ note __.

262 See Safia Hussain, _Attacking the Dog-Bite Epidemic: Why Breed Specific Legislation Won’t Solve the Dangerous Dog Dilemma_, 74 FORDHAM L. REV. 2847 (2006); see also _supra_ notes ___ - ___ and accompanying text.

263 These often go by the name “genetic algorithms.”
A self-learning AI may behave differently in both good and bad ways, and those differences may be related. The robot death penalty kills off the good as well as the bad. So we want to do it only if we think the harm the robot is causing is sufficiently great and the unique benefit of its approach sufficiently low that the cost of losing the benefit is worth it.

For this reason, the use of the robot death penalty should probably be rare. Shutting down a robot, especially a self-learning one, means shutting down an avenue of innovation. We should do that only if there is strong evidence that the AI does more harm than good and that there isn’t a less intrusive way to solve the problem. Just as courts should be reluctant to tell robots to change how they behave, they should be reluctant to turn the robots off altogether.

Further, the robot death penalty presents more serious due process issues with respect to the existing stock of robots in the hands of people other than the defendant. Courts generally can’t reach out and take away property in the hands of non-parties without due process, even if those products cause problems and even if the court can order the company to stop selling new copies of the product. But the malleability of software presents some grey areas here. It is OK to order a defendant to push out changes to the product, though it’s an easier case if the recipient has the choice of whether to accept those changes. The company can probably stop supporting

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the product remotely. But a software “upgrade” that is really just an effort to “brick” an existing product seems a reach too far.266

Finally, there is the possibility that the law will recognize robots as sentient entities with their own rights.267 That isn’t as far-fetched as it sounds. Corporations aren’t people either, but they get legal rights (in some instances more rights than people).268 Animals also have some rights, though fewer than humans or corporations.269 Charles Stross has called corporations the first AIs.270 Like AIs, corporations are created by people, designed to serve ends dictated by people, but over time come to serve their own purposes.271 It’s not impossible that in the future we will extend at least some legal rights to robots as well, particularly unique robots with learned

266 See, e.g., Universal City Studios Productions LLLP v. TickBox TV LLC, No. CV 17-7496-MWF (ASx) (C.D. Cal. Jan. 30, 2018). It appears that the court is poised to order a device maker to use its software update mechanism to remove functionality and content from users’ devices.


269 See Hussain, supra note __; Christopher Seips, Animal Law Evolution: Treating Pets as Persons in Tort and Custody Disputes 2010 U. ILL. L. REV. 1339 (2010). Animals have only limited standing to bring cases, but they sometimes can. See, e.g., Naruto v. Slater, 2018 WL 1902414 (9th Cir. April 23, 2018) (finding that a crested macaque alleged facts sufficient to establish Article III standing because it was the apparent author and owner of selfies it took and may have suffered legally cognizable harms); Cetacean Cmty. v. Bush, 386 F.3d 1169, 1175 (9th Cir. 2004) (stating that mere fact that plaintiffs were animals did not rule out possibility of standing). But the law also refuses to treat animals as anything other than property in many instances. See, e.g., Johnson v. Douglas, 723 N.Y.S.2d 627, 628 (Sup. Ct. 2001) (refusing to allow emotional distress damages because dog was considered personal property).


271 Id.
behavior. And one of those rights may well be the right not to be shut down without due process.272

E. What Robots Can Teach Us about Remedies for Humans

Robots present a number of challenges to courts imposing remedies on robotic and AI defendants. Working through those challenges is valuable and important in its own right. But doing so can also teach us some things about the law of remedies as it currently applies to people and corporations.

First, much of remedies, like much of law, is preoccupied with fault—identifying wrongdoers and treating them differently. There may be good reasons for that, both within the legal system and in society as a whole. But it works better in some types of cases than in others. Our preoccupation with blame motivates many remedies, particularly monetary equitable relief. It distorts damage awards, particularly when something really bad happens and there is not an obvious culprit. It also applies poorly to corporations, which don’t really have a unitary purpose in the way a person might.273 As importantly, it is also costly, requiring us to assess blame in traffic cases that could otherwise be resolved more easily if we didn’t have to evaluate witness credibility. A fault-based legal system doesn’t work particularly well in a world of robots. But perhaps the problem is bigger than that: it might not work well in a world of multinational

272 Cf. Asimov’s three laws of robotics, supra note __, which would allow any person to kill a robot for any reason. Isaac Asimov clearly never anticipated Reddit. Trying to implement the three laws of robotics would leave the world strewn with the carcasses of robots killed by griefers.

273 For an argument that current methods of punishing corporations are ineffective and that corporations should face organizational remedies—the equivalent of rewriting their “code”—see Mihailis E. Diamantis, How to Punish a Corporation (working paper 2018).
corporations either.\textsuperscript{274} We should look for opportunities to avoid deciding fault, particularly when human behavior is not the primary issue in a legal case.\textsuperscript{275}

A second lesson is the extent to which our legal remedies, while nominally about compensation, actually serve other purposes, particularly retribution. We described remedies law at the outset of the paper as being about “what you get when you win.” But decades of personal experience litigating cases\textsuperscript{276} have reinforced the important lesson that what plaintiffs want is quite often something the legal system isn’t prepared to give. They may want to be heard, they may want justice to be done, or they may want to send a message to the defendant or to others. Often what they want—closure, or for the wrong to be undone—is something the system not only can’t give them but that the process of a lawsuit actually makes worse. The disconnect between what plaintiffs want and what the law can give them skews remedies law in various ways. Some do no harm: awards of nominal damages or injunctions that vindicate a position while not really changing the status quo. But we often do the legal equivalent of punching robots—punishing people to make ourselves feel better, even as we frequently deny compensation for real injuries. It’s just that it’s easier to see when it’s a robot you’re punching.

\textsuperscript{274} We are by no means the first to have advanced this line of argument.

\textsuperscript{275} Shavell, \textit{supra} note __. This does not mean, however, that we don’t need laws. Some have suggested that we won’t need rules or standards in the future because we can just rely on machine judgment to decide what the right thing to do is in any specific situation. \textit{See} Anthony J. Casey & Anthony Niblett, \textit{The Death of Rules and Standards}, 92 \textit{Ind. L.J.} 1401 (2017). For the reasons we explained in Part I, we think that highly unlikely. Robots will cause all sorts of harm the legal system will want to remedy. \textit{Cf.} Dan L. Burk, \textit{Algorithmic Fair Use}, _ U. CHI. L. REV. _ (forthcoming 2018) (explaining why algorithms won’t effectively replace standards in many cases).

\textsuperscript{276} Lemley, not Casey.
A final lesson is that our legal system sweeps some hard problems under the rug. We don’t tell the world how much a human life is worth. We make judgments on that issue every day, but we do them haphazardly and indirectly, often while denying we are doing any such thing. We make compromises and bargains in the jury room, awarding damages that don’t reflect the actual injury the law is intended to redress but some other, perhaps impermissible consideration. And we make judgments about people and situations in and outside of court without articulating a reason for it, and often in circumstances where we either couldn’t articulate that decisionmaking process or where doing so would make it clear we were violating the law. We swerve our car on reflex or instinct, sometimes avoiding danger but sometimes making things worse. We don’t do that because of a rational cost-benefit calculus, but in a split-second judgment based on imperfect information. Police decide whether to stop a car, and judges whether to grant bail, based on experience, instinct, and bias as much as on cold, hard data.

Robots expose those hidden aspects of our legal system and our society. A robot can’t make an instinctive judgment about the value of a human life, or about the safety of swerving to avoid a squirrel, or about the likelihood of female convicts reoffending compared to their male counterparts. If robots have to make those decisions—and they will, just as people do—they will have to show their work. And showing that work will, at times, expose the tolerances and affordances our legal system currently ignores. That might be a good thing, ferreting out our

277 Aaron McKnight, Jury Nullification as a Tool to Balance the Demands of Law and Justice, 2013 BYU L. REV. 1103 (2014) (discussing this phenomenon with respect to jury nullification).
racism, unequal treatment, and sloppy economic thinking in the valuation of life and property. Or it might be a bad thing, particularly if we have to confront our failings but can’t actually do away with them. It’s probably both. But whatever one thinks about it, robots make explicit many decisions our legal system and our society have long decided not to think or talk about. For that, if nothing else, remedies for robots deserve serious attention.

IV. Conclusion

Robots and AI systems will do bad things. When they do, our legal system will step in to try to make things right. But how it does so matters. Our remedies rules, not surprisingly, aren’t written with robots in mind. Adapting those rules to deal with bad robots will require a nuanced understanding of how robots and AI work, but also some fundamental rethinking of what remedies we award and why. That rethinking, in turn, will expose some issues that affect people, not just robots. We need a law of remedies for robots. But in the final analysis, remedies for robots may also end up being remedies for all of us.
The Dos and Don’ts of Disclosure for Professionals in Business Cases: "Tell me now or pay me later!"
The Dos and Don’ts of Disclosure for Professionals in Business Cases
"Tell me now, or pay me later!"

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The Alix Protocol

Protocol for Engagement of Jay Alix & Associates and Affiliates

1. Retention Guidelines
   
   A. Jay Alix & Associates ("JA&A") is a firm that provides turnaround and crisis management services, financial advisory services, management consulting services, information systems services and claims management services. In some cases the firm provides these services as advisors to management, in other cases one or more of its staff serve as corporate officers and other of its staff fill positions as full time or part time temporary employees ("crisis manager"), and in still other cases the firm may serve as a claims administrator as an agent of the Bankruptcy Court. JA&A and its affiliates will not act in more than one of the following capacities in any single bankruptcy case: (i) crisis manager retained under Sec. 363, (ii) financial advisor retained under Sec. 327, (iii) claims agent/claims administrator appointed pursuant to 28 U.S.C. § 156(c) and any applicable local rules or (iv) investor/acquirer; and upon confirmation of a Plan may only continue to serve in a similar capacity. Further, once JA&A or one of its affiliates is retained under one of the foregoing categories it may not switch to a different retention capacity in the same case. However, with respect to subsequent investments by Questor this prohibition is subject to the time limitations set forth in IV.B below.
   
   B. Engagements involving the furnishing of interim executive officers whether prepetition or postpetition (hereinafter "crisis management" engagements) shall be provided through JA&A Services LLC ("JAS").

   C. JAS shall seek retention under section 363 of the Bankruptcy Code. The application of JAS shall disclose the individuals identified for executive officer positions as well as the names and proposed functions of any additional staff to be furnished by JAS. In the event the Debtor or JAS seeks to assume additional or different executive officer positions, or to modify materially the functions of the persons engaged, a motion to modify the retention shall be filed. It is often not possible for JAS to know the extent to which full time or

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1 Affiliates of JA&A presently are System Advisory Group (an organization that provides information services), JA&A Services LLC (an entity that provides temporary employees), Questor Management Company LLC, an organization that manages Questor Partners Fund, Questor Partners Fund II, and various Side-by-Side entities, which are limited partnerships that invest in underperforming and troubled companies, and ACT Two (an entity that owns and operates a private airplane). Future affiliates of JA&A, if any, will be subject to the limitations set forth herein.

2 "Executive officers" shall include but is not necessarily limited to Chief Executive Officer, President, Chief Operating Officer, Treasurer, Chief Financial Officer, Chief Restructuring Officer, Chief Information Officer, and any other officers having similar roles, power or authority, as well as any other officers provided for in the company's bylaws.
part time temporary employees will be required when beginning an engagement. In part this is because the extent of the tasks that need to be accomplished is not fully known and in part it is because JAS is not yet knowledgeable about the capability and depth of the client’s existing staff. Accordingly, JAS shall file with the Court with copies to the UST and all official committees a report of staffing on the engagement for the previous month. Such report shall include the names and functions filled of individuals assigned. All staffing shall be subject to review by the Court in the event an objection is filed.

D. Persons furnished by JAS for executive officer positions shall be retained in such positions upon the express approval thereof by an independent Board of Directors whose members are performing their duties and obligations as required under applicable law (“Board”), and will act under the direction, control and guidance of the Board and shall serve at the Board’s pleasure (i.e. may be removed by majority vote of the Board).

E. The application to retain JAS shall make all appropriate disclosures of any and all facts that may have a bearing on whether JAS, its affiliates, and/or the individuals working on the engagement have any conflict of interest or material adverse interest, including but not necessarily limited to the following:

1. Connection, relationship or affiliation with secured creditors, postpetition lenders, significant unsecured lenders, equity holders, current or former officers and directors, prospective buyers, or investors.

2. Involvement as a creditor, service provider or professional of any entity with which JA&A or any affiliate has an alliance agreement, marketing agreement, joint venture, referral arrangement or similar agreement.

3. Any prepetition role as officer, director, employee or consultant,3 but service as a pre-petition officer will not per se cause disqualification.

4. Any prepetition on involvement in voting on the decision to engage JA&A or JAS in the bankruptcy case, and/or any prepetition role carrying the authority to decide unilaterally to engage JA&A or JAS.

3 In no case shall any principal, employee or independent contractor of JA&A, JAS and affiliates serve as a director of any entity while JA&A, JAS or any affiliate is rendering services in a bankruptcy proceeding, and JA&A, JAS and their affiliates shall not seek to be retained in any capacity in a bankruptcy proceeding for an entity where any principal, employee or independent contractor of JA&A, JAS and affiliates serves or has previously served as a director of the entity or an affiliate thereof within two years prior to the petition date. During such two year period, neither JA&A, JAS or affiliates shall have provided any professional services to the entity nor shall any individuals associated with JA&A, JAS and affiliates have served as an Executive Officer.
5. Information regarding the size, membership and structure of the Board so as to enable the UST and other interested parties to determine that the Board is independent.

6. Whether the executive officers and other staff for the engagement are expected to be engaged on a full time or part time basis, and if part-time whether any simultaneous or prospective engagement exists that may be pertinent to the question of conflict or adverse interest.

7. The existence of any unpaid balances for prepetition services.

8. The existence of any asserted or threatened claims against JA&A, JAS or any person furnished by JA&A/JAS arising from any act or omission in the course of a prepetition engagement.

F. Disclosures shall be supplemented on a timely basis as needed throughout the engagement.

G. Where JA&A does not act as a crisis manager its retention will be sought as a financial advisor under section 327 of the Code or as a Court appointed claims representative.

II. Compensation

A. Compensation in crisis management engagements shall be paid to JAS.

B. The application to retain JAS shall disclose the compensation terms including hourly rates and the terms under which any success fee or back-end fee may be requested.

C. JAS shall file with the Court, and provide notice to the UST and all official committees, reports of compensation earned and expenses incurred on at least a quarterly basis. Such reports shall summarize the services provided, identify the compensation earned by each executive officer and staff employee provided, and itemize the expenses incurred. The notice shall provide a time period for objections. All compensation shall be subject to review by the Court in the event an objection is filed (i.e., a "negative notice" procedure).

D. Success fees or other back-end fees shall be approved by the Court at the conclusion of the case on a reasonableness standard and shall not be pre-approved under section 328(a). No success fee or back-end fee shall be sought upon conversion of the case, dismissal of the case for cause or appointment of a trustee.
III. Indemnification

A. Debtor is permitted to indemnify those persons serving as executive officers on the same terms as provided to the debtor's other officers and directors under the corporate bylaws and applicable state law, along with insurance coverage under the debtor's D&O policy.

B. There shall be no other indemnification of JA&A, JAS or affiliates.

IV. Subsequent Engagements

A. Pursuant to the "one hat" policy as stated above, after accepting an engagement in one capacity, JA&A and affiliates shall not accept another engagement for the same or affiliated debtors in another capacity.

B. For a period of three years after the conclusion of the engagement, Questor shall not make any investments in the debtor or reorganized debtor where JA&A, JAS or another affiliate has been engaged.

Rule 1.6: Confidentiality of Information

Client-Lawyer Relationship

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain 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 prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted 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;

(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;

(6) to comply with other law or a court order; or

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.
Rule 1.7: Conflict of Interest: Current Clients

Client-Lawyer Relationship

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent 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 responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

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;

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 or other proceeding before a tribunal; and

4. each affected client gives informed consent, confirmed in writing.
Rule 1.8: Current Clients: Specific Rules

Client-Lawyer Relationship

(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 in a manner 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 on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client 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 gives informed consent, except as permitted or required by these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.

(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 for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer 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 gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include 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 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 unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(i) 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 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.

(j) A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.
Rule 1.9: Duties to Former Clients

Client-Lawyer Relationship

(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 gives informed consent, confirmed in writing.

(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 gives informed consent, confirmed in writing.

(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:

   (1) use information relating to the representation to the disadvantage of the former client except as these Rules 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 these Rules would permit or require with respect to a client.
Rule 1.10: Imputation of Conflicts of Interest: General Rule

Client-Lawyer Relationship

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless

(1) the prohibition is based on a personal interest of the disqualified lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm; or

(2) the prohibition is based upon Rule 1.9(a) or (b) and arises out of the disqualified lawyer’s association with a prior firm, and

(i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom;

(ii) written notice is promptly given to any affected former client to enable the former client to ascertain compliance with the provisions of this Rule, which shall include a description of the screening procedures employed; a statement of the firm's and of the screened lawyer’s compliance with these Rules; a statement that review may be available before a tribunal; and an agreement by the firm to respond promptly to any written inquiries or objections by the former client about the screening procedures; and

(iii) certifications of compliance with these Rules and with the screening procedures are provided to the former client by the screened lawyer and by a partner of the firm, at reasonable intervals upon the former client's written request and upon termination of the screening procedures.

(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.

(d) The disqualification of lawyers associated in a firm with former or current government lawyers is governed by Rule 1.11.
Rule 1.11: Special Conflicts of Interest for Former & Current Government Officers & Employees

Client-Lawyer Relationship

(a) Except as law may otherwise expressly permit, a lawyer who has formerly served as a public officer or employee of the government:

(1) is subject to Rule 1.9(c); and

(2) shall not otherwise represent a client in connection with a matter in which the lawyer participated personally and substantially as a public officer or employee, unless the appropriate government agency gives its informed consent, confirmed in writing, to the representation.

(b) When a lawyer is disqualified from representation under paragraph (a), no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter unless:

(1) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and

(2) written notice is promptly given to the appropriate government agency to enable it to ascertain compliance with the provisions of this rule.

(c) Except as law may otherwise expressly permit, a lawyer having information that the lawyer knows is confidential government information about a person acquired when the lawyer was a public officer or employee, may not represent a private client whose interests are adverse to that person in a matter in which the information could be used to the material disadvantage of that person. As used in this Rule, the term "confidential government information" means information that has been obtained under governmental authority and which, at the time this Rule is applied, the government is prohibited by law from disclosing to the public or has a legal privilege not to disclose and which is not otherwise available to the public. A firm with which that lawyer is associated may undertake or continue representation in the matter only if the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom.

(d) Except as law may otherwise expressly permit, a lawyer currently serving as a public officer or employee:

(1) is subject to Rules 1.7 and 1.9; and

(2) shall not:

(i) participate in a matter in which the lawyer participated personally and substantially while in private practice or nongovernmental employment, unless the appropriate government agency gives its informed consent, confirmed in writing; or
(ii) negotiate for private employment with any person who is involved as a party or as lawyer for a party in a matter in which the lawyer is participating personally and substantially, except that a lawyer serving as a law clerk to a judge, other adjudicative officer or arbitrator may negotiate for private employment as permitted by Rule 1.12(b) and subject to the conditions stated in Rule 1.12(b).

(c) As used in this Rule, the term "matter" includes:

(1) any judicial or other proceeding, application, request for a ruling or other determination, contract, claim, controversy, investigation, charge, accusation, arrest or other particular matter involving a specific party or parties, and

(2) any other matter covered by the conflict of interest rules of the appropriate government agency.
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<th>Chapter 11</th>
</tr>
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<tbody>
<tr>
<td>WESTMORELAND COAL COMPANY, et al.</td>
<td>Case No. 18-35672 (DRJ)</td>
</tr>
<tr>
<td>Debtors.</td>
<td>(Jointly Administered)</td>
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**MCKINSEY RECOVERY & TRANSFORMATION SERVICES U.S., LLC'S EIGHTH STATUS REPORT IN ACCORDANCE WITH ORDER ON JOINT MOTION IN FURTHERANCE OF MEDIATION AGREEMENT [DKT. 1427]**

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1 Due to the large number of debtors in these chapter 11 cases, which are consolidated for procedural purposes only, a complete list of the debtors and the last four digits of their tax identification, registration, or like numbers is not provided herein. A complete list of such information may be obtained on the website of the proposed claim and noticing agent in these chapter 11 cases at www.onlinereclame.com/westmoreland. Westmoreland Coal Company's service address for the purposes of these chapter 11 cases is 9540 South Maroon Circle, Suite 300, Englewood, Colorado 80112.
EIGHTH STATUS REPORT

1. McKinsey Recovery & Transformation Services U.S., LLC ("RTS") submits this eighth status report in accordance with the procedures set forth in the joint motion filed on February 20, 2019 by RTS and Westmoreland Coal Company and certain of its debtor affiliates, Dkt. 1422 ("Motion"), and so-ordered by this Court on February 21, 2019, Dkt. 1427, at ¶¶ 1, 3.

2. RTS agreed to "report back to the Court within two weeks of the entry of the order contemplated by this motion" and to "file a status report every two weeks thereafter." See Mot. at ¶¶ 5(a) & 6.

3. On March 6, 2019, RTS filed its initial status report, naming D.J. (Jan) Baker as the expert that RTS planned to retain to work with it to develop a new disclosure protocol. See Dkt. 1586. Two weeks later, on March 20, 2019, RTS filed a second status report attaching Mr. Baker's consulting agreement. Dkt. 1626, Ex. A. On April 3, 2019, RTS filed a third status report informing the Court that it had retained Mr. Paul Singerman to serve as a "fresh eyes" expert to review the draft protocol. Dkt. 1686. RTS attached Mr. Singerman's consulting agreement to the Third Status Report. Id. at Ex. B. On April 17, 2019, RTS filed a fourth status report reporting that RTS anticipates filing a proposed final version of the disclosure protocol by the end of May and updated disclosures in accordance with that protocol by July 3, 2019. See Dkt. 1759, at ¶ 6. On May 1, May 15, and May 29, 2019, RTS filed a fifth, sixth, and seventh status report, in each case confirming these deadlines and describing the additional protocol drafting progress made by Mr. Baker and Mr. Singerman to date. See Dkt. 1803, at ¶¶ 4-5; Dkt. 1842, at ¶¶ 4-5; Dkt. 1894, at ¶¶ 4-6.
4. As noted in the Seventh Status Report, Mr. Baker and Mr. Singerman spent this week continuing to refine the protocol. Consistent with the deadline set out in RTS's previous status reports, the final protocol is attached to this status report as Exhibit A.

Dated: May 31, 2019  Houston, TX

Respectfully submitted,

By: /s/ Faith E. Gay  
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Attorneys for RTS
CERTIFICATE OF SERVICE

I hereby certify that on May 31, 2019, I caused the foregoing pleading to be filed with the Court and thereby served by the Court's CM/ECF noticing to all parties registered to receive electronic notice in this case.

/s/    Zack A. Clement
Exhibit A
HOUSTON DISCLOSURE PROTOCOL

Summary

The following Houston Disclosure Protocol addresses the complex legal and business issues surrounding the disclosure obligations arising from a Proposed Professional's retention under Section 327 in bankruptcy cases involving more than $50 million in claims. The Protocol addresses Proposed Professionals of varying types, including law, accounting, financial advisory, and investment banking firms, that seek compensation from a bankrupt estate. A Schedule of Defined Terms immediately follows this Summary, and capitalized terms used in this Summary and in the Protocol have the meanings ascribed to them there. This Summary outlines the Protocol's disclosure recommendations and the means or process to satisfy them.

The Protocol focuses on a Proposed Professional's disclosure regarding Connections to parties that could affect the Proposed Professional's "disinterestedness" and contemplates that the debtor will create and maintain an Interested Party List to facilitate identification of Connections (Exhibit "A" to the Protocol addresses the IPL). The Protocol recommends that a Proposed Professional obtain the data to support disclosure of Connections by procedures that include, as applicable, a computerized search of client databases, distribution of a questionnaire (a proposed form of which is provided in Exhibit "B" to the Protocol), and inquiry of the Proposed Professional's AMAs (if any), as discussed below. While recognizing that a Proposed Professional bears the burden of adequate disclosure in its retention application and an Estate Professional bears that burden in all appropriate supplemental disclosures, the Protocol provides that disclosure of Connections should be based on a Proposed Professional's actual knowledge of them, including from the results of a computer search and questionnaire process, as applicable.

The Protocol distinguishes Connections arising from the different kinds of the Proposed Professional's affiliates, including: (a) Retained Affiliates, which the Protocol classifies as generating Direct Connections of the Proposed Professional, and (b) Unretained Affiliates (including AMAs), which the Protocol classifies as generating Indirect Connections. As set forth in the Protocol, the disclosure of known Connections and the process to obtain knowledge of them should vary in accordance with the characteristics of each Proposed Professional and its AMAs and other Unretained Affiliates.

The Protocol classifies AMAs into 4 Types and recommends a process to obtain and disclose information regarding Connections that varies based on the extent to which the AMA: (i) is subject to Securities Registration, Regulatory Oversight, and/or Independent Personnel and Management; (ii) refrains from investing directly in Named Issuers; and (iii) accepts investment funds from third parties rather than Related Investors. The Protocol recommends that: (a) Proposed Professionals that qualify as Type 1 Financial Organizations or have Type 1 AMAs disclose only Direct Connections known to the Proposed Professional without review of the IPL by an AMA; (b) Proposed Professionals with Type 2, 3 or 4 AMAs should also disclose Direct Connections known to the Proposed Professional; (c) Proposed Professionals with Type 2 AMAs should also disclose the names of IPL Parties with Indirect Connections known to the Type 2 AMA as reported by the Type 2 AMA to the Proposed Professional; (d) Proposed Professionals

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1 This Protocol does not address retention applications filed by claims and noticing agents under 28 U.S.C. § 156.
with Types 3 and/or 4 AMAs should disclose Indirect Connections known to the AMA(s) and reported to the Proposed Professional, including direct investments in Named Issuers that are IPL Parties, and (e) Proposed Professionals with Type 4 AMAs should make such additional disclosures, if any, as may be appropriate in the circumstances.

The Protocol recognizes that disclosure of Connections may vary in response to, inter alia, the size of the bankruptcy case and should exclude de minimis matters. The de minimis concept is applicable to both the IPL and the disclosure of Connections in a Proposed Professional’s retention application. De minimis exclusions can be based, for example, on the small value of a claim, the small ownership percentage and value of an equity interest, or other, similar considerations. An IPL, and a Proposed Professional’s disclosure of Connections in its retention application, should state the criteria applied in making de minimis exclusions.
DEFINED TERMS

AMA means an affiliate or division of a Proposed Professional that is actively engaged in managing or owning financial investments. For clarity, AMA does not refer either to assets that might be held through investment vehicles or to such investment vehicles, e.g., mutual funds, but does refer to the entity managing such investment vehicles, i.e., a mutual fund manager.

CFTC means the Commodities Futures Trading Commission.

Connection means, in the context of Section 327 and Rule 2014, an association or relationship with an IPL Party that a reasonable person might find bears on whether the Proposed Professional “holds or represents an interest adverse to the estate” and is “disinterested” under Section 327 and Section 101(14), based on the facts of a particular bankruptcy case.

De minimis means a matter too distant in time, remote in probability, or insignificant to warrant consideration in the context of a particular bankruptcy case.

Direct Connection means a known Connection between a Proposed Professional and an IPL Party (other than an Indirect Connection).

Estate Professional means a Proposed Professional whose retention has been approved by the Bankruptcy Court.

FINRA means the Financial Industry Regulatory Authority.

Immediate Indirect Connection means a known Connection between an IPL Party and a Proposed Professional’s Unretained Affiliate (including an AMA).

Independent Personnel and Management means, with respect to an AMA of a Proposed Professional, the employment or engagement of management, professional and other personnel separate from those of such Proposed Professional, (e.g., excluding the Proposed Professional’s active employees from the AMA’s management, so that only independent directors/managers or professionals that are not active employees of (or that have retired from) the related Proposed Professional serve on the AMA’s board of directors (or other equivalent governing body)).

Indirect Connection means an Immediate Indirect Connection or a Remote Indirect Connection.

Information Barriers means policies and procedures of a referenced entity (including but not limited to policies and procedures adopted in compliance with Rule 10b5-1) that seek reasonably to ensure that (a) such entity’s investment decisions not violate the laws prohibiting trading on the basis of MNPI, and (b) Proposed Professional Personnel have no participation in or knowledge concerning investment decisions made by the Proposed Professional or its affiliates.

Interested Party List or IPL means a list of parties with Connections to the debtor’s estate (other than de minimis connections).

IPL Parties means the persons or parties listed on an IPL.
**MNPI** means material non-public information.

**Named Issuers** means an issuer of debt or equity securities (including a municipality), including parties that could become a debtor in a bankruptcy case.

**NFA** means the National Futures Association.

**Other Regulatory Oversight** means examination by any federal, state or foreign regulatory authority regarding compliance with regulatory requirements, other than Regulatory Oversight.

**Proposed Professional** means a professional person or entity proposed to be retained in connection with a pending bankruptcy case under Section 327. As used in this Protocol, the term “Proposed Professional” includes Retained Affiliates.

**Proposed Professional Personnel** means the primary working group within a Proposed Professional entity that directly provides the services for which the Proposed Professional is retained in the particular bankruptcy case, and excludes personnel that only episodically provide such services.

**Regulatory Oversight** means periodic regulatory examinations by the SEC, FINRA, or the NFA.

**Related Investors** means, with respect to a Proposed Professional, the Proposed Professional’s current and former ultimate beneficial owners, employees and their immediate family members.

**Remote Indirect Connection** means a known connection arising from a relationship between a Proposed Professional’s Unrelated Affiliate (including an AIA) and a third party, which third party, in turn, has a connection with an IEP Party.

**Retained Affiliates** means those affiliates of a Proposed Professional that employ professional personnel for whom the Proposed Professional will seek compensation pursuant to Section 330 of the Bankruptcy Code.

**Rule 10b5-1** means 17 C.F.R. 240.10b-5.


**SEC** means the United States Securities and Exchange Commission.


**Section 327** means 11 U.S.C. § 327.

**Securities Registration** means, with respect to a referenced entity, such entity’s registration (and attendant regulation) as an investment advisor by the SEC, as a securities broker/dealer by FINRA, or under the requirements of the CFTC.

Third-Party Managed Investments means investments (including through mutual funds and other investment vehicles) that are managed by third parties with delegated investment authority and discretion.

Type means one of the four (4) types of AMAs that are classified in this Protocol.

Type 1 AMA means an AMA that either:

A. (i) employs Information Barriers, (ii) is subject to both Securities Registration and Regulatory Oversight, and (iii) obtains most or all of its assets under management from third parties (i.e., parties other than Related Investors); or

B. qualifies under the criteria provided in subsections (A)(i) and (ii), above, but obtains most or all of its assets under management from Related Investors and not from third parties, and also insulates its personnel and management by means of Independent Personnel and Management.

Type 2 AMA means an AMA that: (i) qualifies under the criteria provided in subsections (A)(i) and (ii) in the definition of Type 1 AMA, above; (ii) obtains most or all of its assets under management from Related Investors and not from third parties; (iii) does not make direct investments in Named Issuers but only, if at all, holds investments in Named Issuers as Third-Party Managed Investments; and (iv) does not have Independent Personnel and Management.

Type 3 AMA means an AMA that: (i) employs Information Barriers; (ii) is subject to either: (A) Regulatory Oversight, or (B) Other Regulatory Oversight; (iii) obtains its assets under management from Related Investors or third parties; and (iv) may make direct investments in the debt or equity of Named Issuers, whether or not it also holds such investments as a result of Third-Party Managed Investments.

Type 4 AMA means an AMA not qualifying as a Type 1, Type 2 or Type 3 AMA.

Type 1 Financial Organization means a Proposed Professional, including an investment banking or similar institution (including a financial advisor affiliated with an investment bank), that has Information Barriers and other characteristics of and would therefore qualify as a Type 1 AMA. A Type 1 Financial Organization retains its classification as such even if it does not have assets under management. A Type 1 Financial Organization also retains its classification as such notwithstanding that it may include affiliates of other Types (e.g., Type 3 AMAs engaged in insurance activities, and Type 4 AMAs acting in various capacities in ownership and/or management of investment assets).

Unretained Affiliate means an affiliate of a Proposed Professional other than a Retained Affiliate.
Introduction

Rule 2014 requires disclosure of connections between a Proposed Professional and certain parties in interest in bankruptcy cases. None of Rule 2014, Section 327, or the decisional law construing any of them provides Proposed Professionals (and Estate Professionals) and in particular, those having an AMA, any clear guidance regarding adequate disclosure of their AMA’s connections with parties in interest in a bankruptcy case. This Protocol: (a) suggests definitions for a Connection requiring disclosure and categorizes such Connections; (b) classifies AMAs within four Types; (c) differentiates the disclosure of Connections recommended for the four Types of AMAs; (d) discusses knowledge of Connections and the means to obtain it; and (e) addresses confidentiality concerns and requirements for updating disclosure of Connections.

This Protocol does not endeavor to and could not effectively provide definitive guidance to all Proposed Professionals in all circumstances. Proposed Professionals range from sole practitioners or single office practices to complex international firms with thousands of professionals and multiple AMAs of various Types. Proposed Professionals may similarly be subject to a wide range of regulation, including self-regulatory rules and standards governing legal and accounting professionals, and Securities Registration and/or Regulatory Oversight to which financial advisory and investment banking firms may be subject. Proposed Professionals also are subject to a broad range of consequences for violation of the respective rules, regulations and laws that govern them, including license suspension or loss, enforcement under Securities Registration and/or Regulatory Oversight, and potential civil and criminal liabilities for misuse of MNPI. This Protocol therefore provides general guidance regarding how Proposed Professionals may obtain information and make proper disclosures to support their retention in U.S. bankruptcy cases that are within the scope of this Protocol, but this Protocol does not provide specific guidance for all Proposed Professionals, regardless of their type, size and structure, or in all bankruptcy cases, regardless of their size, scope, or operative facts. This Protocol recognizes that a Proposed Professional may deviate from its suggested data gathering procedures and disclosure recommendations based upon its particular facts and circumstances. No such deviation, per se, however, should support a contention that a Proposed Professional is not disinterested or that its retention should not be approved.

A Proposed Professional bears the burden of making appropriate disclosure of Connections in its initial retention application and an Estate Professional bears a continuing burden to supplement that disclosure as appropriate in the circumstances. This Protocol proposes a framework for disclosure of Connections by Proposed Professionals, Estate Professionals, and their affiliates in bankruptcy cases involving more than $50 million in liabilities.

Connection should be broadly defined to respect the term’s ordinary meaning and accomplish the important purposes of Rule 2014 and Section 327 to ensure that a Proposed Professional is a “disinterested person” as defined in Section 101(14). Section 327’s primary functions include: (a) allowing the estate to obtain and retain expertise to fulfill its essential functions; (b) requiring disclosure of matters that might affect Estate Professionals’ performance of their duty of loyalty; and (c) maintaining the integrity of the bankruptcy process and promoting the parties’ and the public’s confidence in that integrity. Section 327 requires that Proposed Professionals “not hold or represent an interest adverse to the estate” and are “disinterested persons.” Section 101(14)(c) requires that a disinterested person “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 for any other reason.” Rule 2014 disclosure is intended to provide the Bankruptcy Court and parties in interest in a bankruptcy case with information adequate to evaluate whether a Proposed Professional is a disinterested person and qualified to serve under Section 327.

The definition of Connection and Rule 2014’s related disclosure obligations should not impair an effective evaluation of disinterestedness by requiring disclosure of every possible connection, no matter how de minimis. Further, Rule 2014 disclosure should not impractically require disclosure of unknown information or ignore valid confidentiality concerns.

The formulation of this Protocol has been informed by the Survey. The Survey reflects that, in the absence of any definition of Connection and disclosure guidelines, Proposed Professionals have adopted widely disparate practices governing disclosure of Connections, even among similarly situated Proposed Professionals. This Protocol was further informed by the results of telephone interviews conducted with representatives of more than a dozen separate professional firms with significant Chapter 11 experience, who expressed their willingness to discuss (for themselves and not as an expression of their firm’s policies or procedures), in a candid, off-the-record context and not for attribution in the Protocol, disclosure issues arising from the retention application process. This Protocol provides guidance to Proposed Professionals regarding such disclosures.

1. Description of Connections

a. Requirement of Disclosure. Rule 2014 requires disclosure of the Connections of the “person to be employed,” and Section 101(14) refers to “direct or indirect relationships,” but neither Rule 2014 nor related decisional law addresses whether Indirect Connections (i.e., Connections created by affiliates of a Proposed Professional) must be disclosed.

b. Interested Parties and Interested Party List. In order to facilitate a Proposed Professional’s disclosure of Connections, the debtor, in consultation with its outside restructuring counsel, should prepare and make an Interested Party List (or IPL) available to all Proposed Professionals. If a Proposed Professional believes that the then-current IPL should be amended, such Proposed Professional should so advise the debtor’s counsel. If no IPL has been prepared when a Proposed Professional files its retention application, the retention application should disclose that fact and explain how the Proposed Professional identified Connections. Exhibit “A” to this Protocol includes an IPL template, as well as guidelines for a debtor’s consideration in preparing an IPL in light of the particular facts and circumstances of a bankruptcy case.

c. Retained Affiliates. A Proposed Professional should: (i) seek retention (and include the identity) of Retained Affiliates in its retention application; and (ii) ensure that its retention application discloses all known Connections (other than de minimis connections) among IPL Parties and such Retained Affiliates.

e. **De Minimis Exclusions.** Effective disclosure in large bankruptcy cases requires reasonable exclusion of *de minimis* connections and parties that should not qualify as IPL Parties (e.g., small creditor, vendor, customer exclusions, and investments falling below a threshold), as described on Exhibit “A.” Section 101(14)(c)’s reference to “material” supports excluding *de minimis* connections. For instance, a Proposed Professional may determine that an equity investment in an IPL Party of less than 1% of the outstanding equity or debt (with a value the Proposed Professional determines to be *de minimis*) need not be disclosed. Each IPL and each Proposed Professional’s retention application that excludes *de minimis* parties or connections should state the criteria, based on the facts and circumstances of the case (commonly, a dollar and/or percentage amount) applied to make such exclusions from disclosure.

f. **Disclosure under this Protocol.** Subject to *de minimis* exclusions as set forth herein, this Protocol recommends:

(i) A Proposed Professional (including Retained Affiliates) should disclose all known Direct Connections, and also disclose all Indirect Connections known to its Unretained Affiliates (including AMAs) and reported to it. Except as otherwise provided in this Protocol (including in Paragraph 8 regarding confidentiality), disclosed Connections should be identified by name and adequately described.

(ii) A Proposed Professional should obtain knowledge of Connections through its new matter intake process, by computer database searches, questionnaires and otherwise as described in this Protocol.

(iii) A Proposed Professional should disclose whether it has any AMAs, and if it does, it should describe such AMAs’ classification by Type as provided for in this Protocol, including (as applicable) such AMAs’; (A) Information Barriers; (B) Related Investors; (C) practices regarding direct investments in Named Issuers and/or through Third-Party Managed Investments; (D) Independent Personnel and Management; and (E) Regulatory Oversight and/or Other Regulatory Oversight.

(iv) A Proposed Professional that does not qualify as a Type 1 Financial Organization or have a Type 1 AMA, and does have one or more Type 2, 3 and/or 4 AMAs, should provide the IPL to such Type 2, 3 and/or 4 AMAs and request the AMAs to report Indirect Connections to the Proposed Professional as provided in this Protocol (including enhanced disclosure for Type 3 and 4 AMAs).

2. **Indirect Connections**

a. **Requirement of Disclosure.** Immediate Indirect Connections should be disclosed, as bearing upon whether the Proposed Professional “holds or represents an interest adverse to the debtor,” including Immediate Indirect Connections of: (i) Unretained Affiliates (as disclosed pursuant to an applicable questionnaire process), and (ii) Type 2, 3 and 4 AMAs (as disclosed in response to the distribution of the IPL), all as discussed below.

b. **Remote Indirect Connection.** The Survey reflects that Remote Indirect Connections are not generally disclosed, likely because Proposed Professionals have no knowledge of them. This Protocol recommends disclosure of a Remote Indirect Connection (other than a *de minimis* connection) only if the Proposed Professional has knowledge thereof. A
Proposed Professional’s retention application should disclose the potential existence of unknown Remote Indirect Connections with CPL Parties. A Proposed Professional is not required to conduct procedures other than those set forth in this Protocol to identify Remote Indirect Connections.

3. **Indirect Connections through Asset Management Affiliates**

   a. **AMA Disclosure.** When a Proposed Professional (including, without limitation, a law, accounting, financial advisory or investment banking firm) has an Unretained Affiliate that is an AMA, additional disclosure may be required to explain the AMA’s Connections and their impact, if any, on the Proposed Professional’s disinterestedness. That additional disclosure should also describe whether the AMA accepts funds from third parties or Related Investors, and whether the AMA makes direct investments in the debt or equity securities (i.e., buys or sells short, long, option or other positions) of Named Issuers or holds investments in Named Issuers through Third-Party Managed Investments, or both. Based on the Survey, many Proposed Professionals do not identify such AMAs individually by name, but rather identify them descriptively and generically. This Protocol does not intend to change that practice. The description of such AMAs should categorize them by reference to the applicable “Types” described below. Most Proposed Professionals (in common with most employers) maintain 401(k) programs and support various other pension and/or other retirement account programs for their employees’ benefit as Third-Party Managed Investments and without using an AMA; such arrangements do not trigger any requirement for analysis as an AMA under this Protocol.

   b. **Material Non-Public Information; Regulation and Oversight.** Proposed Professionals, Estate Professionals and their respective AMAs frequently possess MNPI and often implement Information Barriers to address this. These entities may also be subject to regulation and oversight, including Securities Registration and/or Regulatory Oversight.

   c. **AMA Classification.** This Protocol identifies four Types of AMAs (Types 1, 2, 3 and 4) and proposes corresponding disclosure requirements for each Type. If a Proposed Professional believes its AMA has characteristics of more than one Type, its retention application should discuss these characteristics and include disclosure applicable to the higher numbered Type (e.g., an AMA with characteristics of both a Type 3 and Type 4 AMA should make the disclosure required for a Type 4 AMA). If a Proposed Professional believes its AMA should be classified differently from these Types, its retention application should discuss this and include disclosure most appropriate to such AMA.

   d. **Change in AMA Type.** An AMA’s classification can change over time. For example: a Type 4 can qualify as a Type 3 by implementing Information Barriers and becoming subject to Regulatory Oversight or Other Regulatory Oversight; a Type 3 can qualify as a Type 2 by becoming subject to Securities Registration (and, if applicable, Regulatory Oversight rather than Other Regulatory Oversight) and holding investments in Named Issuers only as Third-Party Managed Investments; and a Type 2 can become a Type 1 by implementing Independent Personnel and Management. With respect to each bankruptcy case in which a Proposed Professional files a retention application, however, the Proposed Professional should classify its AMA(s) (as a Type 1, 2, 3 or 4) based on the AMA’s characteristics when the Proposed Professional files its initial retention application in such case, and this classification should remain in effect throughout the course of such case (i.e., the same classification should apply to
an Estate Professional’s updated retention application disclosures). Accordingly, the same AMA of a Proposed Professional may be classified differently in different bankruptcy cases, based on its characteristics at the time that the Proposed Professional files its initial retention application in the different bankruptcy cases.

4. **Disclosures Relating to Type 1 Financial Organizations and Type 1 AMAS**

a. **Present Type 1 Financial Organization and Type 1 AMA Disclosure.** The Survey indicates that a retention application for a Proposed Professional qualifying as a Type 1 Financial Organization or having an AMA that this Protocol categorizes as a Type 1 AMA commonly discloses only Direct Connections known to the Proposed Professional Personnel because its Information Barriers, Securities Registration and Regulatory Oversight fully protect MNPI, and insulate the Proposed Professional Personnel from any effects that MNPI could potentially create with respect to the Proposed Professional’s disinterestedness. Such Proposed Professional Personnel generally have no knowledge of (and therefore the Proposed Professional does not disclose) debt or equity investments in IPL Parties because of the effectiveness of the Information Barriers applicable to communication and misuse of MNPI and insulating Proposed Professional Personnel from participation in or knowledge of investment decisions.

b. **Proposed Type 1 Financial Organization and Type 1 AMA Disclosure.** This Protocol proposes that the disclosures of Connections in a retention application for a Proposed Professional qualifying as a Type 1 Financial Organization or having a Type 1 AMA may properly be limited to identifying the names (subject to confidentiality considerations) of Direct Connections (other than de minimis connections) known to such Proposed Professional in reliance on the presumed effectiveness of Information Barriers. Such named entities should ordinarily be described as “a current or former client, but with respect to matters unrelated to the Debtor,” absent facts or circumstances that require enhanced disclosure. Bankruptcy Courts have consistently approved retention applications based upon such disclosures.

5. **Disclosures relating to Type 2, 3 and 4 AMAs**

a. **Present Type 2, 3 and 4 AMA Disclosure.** The Survey indicates that retention applications for a Proposed Professional with an AMA that this Protocol categorizes as a Type 2, 3, or 4 AMA include increased disclosures because: (i) such a firm accepts most or all of its investments from Related Investors; (ii) a Type 3 AMA may be subject only to Other Regulatory Oversight (and may not be subject to any Securities Registration); (iii) a Type 4 AMA may not be subject to regulatory examinations or Securities Registration at all; and (iv) a Type 3 or 4 AMA may make direct investments in Named Issuers, rather than investing exclusively through Third-Party Managed Investments.

b. **Considerations for Type 2 AMA Disclosures.** A Proposed Professional with an AMA that this Protocol categorizes as a Type 2 AMA could credibly contend that its disclosure obligations in respect of its Type 2 AMA should be the same as the disclosure obligations in respect of Type 1 AMAs because its Type 2 AMA protects MNPI by means of the same Information Barriers enforced by the same Securities Registration and Regulatory Oversight as those that apply to Type 1 AMAs. In addition, a Type 2 AMA refrains from direct investments in Named Issuers, and a Type 1 AMA may make direct investments in Named Issuers. Nonetheless, this Protocol recommends increased disclosure by a Proposed Professional with a Type 2 AMA in order to advance the purposes of (i) protecting public confidence in the integrity
of the restructuring process, and (ii) ensuring an absence of self-dealing because a Type 2 AMA obtains most or all of its funds under management from Related Investors and may be managed and controlled by active professional personnel that also manage and control the related Proposed Professional (rather than utilizing independent Personnel and Management).

c. Proposed Type 2 AMA Disclosure. A retention application for a Proposed Professional (other than a Type 1 Financial Organization) with a Type 2 AMA should disclose known (i) Direct Connections of the Proposed Professional, and (ii) Immediate Indirect Connections of its Type 2 AMA, in each case other than de minimis connections. Disclosure of known Immediate Indirect Connections (other than de minimis connections) of a Type 2 AMA will consist of identifying the IPL Parties, if any, to which the Type 2 AMA has Immediate Indirect Connections, if and as reported by the Type 2 AMA to its related Proposed Professional. A Proposed Professional with a Type 2 AMA should provide the IPL to its Type 2 AMA, and request its Type 2 AMA to inform it of known Immediate Indirect Connections (other than de minimis connections) to IPL Parties for potential disclosure in the Proposed Professional's retention application pursuant to this Protocol, including Paragraph 6, below, regarding knowledge.

d. Proposed Type 3 AMA Disclosure. A retention application for a Proposed Professional (other than a Type 1 Financial Organization) with a Type 3 AMA should contain enhanced disclosure that reflects (i) such AMA’s Regulatory Oversight or Other Regulatory Oversight, as applicable; and (ii) the extent of any Securities Registration applicable to such AMA. Such retention application disclosure should also address how, if at all, these characteristics of its AMA could cause any potential impairment to the Proposed Professional’s perceived or actual disinterestedness. Because Type 3 AMAs may make direct investments in Named Issuers, the disclosures required from such a Proposed Professional with a Type 3 AMA should disclose known Indirect Connections (other than de minimis connections) between the Type 3 AMA and IPL Parties including those arising from any such direct investments in Named Issuers that appear in the IPL, in each case as reported by the Type 3 AMA to its related Proposed Professional.

e. Proposed Type 4 AMA Disclosure. A retention application for a Proposed Professional (other than a Type 1 Financial Organization) with a Type 4 AMA should contain enhanced disclosure that sets forth the Securities Registration, Regulatory Oversight and/or Other Regulatory Oversight (or lack thereof) applicable to the Proposed Professional. Such retention application disclosure should also address how, if at all, these characteristics of its AMA could cause any potential impairment to the Proposed Professional’s perceived or actual disinterestedness. If the applicable Type 4 AMA makes direct investments in Named Issuers, the disclosures required from such a Proposed Professional with such Type 4 AMA should disclose known Indirect Connections (other than de minimis connections) between the Type 4 AMA and IPL Parties, including those arising from any such direct investments in Named Issuers that appear in the IPL, in each case if and as reported by the Type 4 AMA to its related Proposed Professional. The disclosures required in a retention application of a Proposed Professional with a Type 4 AMA should be informed by the disclosure provided with respect to other categories of AMAs and supplemented as appropriate based on the facts and circumstances applicable to the particular AMA and bankruptcy case.
6. Disclosure Based on Actual Knowledge

The disclosure obligations of a Proposed Professional under this Protocol derive from the Proposed Professional's knowledge of Connections (other than de minimis connections), including the knowledge of Connections of a Proposed Professional's AMAs (if any) which the AMA may report to the Proposed Professional. In the case of Type 2, 3 and 4 AMAs with only Third-Party Managed Investments, disclosure of investments in Named Issuers included in the IPL Parties that such managers may make from time to time would be impractical because of, inter alia, the frequency of trading in such positions, and the AMA's limited knowledge thereof (if any). To be sure, Proposed Professionals cannot disclose unknown Connections, and this Protocol does not suggest that they do so. Instead, this Protocol provides procedures to obtain such knowledge. For purposes of this Protocol, a Proposed Professional’s knowledge of Connections means actual knowledge derived from its new matter intake process and the results of the Proposed Professional’s: (a) computer client database check (as described in Paragraph 7, below); (b) any applicable inquiry of its professional personnel (and Unrelated Affiliates other than AMAs) by a questionnaire process or otherwise (also as described in Paragraph 7, below); (c) review of the report it receives of its AMA’s (if applicable) check for conflicts and Connections (or any other applicable process); and (d) review of any other process for its Unrelated Affiliates (if any, and other than an AMA). All references to "knowledge" in this Protocol refer to actual knowledge. As discussed in Paragraph 7(e), below, if a Proposed Professional limits its retention application disclosure to the knowledge of Proposed Professional Personnel, that limitation should be disclosed in the retention application. A retention application of a Proposed Professional with knowledge of Direct Connections or Indirect Connections with IPL Parties (other than de minimis connections), should disclose all such Connections. In addition, if a Proposed Professional has knowledge of a Connection (other than a de minimis connection) with a person not included in the IPL, such Connection should be disclosed.

7. Determination of Whether a Connection Exists

Proposed Professionals should obtain knowledge of whether Connections exist generally by following the procedures discussed below, subject to adaptations to disclose particular circumstances affecting a particular Proposed Professional and bankruptcy case. Each retention application for a Proposed Professional should describe the process and procedures utilized to obtain knowledge of Connections.

a. Interested Party List. Subject to Paragraph 6 of this Protocol regarding knowledge, Proposed Professionals can reasonably and in good faith rely on the list of IPL Parties, consistent with the description and template attached as Exhibit “A,” prepared (and periodically updated, with information derived from the debtor’s bankruptcy schedules and otherwise, as described in Exhibit “A” and in Paragraph 10, below) by the debtor.

b. Process to Check for Conflicts and Connections. Every Proposed Professional should perform (in connection with its other new matter intake procedures) a process to check such Proposed Professional’s client databases for conflicts and Connections with IPL Parties. A Proposed Professional should utilize a process designed to identify Connections adequately in the context of the size and organizational complexity of the Proposed Professional. For entities
with a significant number of professionals, this process often utilizes computer software. For Proposed Professionals with a large number of professionals, this Protocol recommends deployment of adequate software within a reasonable time. Pending such deployment, a Proposed Professional may retain an independent third party to assess the adequacy of the alternative procedures the Proposed Professional uses to identify and appropriately disclose Connections.

A Proposed Professional (other than a Type 1 Financial Organization or a Proposed Professional with Type 1 AMAs) should distribute the IPL to its Type 2, 3 and 4 AMAs, request them to report any Connections (other than de minimis connections) to the Proposed Professional, and disclose in its retention application all Connections so reported. In addition, a Proposed Professional should distribute the IPL to its Proposed Professional Personnel, request them to report any Connections (other than de minimis connections) to the Proposed Professional, and disclose in its retention application all Connections so reported.

c. Questionnaires. A Proposed Professional should disclose in its retention application the results from written inquiries of the Proposed Professional’s professional personnel (as distinguished from staff, support or administrative personnel), and (to the extent, if any, appropriate) Unrelated Affiliates (if any) controlled by the Proposed Professional regarding: (i) their known equity or debt investments in the debtor (e.g., excluding Third-Party Managed Investments); and (ii) other connections or relationships with the debtor (other than the Proposed Professional’s proposed engagement), the Bankruptcy Court judges, or United States Trustee personnel. Exhibit “B” to this Protocol presents a sample questionnaire. Particularly for Proposed Professionals organized in complex global structures, Exhibit “B” may require substantial modification, or a different (or even no) approach to seeking this information from certain of its professional employees and affiliates may be appropriate.

d. AMA’s Report. A Proposed Professional should set forth in its retention application the results reported to the Proposed Professional from its AMA’s (if applicable) search with respect to IPL Parties (including any alternative processes or rationale for omission thereof).

e. Type 1 Financial Organizations and Type 1 AMAs. As discussed above, Type 1 Financial Organizations and Type 1 AMAs are subject to Information Barriers that not only protect against misuse of MNPI but also insulate Proposed Professional Personnel from participation in or knowledge concerning investment decisions. Accordingly, it may be appropriate for such Proposed Professionals to obtain knowledge of Connections from their new matter intake procedures and computer client database reviews and base their disclosures on the knowledge of their Proposed Professional Personnel derived therefrom, without using questionnaires (other than directed to its Proposed Professional Personnel) or other procedures.

8. Confidentiality Considerations

If a Connection (or the identity of an IPL Party) that should be disclosed under this Protocol is subject to confidentiality considerations and the Proposed Professional seeks not to disclose the Connection or the name of the IPL Party, the following steps should be taken:

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1 Law firms generally use proprietary software licensed from vendors, while financial advisory firms more typically develop such software themselves or through third-party consultants.
a. **Description in IFL.** The Connection (or IPL Party) should be described (but not identified) in sufficient detail to permit informed decisions concerning the Proposed Professional’s “disinterestedness” (as defined in Section 101(14));

b. **Identity Filed Under Seal.** The party seeking to preserve confidentiality with respect to IPL Parties or Connections may file a motion for leave to file the identity of the confidential party under seal under Rule 9018, Federal Rules of Bankruptcy Procedure, on notice to the Office of the U.S. Trustee, the Debtor, any official committee, the holders of the 20 largest claims against the Debtor, any party that has requested notice pursuant to Rule 2002, Federal Rules of Bankruptcy Procedure, any applicable local rule, and all other parties entitled to notice of motions of this type under orders of the Bankruptcy Court in the Debtor’s bankruptcy case. If the Bankruptcy Court enters an order granting such relief, in whole or in part, the party obtaining such relief should proceed in accordance therewith; and

c. **Access to Sealed Information.** Subject to the provisions of any particular Bankruptcy Court’s sealing order, any party in interest, including the United States Trustee, may ask the Bankruptcy Court for permission to review (or for their counsel to review) the sealed information, and the party seeking access to the information bears the burden of proof regarding such request. The Bankruptcy Court order granting such access may protect the information’s continuing confidentiality. See, e.g., Order Authorizing Evcore Group, LLC To File Under Seal Certain Confidential Information Related to Evcore’s Retention Application, In re: Jones Energy, Inc., et al., Case No. 19-32112 (Bankr. S. D. Tex.), ECF No. 210.

9. **Look-back Period and Diligence**

a. **Time Period.** A Proposed Professional should disclose Connections during the three years preceding the commencement of the bankruptcy case unless the circumstances reasonably warrant a longer period. For example, if a Proposed Professional represented a party in interest in a leveraged buy-out of the debtor eight years before the petition date, the Connection should be disclosed. Conversely, if a Proposed Professional represented a creditor of the debtor in a matter unrelated to the debtor four years before the petition date, no disclosure of that connection should be required.

b. **Additional Processes.** A Proposed Professional (and AMAs and other Unretained Affiliates) may, but should not be required to, conduct a process or procedure to identify Connections in addition to those set forth in this Protocol.

10. **Updates**

A Proposed Professional, once retained, has ongoing disclosure obligations. The Debtor has the continuing obligation to update the IPL. This Protocol recommends that a Debtor update, file and serve the IPL in a manner that clearly identifies changes thereto from prior versions no less frequently than every 90 days, including in connection with the filing of the Debtor’s schedules and statements, the passage of the claims bar date, the commencement of adversary proceedings, and filings under Bankruptcy Rule 2019 or by prospective purchasers of the Debtor’s assets. Estate Professionals should supplement their Rule 2014 disclosures, to the extent necessary as a result of updated IPLs and other developments in the bankruptcy case, including by reason of newly discovered or inadvertently omitted Connections. Without limiting Estate Professionals’ obligations relating to prompt disclosure of known Connections, Estate
Professionals may maintain continuing compliance with their supplemental disclosure obligations under Rule 2014 by updating their disclosures in accordance with this Protocol within a reasonable time after the debtor's filing of updated IPLs, to the extent required as a result thereof.
EXHIBIT A TO HOUSTON DISCLOSURE PROTOCOL

3 Defined terms used and not otherwise defined in this Exhibit have the meanings ascribed to them in the Protocol.

Exhibit A - 1
GUIDELINES AND TEMPLATE FOR INTERESTED PARTY LIST

"Interested Parties List" or "IPL" means a list of people and entities, grouped into categories of their Connections, identified by name, and prepared to assist Proposed Professionals in complying with disclosure obligations under Rule 2014. The debtor, with the assistance of its outside restructuring counsel, should compile the initial IPL as part of due diligence leading up to the bankruptcy filing. An IPL categorizes each IPL Party in accordance with the nature of the Connection it has with the debtor, parties associated with the debtor (e.g., current directors, executive officers and debt and equity holders), and other IPL Parties (e.g., vendors, customers, contract, lease and litigation counterparties). Proposed Professionals rely on the IPL to provide the names of parties to review for possible Connections. In bankruptcy cases involving issuers of public debt or equity securities, it may be most efficient to construct the IPL using commercially available databases that offer exact legal names of entities and their affiliates.

An IPL may be both broader and narrower than the persons or entities the debtor lists in schedules and statements of financial affairs. An IPL (and updates to it as provided for in the Protocol) should include, without limitation, members of official committees, proposed purchasers of the debtor’s assets, and other Estate Professionals, none of which may appear in the debtor’s schedules and statements. An IPL may exclude de minimis potential IPL Parties that the debtor’s schedules and statements will include. Particularly in larger cases, the debtor’s schedules and statements may not be available before a Proposed Professional files its retention application. Accordingly, an IPL that the debtor makes available may form the best source of this information available to a Proposed Professional filing its retention application early in the bankruptcy case.

As set forth in the Protocol, a debtor should change and update the IPL during the course of a bankruptcy case, at intervals no less than 90 days, to reflect changing facts and circumstances in the case, including new developments, as well as to cure inadvertent omissions. Updates should reflect, among other things, the matters, events and circumstances addressed in the template provided below.

Exhibit A - 2
EXHIBIT “A”

IPL TEMPLATE

In its initial compilation of the IPL, the debtor should consider including the following categories of parties with Connections, as applicable:

- Debtor(s)
- Debtor affiliates and subsidiaries
- Current and former officers and directors (within the last 3 years)
- Affiliates of current and former officers and directors
- Significant equity holders (more than 5%)
- Prepetition lenders / noteholders
- Prepetition Indenture trustees / agents
- Initial DIP lenders
- U.S. Bankruptcy Court Judges serving in the District (as updated, only the Bankruptcy Judge presiding over the bankruptcy case will remain an IPL Party)
- U.S. District Court Judges for the applicable district
- U.S. Trustee (for the applicable region) and Staff Attorneys and Trial Attorneys in the District in which the case is filed
- Top 50 unsecured creditors
- Identified bankruptcy professionals
- Ordinary course professionals
- Contract counter-parties (other than de minimis)
- Vendors / suppliers (other than de minimis)
- Customers (other than de minimis)
- Competitors (other than de minimis)
- Landlords and lease counter-parties (other than de minimis)
- Licensees and licensors (including under intellectual property rights) (other than de minimis)
- Utility companies (other than de minimis)
- Litigation counter-parties (other than de minimis)
- Regulatory agencies / governmental bodies
- Taxing authorities (other than de minimis)
- Labor unions
- Depository banks (other than de minimis)
- L/C issuers
- Lien claimants
- Insurance providers and agents
- Surety bonds and surety providers
- Other IPL Parties significant to the bankruptcy case, and not included above.

The parameters for excluding de minimis parties from the IPL depend on the facts and circumstances of each particular bankruptcy case. In each category appropriate for de minimis exclusions, the debtor should consider a practical de minimis limitation so that category will contain only IPL Parties that bear on a Proposed Professional’s disinterestedness. The IPL should
disclose the dollar amount, percentage amount or other criteria (e.g., limiting equity holders to thresholds based on value and percentage interest) chosen for de minimis exclusions in each applicable category.

Updates

As set forth in the Protocol, the IPL is a dynamic document, and a debtor should change and update the IPL during the course of a bankruptcy case. The debtor should update the IPL no less frequently than every 90 days to reflect changing facts and circumstances, new developments, and information learned during the bankruptcy case, as well as to cure inadvertent omissions. After the filing of the bankruptcy case, the IPL should be updated to include additional IPL Parties identified in:

- The debtor's schedules and statements (including any amendments)
- Proofs of Claim
- Notices of appearance
- Adversary proceedings and other motions or applications
- Filings by prospective purchasers of debtor's assets, plan proponents and under Bankruptcy Rule 2019
- Appointments of official committees and retention of Estate Professionals
EXHIBIT B TO HOUSTON-DISCLOSURE PROTOCOL.

Exhibit B - 1
Exhibit B
Form of Questionnaire

Urgent Request for Information

THIS IS AN URGENT REQUEST FOR INFORMATION THAT REQUIRES YOUR IMMEDIATE ATTENTION AND RESPONSE IF YOU HAVE ANY INFORMATION TO REPORT OR MATTERS TO DISCLOSE. YOUR FAILURE TIMELY TO RESPOND WILL CONSTITUTE YOUR AFFIRMATION THAT YOU HAVE NO INFORMATION TO REPORT OR MATTERS TO DISCLOSE. IF YOU WOULD SELECT OPTION #1 TO EACH OF THE THREE QUESTIONS BELOW, YOU NEED NOT RESPOND TO THIS QUESTIONNAIRE. THANK YOU IN ADVANCE FOR YOUR PROMPT ASSISTANCE.

(Name of Proposed Professional) represents (or is applying for Bankruptcy Court authorization to represent) (name of entity) and its affiliates listed below (collectively, the “Debtors”) or (the Official Committee of Unsecured Creditors) (or other applicable official committee or party; as the case may be, the “Client”)) in their (recently filed) (contemplated) chapter 11 bankruptcy cases in the United States Bankruptcy Court for the __________ District of __________.

As an advisor to the Client, there are several types of disclosures that we must make in order for the Bankruptcy Court to approve retention of our firm. Most of the information required to be disclosed can be obtained from the databases and conflicts records our firm maintains. That process is underway. A limited amount of information, however, may most efficiently be obtained directly from professionals employed by our firm and affiliates of our firm who receive this Questionnaire (collectively, the “Questionnaire Recipients”). This request relates to the second type of material listed above, which is why you are being contacted. The specific disclosures that we are required to make are listed below.

First, we must disclose to the Bankruptcy Court presiding over the Debtors' cases any holdings by the Questionnaire Recipients in either the debt or equity securities of the Debtors (e.g., excluding any investments, whether held through mutual funds or other investment vehicles, that are managed by third parties with delegated investment authority and discretion; “Third-Party Managed Investments”), as well as the existence of any other claims against the Debtors held by any Questionnaire Recipient.

Second, we must disclose to the Bankruptcy Court whether any Questionnaire Recipient has any connections to the United State Trustee or any person employed in the Office of the United States Trustee for the __________ District of __________.

Third, we must disclose to the Bankruptcy Court whether any Questionnaire Recipient has any connections to any of the Bankruptcy Judges for the __________ District of __________.

Please respond to this email no later than __________ at noon EST.

Exhibit B - 2
1. **Debt-or Equity Securities, or Other Claims Against the Debtors.**

Please indicate by replying to this email whether you, on or after [90 days prior to the date of this questionnaire] have owned or held a beneficial interest in any debt or equity securities (other than Third Party Managed Investments) of, or claims against, any of the Debtors. **To reply, review the options listed below and (electronically check the appropriate box). (select the appropriate button at the top of this message).**

Option #1 -- I have not held and do not hold debt or equity securities of, or other claims against, any of the Debtors.

Option #2 -- I have held but no longer hold debt or equity securities (other than Third-Party Managed Investments) of, or other claims against, any of the Debtors.

Option #3 -- I currently hold debt or equity securities (other than Third-Party Managed Investments) of, or other claims against, one or more of the Debtors. (If selecting this option, please describe in your reply the type of debt or equity securities that you hold, the name of the issuer, and/or the nature of any claim that you may hold or assert. To do this, select "Edit the response before sending" option to enter your comments.)

2. **Connections to the United States Trustee or any Person Employed by the Office of the United States Trustee for the [Insert District].**

The names of the United States Trustee and employees in the office of the United States Trustee for the [Insert District] are listed below.


To reply, review the options listed below and (electronically check the appropriate box) or (select the appropriate button at the top of this message).

Option #1 - I have no connections to the United States Trustee or to anyone employed in the office of the United States Trustee for the [Insert District]

Option #2 - I have the following connections to the United States Trustee or to someone employed in the office of the United States Trustee for the [Insert District]. (If selecting this option, please describe in your reply the connections that you have to the United States Trustee or to anyone employed in the office of the United States Trustee.)

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Exhibit B - 3
Trustee for the __________ District of __________. To do this, select "Edit the response before sending" option to enter your comments.

3. Connections to any Bankruptcy Judges in the __________ District of __________. The names of the Bankruptcy Judges in the __________ District of __________ are listed below.

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

To reply, review the options listed below and (electronically check the appropriate box) or (select the appropriate button at the top of this message).

Option #1 - I have no connections to any of the Bankruptcy Judges for the __________ District of __________.

Option #2 - I have the following connections to a Bankruptcy Judge for the __________ District of __________ (If selecting this option, please describe in your reply the connections that you have to a Bankruptcy Judge for the __________ District of __________. To do this, select "Edit the response before sending" to enter your comments).

(Insert "Edit Response Before Sending" option at appropriate point to facilitate electronic response)

If you have any questions concerning this urgent request for information, please call (______________) at ( ) ____-_____.

THANK YOU VERY MUCH FOR YOUR PROMPT ATTENTION TO THIS MATTER

List of [___] Debtors:

(Each Debtor entity)
118TH CONGRESS
1ST SESSION

H. R. 683

To impose requirements on the payment of compensation to professional persons employed in voluntary cases commenced under title III of the Puerto Rico Oversight, Management and Economic Stability Act (commonly known as “PROMESA”).

IN THE HOUSE OF REPRESENTATIVES

JANUARY 17, 2019

Ms. Velázquez (for herself, Miss González-Colón of Puerto Rico, Mr. Cuellar, Mr. Bishop of Utah, and Mr. Brooks) introduced the following bill; which was referred to the Committees on the Judiciary.

A BILL

To impose requirements on the payment of compensation to professional persons employed in voluntary cases commenced under title III of the Puerto Rico Oversight, Management and Economic Stability Act (commonly known as “PROMESA”).

1 Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

3 SECTION 1. SHORT TITLE.

4 This Act may be cited as the “Puerto Rico Recovery Accuracy in Disclosures Act of 2019” or “(PRRADA)”.

Page 672 of 1015
SEC. 2. DISCLOSURE BY PROFESSIONAL PERSONS EMPLOYED BY COURT ORDER.

(a) REQUIRED DISCLOSURE.—In a voluntary case commenced under section 304 of the Puerto Rico Oversight Management and Economic Stability Act (commonly known as "PROMESA"; 48 U.S.C. 2164), no attorneys, accountants, appraisers, auctioneers, agents, consultants, or other professional persons shall be compensated under section 316 of PROMESA (48 U.S.C. 2176) unless prior to making a request for compensation, such a professional person has submitted a verified statement conforming to the disclosure requirements of rule 2014(a) of the Federal Rules of Bankruptcy Procedure setting forth the professional person's connections with the debtor, creditors, any other parties in interest, their respective attorneys and accountants, the Oversight Board, and any person employed by the Oversight Board. Such statement shall include information on the identity of each entity or person with whom such professional person has a connection. Such professional person shall be required—

(1) to supplement such verified statement as additional relevant information becomes known to such person; and

(2) to file annually a notice confirming the accuracy of such statement.
(b) REVIEW.—The United States Trustee shall re-
view each verified statement submitted pursuant to sub-
section (a) and may file with the court comments on such
verified statements before the professionals filing such
statements seek compensation under section 316 of
PROMESA (48 U.S.C. 2176). The United States Trustee
may also object to compensation applications filed under
section 316 of PROMESA (48 U.S.C. 2176) that fail to
satisfy the requirements of subsection (d) of this Act.
Each person having standing under section 1109 of title
11 of the United States Code shall also have standing
under this section. The district court shall have jurisdic-
tion to adjudicate all matters arising under this section.

(e) RETROACTIVITY.—If, at the time subsection (a)
is enacted, the court has entered orders approving com-
pensation under cases commenced under section 304 of
PROMESA (48 U.S.C. 2164) each professional person
previously awarded compensation shall file a verified state-
ment in accordance with subsection (a) not later than 30
days after such person’s first request for compensation
under section 316 of PROMESA (48 U.S.C. 2176) occur-
ing after the date of the enactment of this Act, except
that the court may not delay any proceeding in connection
with a case commenced under section 304 of PROMESA
(d) LIMITATION ON COMPENSATION.—In a voluntary case commenced under section 304 of PROMESA (48 U.S.C. 2164), in connection with the review and approval of professional compensation under section 316 of PROMESA (48 U.S.C. 2176), the court may deny allowance of compensation for services and reimbursement of expenses, accruing after the date of the enactment of this Act of a professional person if such professional person—

(1) has failed to file statements of connections required by subsection (a) or has filed inadequate statements of connections;

(2) is at any time during such professional person's employment in such case not a disinterested person as defined in section 101(14) of title 11 of the United States Code; or

(3) represents, or holds an interest adverse to, the interest of the estate with respect to the matter on which such professional person is employed, except that the qualification standards for committee professionals shall be those set forth in section 1103(b) of title 11 of the United States Code.
S. 1675

116TH CONGRESS
1ST SESSION

To impose requirements on the payment of compensation to professional persons employed in voluntary cases commenced under title III of PROMESA.

IN THE SENATE OF THE UNITED STATES

MAY 23 (legislative day, MAY 22), 2019

Mr. MENENDEZ (for himself, Mr. RUBIO, Mr. BLUMENTHAL, and Mr. KENNEDY) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources.

A BILL

To impose requirements on the payment of compensation to professional persons employed in voluntary cases commenced under title III of PROMESA.

1 Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

2 SECTION 1. SHORT TITLE.

3 This Act may be cited as the “Puerto Rico Recovery Accuracy in Disclosures Act of 2019” or “PRRADA”.

4 SEC. 2. DISCLOSURE BY PROFESSIONAL PERSONS SEEKING APPROVAL OF COMPENSATION UNDER SECTION 316 OR 317 OF PROMESA.

5 (a) REQUIRED DISCLOSURE—
(1) IN GENERAL.—In a voluntary case commenced under section 304 of PROMESA (48 U.S.C. 2164), no attorney, accountant, appraiser, auctioneer, agent, consultant, or other professional person may be compensated under section 316 or 317 of that Act (48 U.S.C. 2176, 2177) unless prior to making a request for compensation, the professional person has submitted a verified statement conforming to the disclosure requirements of rule 2014(a) of the Federal Rules of Bankruptcy Procedure setting forth the connection of the professional person with—

(A) the debtor;

(B) any creditor;

(C) any other party in interest, including any attorney or accountant;

(D) the Financial Oversight and Management Board established in accordance with section 101 of PROMESA (48 U.S.C. 2121); and

(E) any person employed by the Oversight Board described in subparagraph (D).

(2) OTHER REQUIREMENTS.—A professional person that submits a statement under paragraph (1) shall—
(A) supplement the statement with any additional relevant information that becomes known to the person; and

(B) file annually a notice confirming the accuracy of the statement.

(b) REVIEW.—

(1) IN GENERAL.—The United States Trustee shall review each verified statement submitted pursuant to subsection (a) and may file with the court comments on such verified statements before the professionals filing such statements seek compensation under section 316 or 317 of PROMESA (48 U.S.C. 2176, 2177).

(2) OBJECTION.—The United States Trustee may object to compensation applications filed under section 316 or 317 of PROMESA (48 U.S.C. 2176, 2177) that fail to satisfy the requirements of subsection (a).

(3) RIGHT TO BE HEARD.—Each person described in section 1109 of title 11, United States Code, may appear and be heard on any issue in a case under this section.

(c) JURISDICTION.—The district courts of the United States shall have jurisdiction of all cases under this section.
(d) RETROACTIVITY.—

(1) IN GENERAL.—If a court has entered an order approving compensation under a case commenced under section 304 of PROMESA (48 U.S.C. 2164), each professional person subject to the order shall file a verified statement in accordance with subsection (a) not later than 30 days after the date of enactment of this Act.

(2) NO DELAY.—A court may not delay any proceeding in connection with a case commenced under section 304 of PROMESA (48 U.S.C. 2164) pending the filing of a verified statement under paragraph (1).

(e) LIMITATION ON COMPENSATION.—

(1) IN GENERAL.—In a voluntary case commenced under section 304 of PROMESA (48 U.S.C. 2164), in connection with the review and approval of professional compensation under section 316 or 317 of PROMESA (48 U.S.C. 2176, 2177), the court may deny allowance of compensation for services and reimbursement of expenses, accruing after the date of the enactment of this Act of a professional person if the professional person—
(A) has failed to file statements of connections required by subsection (a) or has filed inadequate statements of connections;

(B) except as provided in paragraph (3), is on or after the date of enactment of this Act not a disinterested person, as defined in section 101 of title 11, United States Code; or

(C) except as provided in paragraph (3), represents, or holds an interest adverse to, the interest of the estate with respect to the matter on which such professional person is employed.

(2) CONSIDERATIONS.—In making a determination under paragraph (1), the court may take into consideration whether the services and expenses are in the best interests of creditors and the estate.

(3) COMMITTEE PROFESSIONAL STANDARDS.—An attorney or accountant described in section 1103(b) of title 11, United States Code, shall be deemed to have violated paragraph (1) if the attorney or accountant violates section 1103(b) of title 11, United States Code.
Avoiding Potential Ethical Traps in Unbundling, Factoring, and Other Fee Arrangements in Consumer Cases
Avoiding Potential Ethical Traps in Unbundling, Factoring, and Other Fee Arrangements in Consumer Cases

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1. What is Included in the “No-Look” Fee?

   a. Total “no-look” fee is generally deemed to cover ancillary and routine tasks and advice to the debtor throughout the course of the case.

   i. Required services included in no-look fee may be listed in an applicable local rule or general order. *E.g.* District of Arizona, General Order 106 (listing “Minimum Required Services”; District of Colorado General Procedure Order Number 2013-2, Exhibit A, Basic Services Anticipated In Chapter 13 Cases).

   ii. *In re Cahill*, 428 F.3d 536 (5th Cir. 2005) (approving use of “precalculated lodestar,” which “aids bankruptcy courts in disposing of run-of-the-mill Chapter 13 fee applications expeditiously and uniformly, obviating the need for bankruptcy courts to make the same findings of fact regarding reasonable attorney time expenditures and rates in typical cases for each fee application that they review.”);

   iii. *In re Snyder*, 445 B.R. 431 (Bankr. E.D. Pa. 2010) (chapter 13 fee agreement construed against debtor’s attorney where ambiguous as to ancillary matters excluded from flat fee; fees reduced from requested $11,700 to $3,500);

   iv. *In re Wesseldine*, 434 B.R. 3, 40 (Bankr. N.D.N.Y. 2010) (lien avoidance motion included in “no-look” chapter 13 flat fee under local rule, precluding separate fee claim; “Attorneys who consistently use the flat fee of $3,700.00 must expect to occasionally encounter a case with unforeseen complications, thus resulting in a lower return than cases that proceed in a routine manner. [] This is, however, the exception rather than the rule. Cases of increased complexity more often than not will be identified prior to the filing of the petition, such that attorneys can opt to utilize the hourly fee arrangement. The Court trusts that attorneys will exercise their best business judgment and chose the hourly fee option from the outset in a particular case if and when appropriate.”);
v. In re Shamburger, 189 B.R. 965, 969–70 (Bankr. N.D. Ala. 1995) (“The problem that a lodestar analysis would create in trying to apply it to a chapter 13 system is having to determine what is compensable where the vast majority of work in a chapter 13 case is normal and customary.”).

b. Some courts have different no-look fees amounts that may be charged depending upon the anticipated complexity of the case or expertise of counsel.

i. Income of Debtor. E.g., Middle District of Alabama ($3,000 for below median debtor; $3,250 for above median debtor);

ii. Business Case. E.g., District of Alaska ($3,500 in consumer, non-business cases; $5,000 in business, non-consumer cases); Eastern District of Washington ($3,000 in a consumer case or $4,000 in a business case as defined in § 1304(a) of the Code);

iii. Mortgage Payments. E.g., District of Vermont (up to $2,500 for a “simple” chapter 13 case where the plan pays only unsecured claims and attorney’s fees; up to $3,500 for a chapter 13 case where ongoing monthly mortgage payments are paid directly, consisting of up to $2,700 for pre-confirmation services, plus up to $800 for post-confirmation services; up to $4,300 for a chapter 13 case where ongoing monthly mortgage payments are paid through the plan, consisting of up to $3,700 for pre-confirmation services, plus up to $600 for post-confirmation services).

iv. Attorney Expertise. E.g., Western District of Michigan (general no-look fee is $2,600 ($175 per hour presumptive fee); $3,200 ($220 per hour) if attorney attends at least 7 hours of bankruptcy CLE programs; $3,650 ($250 per hour) if attorney is ABC certified).

c. Some courts structure the no-look fee so that additional amounts may be paid to counsel for the post-confirmation period in which a chapter 13 case remains pending and in good status.

i. E.g. Eastern District of Louisiana, General Order No. 2011-1 provides that the “no-look fee is $2,500. The Order also provides: “IT IS FURTHER ORDERED counsel requesting compensation under the no-look fee will also receive $300.00 in additional compensation payable in months 24, 36, 48, and 60 of confirmed plans. The Trustee shall withhold from distribution, $25.00 per month beginning in month 13 of the plan and for each month thereafter for this purpose. Debtor's counsel will receive an annual $300.00 payment if the case is in good standing and still pending under chapter 13 at the end of the applicable plan year.”
2. Is the Attorney Locked Into the “No-Look” Fee for the Entire Case?

   a. Subject to contrary local rule, counsel may request more than the presumptive “no-look” fee. An election as to whether the attorney will accept the “no-look” fee or will submit a fee application generally must be made at the time of the attorney’s initial Rule 2016(b) disclosure.

      i. E.g., Local Rule 2016-3 for the Eastern District of Missouri requires attorneys to make this election by using the “Attorney Fee Election Form” event when filing the Rule 2016(b) disclosure.

   b. Some courts do not permit counsel to switch to a lodestar approach after the initial fee disclosures are filed:

      i. In re Hyland, 2014 Bankr. LEXIS 368 (Bankr. E.D. Tenn. Jan. 23, 2014)(where counsel had agreed to no-look fee and certified they would not seek further fees for pre-confirmation services, they could not switch to lodestar approach in seeking fees for such services);

      ii. In re Eliapo, 298 B.R. 392 (B.A.P. 9th Cir. 2003) (attorney who had opted for standardized “no-look” standard fee could not later seek lodestar computation of higher fee for services covered by “no-look” fee), aff’d in part, rev’d in part, 468 F.3d 592 (9th Cir. 2006).

   c. Some courts permit counsel to obtain additional compensation for specified post-confirmation services, in addition to the “no-look” fee, without the need to submit a fee application and contemporaneous time and expense records.

      i. E.g., Western District Of Virginia, Standing Order No. 15-1 ($350 for defense of post-confirmation Motion for Relief from the Automatic Stay resolved without evidentiary hearing; $250 for defense of post-confirmation Trustee’s Motion to Dismiss for payment default; $400 for post-confirmation modified Plan or Motion to Suspend; $400 for Motion to Approve Sale/Motion to Approve Refinance/Motion to Incur Debt/Motion to Approve Loan Modification; $450 for Adversary Proceeding (uncontested) including motion for default judgment; $300 for Motion to Avoid Lien (uncontested)).

3. What Must the Attorney Establish in Seeking Fees in Excess of or In Lieu of the “No-Look” Fee?

   a. Subject to contrary local rule, fees sought in excess of or in lieu of the “no-look” fee are subject to a lodestar computation, which provides for compensation at a reasonable hourly rate for time reasonably expended.
i. *In re* Pilgrim’s Pride Corp, 690 F.3d 650 (5th Cir. 2012) (finding in chapter 11 case that lodestar analysis for bankruptcy fees unchanged by Supreme Court decisions in fee-shifting cases);

ii. *In re* Williams, 357 B.R. 434 (B.A.P. 6th Cir. 2007) (holding in chapter 7 case that court should have conducted lodestar analysis when counsel sought amount in excess of basic fee);

iii. *In re* Johnson, 331 B.R. 534 (Bankr. W.D. N.Y. 2005) (attorney seeking compensation for additional tasks above usual chapter 13 fee must submit time records for entire case);


b. Based on the lodestar approach, attorneys who reject the “no-look” fee will need to keep and submit contemporaneous time records for all of the services performed in connection with the case.

i. However, some courts provide that services up to a certain dollar amount may be compensated without an application to the court even if the attorney is not accepting the customary flat fee. *E.g.*, Eastern District of Missouri, Local Rule 2016-3 –A.2 (“Attorneys for debtors in Chapter 13 cases who elect the “Fee Application Option” shall be permitted to be paid, without application to the Court, an initial fee in an amount not to exceed $2,300 (or $2,581 if the filing fee is advanced). All other fees will be allowed to the debtor’s attorneys who elect the “Fee Application Option” only on application filed in accordance with L.R. 2016-1(B).”).

c. Counsel may charge more than the flat fee when the work reasonably required in a case warrants a larger fee, which the client agrees to pay.

i. *In re* Tuttle, 2009 WL 1789286 (Bankr. E.D. Va. June 15, 2009) (fees higher than guideline were reasonable in case likely to be complex; approving total flat fee amount of $4,500, rather than $3,000 presumptive fee, where case involved lien strip-off proceeding);

ii. *In re* Shamburger, 189 B.R. 965 (Bankr. N.D. Ala. 1995) (attorney entitled to additional compensation for work performed on novel issues);

iii. District of Arizona, General Order 106 ("Counsel may request additional compensation only in instances where substantial and unanticipated post-confirmation work is necessary. In the event that counsel files for additional fees, time records in support of such an application must be provided and date from the inception of the case.")
d. However, counsel seeking to deviate from the no-look fee may have a substantial burden in convincing the court that the case is not “routine” and that additional services are reasonable and necessary, particularly if other attorneys in the district routinely perform the same services at a lower cost or without seeking compensation in excess of the no-look fee.

i. Berlinger v. Pappalardo (In re Sullivan), 674 F.3d 65 (1st Cir. 2012) (bankruptcy court need not go line by line through time records to point out duplicative or unnecessary work; court’s general finding that case was not so unusually complex as to warrant high fee was sufficient; in response to counsel’s argument that higher fees were justified because debtors were demanding, court stated that “lawyers have an obligation to keep hand-holding within reasonable limits”);

ii. In re Eliapo, 468 F.3d 592 (9th Cir. 2006) (attorney who had applied for no-look fee did not show extraordinary circumstances justifying additional fees for normal case preparation tasks, but was awarded fees for other additional work; attorney should have been granted opportunity for a hearing on disputed fees);

iii. In re Cahill, 428 F.3d 536 (5th Cir. 2005) (case did not involve sufficient amount of work to deviate from standard fee);

iv. In re Peterson, 251 B.R. 359 (B.A.P. 8th Cir. 2000) (reducing hourly rate and number of hours in fee request based on court’s perceptions of amounts charged by other local attorneys);

v. In re Ulrich, 517 B.R. 77 (Bankr. E.D. Mich. 2014) (approving reasonable fee for debtor's attorney in the amount of $5,375 rather than requested fee of $7,784.50);

vi. In re Szymczak, 246 B.R. 774 (Bankr. D. N.J. 2000) (approving $1,500 based on presumptive fee and $1,850 for services that exceeded the normal and customary standard, rather than the amount of $9,691.25 requested by counsel);

vii. In re Heise, 436 B.R. 143 (Bankr. D.N.M. 2010) (attorney’s reputation as proficient in handling chapter 13 cases did not support fee based on higher hourly rate than other local bankruptcy attorneys);

viii. In re Finlasen, 250 B.R. 446 (Bankr. S.D. Fla. 2000) (reducing fees because time sheets did not indicate date of each entry and there was evidence that they were a form list of time entries);

ix. In re Thorn, 192 B.R. 52 (Bankr. N.D.N.Y. 1995) (fees reduced to amounts customarily charged when no time records or other evidence
introduced to support unusually high fees requested in routine cases).

4. Are “Fee-Only” Chapter 13 Cases Permissible?

   a. Most courts have held that so-called “fee-only” chapter 13 cases, in which most or all of the debtor’s chapter 13 payments will be paid on administrative claims, are not per se impermissible.

      i. In re Brown, 742 F.3d 1309, 1319 (11th Cir. 2014) (“We offer no opinion as to other attorney-fee-centric Chapter 13 plans. There is no hard and fast rule to be applied. Each case has its own special circumstances, and Chapter 13 requires a case-by-case analysis by the fact-finder.”);

      ii. In re Puffer, 674 F.3d 78, 83 (1st Cir. Mass. 2012) (no per se rule that fee-only chapter 13 case was in bad faith simply because no unsecured creditors would be paid; bankruptcy court should consider the totality of circumstances in determining whether chapter 13 case was filed in good faith);

      iii. In re Crager, 691 F.3d 671 (5th Cir. 2012) (debtor had legitimate reason for filing chapter 13 case that paid nothing to unsecured creditors);

      iv. In re Antonio, 2010 WL 1490589 (Bankr. E.D. N.C. Apr. 13, 2010) (rejecting trustee’s request for blanket order denying “no-look” chapter 13 fees in all attorney fee-only chapter 13 cases);


   b. However, the debtor and debtor’s counsel will need to show that the chapter 13 filing was justified based on special circumstances.

      i. In re Puffer, 674 F.3d 78, 83 (1st Cir. Mass. 2012) (“While fee-only plans should not be used as a matter of course, there may be special circumstances, albeit relatively rare, in which this type of odd arrangement is justified.”);

      ii. In re Puffer, 494 B.R. 1 (D. Mass. 2013) (no special circumstances or emergency justified fee-only plan when debtor could obtain same benefit from chapter 7 case);

      iii. In re Brown, 742 F.3d 1309 (11th Cir. 2014) (bankruptcy court’s finding of lack of good faith because only reason debtor filed a chapter 13 case
was to pay attorney’s fees in installments was not clearly erroneous);

iv. Ingram v. Burchard, 482 B.R. 313 (N.D. Cal. 2012) (bankruptcy court’s finding of lack of good faith based on chapter 13 plan that proposed to strip off second mortgage and pay only attorney’s fees was not clearly erroneous);

v. In re Molina, 420 B.R. 825 (Bankr. D. N.M. 2009)(upholding good faith of a fee-only plan in “chapter 20” case filed to stop a wage garnishment);

5. How are Fees for Additional Post-Confirmation Work Approved and Paid?

a. Once the plan has been confirmed, some courts may require a motion to modify the plan if additional attorney’s fees are requested to be paid through the plan.

i. In re Williams, 378 B.R. 811 (Bankr. E.D. Mich. 2007) (court reduced fees sought for post-confirmation legal work that consisted primarily of attempts to modify significantly underfunded chapter 13 plan, finding that the costs of protracted litigation exceeded reasonable benefit to debtor);

ii. In re Hallmark, 225 B.R. 192 (Bankr. C.D. Cal. 1998) (modification must be sought when plan provided specific amount for administrative expense attorney’s fees);

iii. In re Black, 116 B.R. 818 (Bankr. W.D. Okla. 1990) (when attorney sought fees six times higher than those provided for in confirmed plan, which would utilize all funds available to unsecured creditors, and no motion to modify plan had been filed, attorney held bound by confirmed plan and application for additional fees denied).

b. Some courts have developed alternative methods for approving and funding fees for post-confirmation representation.

i. Some courts provide in the local model chapter 13 plan that additional administrative fees allowed by the court may be disbursed under the plan without modification of the plan (generally resulting in a lower dividend to unsecured creditors). E.g., Eastern District of Missouri, Chapter 13 Plan (“Pay Debtor's attorney $__________ in equal monthly payments over _________ months. Any additional fees allowed by the Court shall be paid pursuant to paragraph 6 below.”).

ii. Another solution is for the debtor’s plan to provide for a contingent administrative reserve. See, e.g., District of Maine, Chapter 13 Plan (Form 2), available at: http://www.meb.uscourts.gov/forms.
1. The reserve amount approved at confirmation remains contingent and is not funded until additional fees are approved by the court upon application by the debtor’s counsel.

2. Plan provides that any remaining sums not approved for fees at the end of plan are disbursed to general unsecured creditors. The Maine model chapter 13 plan provides: “Any unused portion of the administrative reserve shall be paid pro rata to general unsecured claims that have not otherwise been paid in full.”

6. Is Attorney Entitled to Hearing on Fee Application?

   a. In re Driscoll, 2014 Bankr. LEXIS 513 (B.A.P. 9th Cir. Feb. 6, 2014) (bankruptcy court must make known its specific concerns about the fee so an attorney may attempt to address them);

   b. In re Eliapo, 468 F.3d 592 (9th Cir. 2006) (attorney should have been granted opportunity for a hearing on disputed fees);


   d. In re Pfleghaar, 215 B.R. 394 (B.A.P. 8th Cir. 1997) (attorney entitled to evidentiary hearing before bankruptcy court denied his fee application).

7. What About Appeals?

   a. In cases likely to be appealed, all parties must be careful to ensure that there is evidence in the record to support their positions. If the bankruptcy court does not make such findings, it should be specifically requested to do so, in order to create an adequate record for appellate review.

   i. In re Clark, 223 F.3d 859 (8th Cir. 2000) (appellant attorney did not provide reviewing court transcript or other record that supported his contentions);

   ii. In re Boddy, 950 F.2d 334 (6th Cir. 1991) (case remanded when court had not discussed how award was calculated under lodestar method);


b. When the record establishes the hours reasonably spent and the bankruptcy court gives no specific reason for reducing fees below the amount requested, an appellate court may reverse the reduction of fees as an abuse of discretion.

i. B.O.C. Law Group., P.C. v. Carroll (In re McKnight), 2013 U.S. Dist. LEXIS 130301 (E.D. Mich. Sept. 11, 2013) (remand required because bankruptcy court did not examine reasonableness of law firm’s specific time entries and fees in lodestar analysis, and only generally found services to be worth less than amount requested);

ii. Potter v. Bailey, 454 B.R. 715, 725 (S.D. Tex. 2011) (remand required because bankruptcy court did not explain its reasoning in reducing fees);

iii. In re Grunau, 376 B.R. 322 (M.D. Fla. 2007) (reversing disgorgement order because bankruptcy court failed to explain legal standard used to evaluate fee award);

iv. In re Paster, 119 B.R. 468 (E.D. Pa. 1990) (under “lodestar” method applicable in circuit to bankruptcy fees, when court did not specifically take issue with number of hours reasonably spent and rate was not excessive, reduction of fees was abuse of discretion).

c. Presumptive fees and procedures for overcoming the presumptions are subject to judicial review and may be set aside when they are arbitrary or outdated.

i. In re Kindhart, 160 F.3d 1176 (7th Cir. 1998) (bankruptcy court required to update presumptive fees, which had not been adjusted in ten years);

ii. In re Ingersoll, 238 B.R. 202 (D. Colo. 1999) (bankruptcy court ordered to change fee procedures which unduly restricted rights to obtain fees above presumptive amounts).
“Unbundled” or “Unhinged” – Ghostwriting in a Limited Representation World

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Since BAPCPA came into effect, consumer bankruptcy attorney’s fees have been rising. Simply put, it has become more complicated to file a Chapter 7 and a Chapter 13 case and, with new software required and a steeper learning curve, many members of the bar who formerly “dabbled” in bankruptcy have left that area of the law altogether. The bar has gotten smaller or more concentrated in many places, and pressure on fees due to competition is not entirely like it was pre-BAPCPA. This is not the case everywhere, especially in large metropolitan areas, but in many smaller markets it is a noticeable reality.

Associate Supreme Court Justice Lewis F. Powell, Jr. eloquently stated “Equal justice under law is not merely a caption on the facade of the Supreme Court building, it is perhaps the most inspiring ideal of our society. It is one of the ends for which our entire legal system exists. . . . it is fundamental that justice should be the same, in substance and availability, without regard to economic status.” However, former ABA President Robert J. Grey, Jr. recently observed that “[f]or far too many Americans . . . equal access to justice remains more of a promise than a practice, particularly in the civil justice system where the right to counsel is not guaranteed. Most people who cannot afford to hire a lawyer cannot secure free or even low-cost legal assistance. They are on their own in a system designed by lawyers for lawyers. This has grave consequences for them and for the judges and court administrators charged with maintaining the orderly functioning of our court system.” Robert J. Grey, Jr., There is no justice as long as millions lack meaningful access to it, ABA Journal (August 30, 2018). Therein lies the rub. Can (or should) United States Bankruptcy Courts further “access to justice” issues and accommodate an economically challenged constituency, especially in consumer cases, and at the same time require bankruptcy attorneys to operate under sometimes fairly rigid ethical guidelines and rules of court governing the attorney-client relationship?

A number of states have elected to deal with access to justice issues by encouraging “unbundling” as a means of providing legal services to segments of the public that cannot afford counsel. Components of unbundling include limited-scope representations, providing advice to clients on how they can represent themselves in court, and assisting a client in preparing pleadings, discovery responses, and other documents for litigation purposes without becoming counsel of record – or colloquially put – “ghostwriting.” As one commentator has observed, “[t]he practice of ghostwriting is controversial and remains almost universally condemned by the courts. However, recent changes to the rules permitting the practice of limited-scope representation should compel courts to re-examine their hostilities to the practice and encourage the adoption of changes to the disclosure and termination rules in order to allow ghostwriting to be openly practiced.” Halley Acklie Ostergard, Unmasking the Ghost: Rectifying Ghostwriting and Limited-Scope Representation with the Ethical and Procedural Rules, 92 Neb. L. Rev. 655

1 The assistance of Elizabeth Blackwell Carroll, career law clerk, is gratefully acknowledged.
This outline will address how a number of courts have addressed issues with ghostwriting in federal court, and in particular, bankruptcy court.

I. What is Ghostwriting?

*In re Mungo*, 305 B.R. 762 (Bankr. D. S.C. 2003), described ghostwriting “as when a member of the bar represents a pro se litigant informally or otherwise, and prepares pleadings, motions, or briefs for the pro se litigant which the assisting lawyer does not sign, and thus escapes the professional, ethical, and substantive obligations imposed on members of the bar.” *Id.* at 767 (citing *Barnett v. LeMaster*, No. 00–2455, 2001 WL 433413 at *3 (10th Cir. 2001); *Ellis v. Maine*, 448 F.2d 1325, 1328 (1st Cir. 1971); *Laremont–Lopez v. Southeastern Tidewater Opportunity Ctr.*., 968 F. Supp. 1075, 1078 (E.D. Va. 1997); *Wesley v. Don Stein Buick*, 987 F. Supp. 884, 885 (D. Kan. 1997); *U.S. v. Eleven Vehicles*, 966 F. Supp. 361, 367 (E.D.Pa.1997)).

*Mungo* observed that the court in *Ricotta v. Cal.*, 4 F. Supp.2d. 961, 987 (S.D. Cal. 1998), went further and addressed the issue of what constitutes ghostwriting by analyzing *Ellis, Johnson v. Board of Comm’rs of Fremont County*, 868 F. Supp. 1226 (D. Colo. 1994), and *Laremont–Lopez* by stating as follows:

[In *Ellis*, the Court stated that its concern was directed at petitions that were “manifestly written” by someone with some legal knowledge and briefs that were prepared in “any substantial way” by a member of the bar. In *Johnson*, the ghostwriting attorney drafted the documents entirely. The Court asserted that it was concerned with attorneys who “authored pleadings and necessarily guided the course of litigation with an unseen hand.” Finally, in *Laremont*, the allegations were that the Plaintiff actually paid attorneys who secretly drafted the complaints, tried to resolve the dispute, and paid the court filing fees out of their law firm’s account. In light of these opinions, in addition to this Court’s basic common sense, it is the Court’s opinion that a licensed attorney does not violate procedural, substantive, and professional rules of a federal court by lending some assistance to friends, family members and others with whom he or she may want to share specialized knowledge. Otherwise, virtually every attorney licensed to practice law would be eligible for contempt proceedings. Attorneys cross the line, however, when they gather and anonymously present legal arguments, with the actual and constructive knowledge that the work will be presented in some similar form in a motion before the Court. With such participation the attorney guides the course of litigation while standing in the shadows of the Courthouse door.

*Mungo*, 305 B.R. at 767-768 (citing *Ricotta v. Cal.*, 4 F. Supp.2d. at 987) (internal citations

However, ghostwriting has been described in softer and simpler tones. Ghostwriting occurs when “[t]he attorney . . . [provides] substantial legal assistance to the pro se litigant without entering an appearance in the matter or otherwise identifying her involvement in the case.” *Ostergard*, 92 Neb. L. Rev. at 659. Further, as *Ostergard* observed, “[w]hile many attorneys bemoan the problems that come with litigating against pro se parties, the fact is

2 Whether one agrees with the concept of ghostwriting or not, the cited law review article is an excellent and thoughtful resource on the issue.
ghostwriting helps ease some of these challenges. The court, opposing counsel, and pro se litigants all benefit when a pleading is clearly written. In those circumstances, the court can more easily evaluate the case on its merits and the opposing counsel gains a clearer picture of what the pro se litigant is actually arguing. While it is preferable and less complicated for the court if counsel represents a party who would otherwise be a pro se litigant, having some assistance from a lawyer is better than no assistance.” Id. at 672-673.

II. Impediments to Ghostwriting

A. Federal Rule of Civil Procedure 11 and its Bankruptcy Counterpart

Federal Rule of Civil Procedure Rule 11 provides that “[e]very pleading, written motion, and other paper must be signed by at least one attorney of record in the attorney’s name – or by a party personally if the party is unrepresented.” Fed. R. Civ. P. 11(a). In Bankruptcy Court, Federal Rule of Bankruptcy Procedure 9011(a) provides as follows: “Every petition, pleading, written motion, and other paper, except a list, schedule, or statement, or amendments thereto, shall be signed by at least one attorney of record in the attorney’s individual name. A party who is not represented by an attorney shall sign all papers. Each paper shall state the signer’s address and telephone number, if any. An unsigned paper shall be stricken unless omission of the signature is corrected promptly after being called to the attention of the attorney or party.”

In Mungo, the court opined that

Fed. R. Civ. P. 11 requires an attorney to sign all documents submitted to the court and to personally represent that there are grounds to support the assertions made in each filing in the course of that attorney’s representation of a client. Ghost-writing frustrates the application of these rules by shielding the attorney who drafted pleadings for pro se litigants in a cloak of anonymity. An obvious result of the anonymity afforded ghost-writing attorneys is that they cannot be policed pursuant to the applicable ethical, professional, and substantive rules enforced by the Court and members of the bar since no other party to the existing litigation is aware of the ghost-writing attorney’s existence. The Court finds this result particularly disturbing; and thus, considers this factor a strong policy ground for prohibiting attorneys from ghost-writing pleadings and motions for pro se litigants.

Mungo, at 768. (internal citations omitted). See also, Johnson v. Board of County Comm’rs for County of Fremont, 868 F. Supp. 1226 (D. Colo. 1994); aff’d in part and disapproved in part, 85 F.3d 489 (10th Cir. 1996), cert. denied sub nom, Greer v. Kane, ___ U.S. ___, 117 S. Ct. 611, 136 L. Ed. 2d 536 (1996).

On the other hand, at least one state supreme court, interpreting a state court equivalent of federal Rule 11, opined that “[t]he plain language of Rule 11 does not implicate ghostwriting because it does not address the author or drafter of the documents. Instead, the linchpin of Rule 11 is its signature requirement. This signature provides the vehicle through which courts may reach attorneys or litigants to impose sanctions, if necessary, for misconduct in the submission of signed papers during the litigation process.” FIA Card Services, N.A. v. Pichette, 116 A.3d 770, 770 (R.I. 2015). Further, the Rhode Island Supreme Court next looked to whether ghostwriting violated the spirit of Rule 11. The Court in Pichette observed that “[t]he Committee Notes to
Rule 11 do not give any suggestion that the rule was intended to cover the author as well as the signer of documents. As many federal courts have astutely noted, Rule 11, and the Federal Rules in general, do not contemplate limited representation. Our version of Rule 11, similar to the federal rule, envisions only a binary concept of representation: either full representation or no representation. However, this formulation of representation often conflicts with the reality of today’s legal practice. . . . Pursuant to our Rules of Professional Conduct, Rule 1.2(c) authorizes limited-scope representation provided that it is reasonable and accompanied by informed consent.” Id. at 780. To date, no federal courts have cited Pichette in allowing ghostwriting in their courts, or in addressing an award of sanctions.

B. Liberality in Pleading Afforded Pro Se Litigants

“A document filed pro se is ‘to be liberally construed,’ Estelle, 429 U.S., at 106, 97 S.Ct. 285, and ‘a pro se complaint, however inartfully pleaded, must be held to less stringent standards than formal pleadings drafted by lawyers,’ ibid. (internal quotation marks omitted). Cf. Fed. Rule Civ. Proc. 8(f) (“All pleadings shall be so construed as to do substantial justice”).” Erickson v. Pardus, 551 U.S. 89, 94, 127 S. Ct. 2197, 2200, 167 L. Ed. 2d 1081 (2007).\(^3\) See also, Gordon v. Leke, 574 F.2d 1147, 1151–52 (4th Cir.), cert. denied, 439 U.S. 970, 99 S.Ct. 464, 58 L.Ed.2d 431 (1978) (courts must liberally construe pro se complaints); In re A.H. Robins Co., Inc., 197 B.R. 516, 518 (E.D. Va. 1994) (“Because Tower is proceeding pro se, this Court gives a generous and liberal reading to her pleading.”). The argument against ghostwriting was succinctly put by one court as follows: “the Court believes that this practice . . . unfairly exploits the Fourth Circuit’s mandate that the pleadings of pro se parties be held to a less stringent standard than pleadings drafted by lawyers, see, e.g., White v. White, 886 F.2d 721, 725 (4th Cir. 1989).” Laremont-Lopez, 968 F. Supp. at 1078. This view is not confined to a single circuit. For example, in Duran v. Carris, 238 F.3d 1268, 1271–72 (10th Cir. 2001), the court addressed a situation where the pro se appellant’s brief was written by his former attorney, which the Tenth Circuit brought before the court on a show cause hearing. There, the court held “[t]his court is concerned with attorneys who ‘author[ ] pleadings and necessarily guide[ ] the course of the litigation with an unseen hand.’ Johnson v. Bd. of County Comm’rs, 868 F. Supp. 1226, 1231 (D. Colo. 1994). Fed. R. Civ. P. 11(a) requires that ‘[e]very pleading, written motion, and other paper shall be signed by at least one attorney of record in the attorney’s individual name, or if the party is not represented by an attorney, shall be signed by the party.’ [The attorney’s] actions in providing substantial legal assistance to Mr. Duran without entering an appearance in this case not only affords Mr. Duran the benefit of this court’s liberal construction of pro se pleadings, see Haines v. Kerner, 404 U.S. 519, 520–21, 92 S.Ct. 594, 30 L.Ed.2d 652 (1972), but also inappropriately shields [the attorney] from responsibility and accountability for his actions [as] counsel.” Duran, at 1271-72.

The Court in Duran further observed as follows:

As stated in a recent law review article: The duty of candor toward the court mandated by Model Rule 3.3 is particularly significant to ghostwritten pleadings.\(^4\)

\(^3\) Federal Rule of Civil Procedure 8, incorporated by Federal Bankruptcy Rule 7008, now reads in subparagraph (e) that “Pleadings must be construed so as to do justice.”

\(^4\) ABA Model Rule 3.3, “Candor Toward the Tribunal,” currently provides as follows:
If neither a ghostwriting attorney nor her pro se litigant client disclose the fact that any pleadings ostensibly filed by a self-represented litigant were actually drafted by the attorney, this could itself violate the duty of candor. The practice of undisclosed ghostwriting might be particularly problematic in light of the special leniency afforded pro se pleadings in the courts. This leniency is designed to compensate for pro se litigants’ lack of legal assistance. Thus, if courts mistakenly believe that the ghostwritten pleading was drafted without legal assistance, they might apply an unwarranted degree of leniency to a pleading that was actually drafted with the assistance of counsel. This situation might create confusion for the court and unfairness toward opposing parties. It is therefore likely that the failure to disclose ghostwriting assistance to courts and opposing parties amounts to a failure to “disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client,” which is prohibited by Model Rule 3.3. Undisclosed ghostwriting would also likely qualify as professional misconduct under Model Rules 8.4(c) and (d), prohibiting conduct involving a misrepresentation, and conduct that is prejudicial to the administration of justice, respectively. John C. Rothermich, *Ethical and Procedural Implications of “Ghostwriting” for Pro Se Litigants: Toward Increased Access to Civil Justice*, 67 Fordham L. Rev. 2687, 2697 (1999) (citing Model Rules of Prof’l Conduct R 3.3(a)(2)) (footnotes omitted).

*Duran*, 238 F.3d at 1272.

In other words, many courts find that ghost-written pleadings unfairly get a benefit from the liberal pleading construction given to true litigants, to the detriment of the opposing party,

(a) A lawyer shall not knowingly:

1. make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

2. fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

3. offer evidence that the lawyer knows to be false. If a lawyer, the lawyer’s client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.
and it may make courts less likely to construe pleadings liberally for true pro se litigants receiving no behind the scenes assistance. See Ricotta, 4 F. Supp. 2d at 986.

C. Local Rules of Court

Various courts have local rules that either specifically outlaw ghostwriting, or have local rules which, although not specifically addressing ghostwriting, govern attorney appearances or scope of representation violated by the practice.

For example, the United States Bankruptcy Court for the Eastern District of Virginia, Local Rule 2090-1(N), provides as follows:

(N) Ghostwriting:

(1) Any attorney who prepares any document that is to be filed in this Court by a person who is known by the attorney, or who is reasonably expected by the attorney, to be proceeding pro se, shall be considered to have entered an appearance in the proceeding in which such document is filed and shall be subject to all rules that govern attorneys who have formally appeared in the proceeding.

(2) All litigants who are proceeding pro se shall certify in writing and under penalty of perjury that a document(s) filed with the Court has not been prepared by, or with the aid of, an attorney or shall identify any attorney who has prepared, or assisted in preparing, the document.

Each document filed with the court by a pro se litigant shall bear the following certification:

CERTIFICATION

I declare under penalty of perjury that (Check one box):

☐ No attorney has prepared, or assisted in the preparation of this document.

or ☐ The following attorney prepared or assisted in the preparation of this document.

(Name of Attorney)

(Address of Attorney)

(Telephone Number of Attorney)

Name of Pro Se Party (Print or Type)

Signature of Pro Se Party

Executed on: (Date)

This Bankruptcy Court Rule substantially mirrors Local Civil Rule 83.1 in the District Court for the Eastern District of Virginia.

Mungo observed that its Local Rule 9010–1(d) provides that “[e]xcept as may be provided in an attorney’s written agreement with the client concerning appeals and adversary proceedings, any attorney who files documents on or behalf of a debtor or party in interest shall remain the responsible attorney of record for all purposes including the representation of the client at all hearings and in all matters that arise in conjunction with the case. Upon motion which details the reasons for the request for withdrawal and which details the portion of any retainer which has been earned, and after notice to the debtor, all creditors and parties in interest
and a hearing, the court may permit an attorney to withdraw as attorney of record.” *Mungo*, 765-766. *Mungo* went on to hold that “the positive effects provided by Local Rule 9010–1(d) are frustrated whenever an attorney either fails to completely satisfy its provisions or anonymously represents a party to a case. Clients who proceed through a case without an attorney to shepherd them through the complexities of the bankruptcy process tax the resources of the Court since these *pro se* individuals often require more time consuming handling by the Clerk’s Office and the Court in order to insure they are provided adequate due process. Additionally, *pro se* litigants are more likely to make errors which require the Clerk and Court to expend resources to correct. Finally, when litigants are properly represented they are more likely to obtain the full benefits of the bankruptcy laws and follow necessary procedures.” *Id.*

**D. Rules of Professional Conduct**

ABA Model Rule of Professional Conduct 1.16(b)(1) provides that “[e]xcept as stated in paragraph (c), a lawyer may withdraw from representing a client if: (1) withdrawal can be accomplished without material adverse effect on the interests of the client.” In addition, Model Rule 1.16(c) provides that “A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.” At least one court has determined that Model Rule 8.4(c) may be implicated, in that undisclosed ghostwriting would “likely qualify as professional misconduct . . . which prohibit[s] conduct involving misrepresentation . . . .” *Duran*, 238 F.3d at 1272 (“We determine that the situation as presented here constitutes a misrepresentation to this court by litigant and attorney.”). *Duran* also held that Model Rule 8.4(d), which prohibits conduct that is prejudicial to the administration of justice, may be implicated. *Id.* Many of these Model Rules have been adopted, or adopted with modification, across the country, and it is a simple reality that if a court sanctions an attorney – in particular for misrepresentation – that is likely to draw the attention of the attorney’s state bar disciplinary authority.  

**III. Shifting Views on Ghostwriting**

**A. ABA Formal Opinion 07-446**

Many cases discussing ghostwriting were decided prior to the ABA’s adoption of Formal Opinion 07-446, which opined that ghostwriting was not a per se violation of the Model Rules. In particular, the ABA opined, in part, that: (1) in its opinion, “the fact that a litigant submitting papers to a tribunal on a *pro se* basis has received legal assistance behind the scenes is not material to the merits of the litigation”, (2) litigants “ordinarily have the right to proceed without representation and may do so without revealing that they have received legal assistance in the absence of a law or rule requiring disclosure”, (3) because “there is no reasonable concern that a litigant appearing *pro se* will receive an unfair benefit from a tribunal as a result of behind-the-scenes legal assistance, the nature or extent of such assistance is immaterial and need not be

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5 The old saying “one bad apple spoils the barrel” can be a reality as well. Such occurs, for example, when an attorney who has an obvious conflict of interest tries to steer or manipulate a *pro se* debtor from behind the scenes, souring a court on permitting the practice for others who may attempt to help a debtor in good faith.
disclosed”, and (4) “[a]bsent an affirmative statement by the client, that can be attributed to the 
lawyer, that the documents were prepared without legal assistance, the lawyer has not been 
dishonest within the meaning of Rule 8.4(c).” ABA Formal Opinion 07-446, Undisclosed Legal 
Assistance to Pro Se Litigants (May 5, 2007). While the ABA Opinion is not binding on Courts, 
it is notable that many, but not all, of the cases deriding the practice of ghostwriting predate 
the ABA opinion. Several cases decided after the opinion was issued, but not specifically addressing 
it, have not followed its path. See Auto Parts Mfg. Mississippi Inc. v. King Const. of Houston, 
Court cautions that an attorney who ghostwrites motion briefs and pleadings is acting unethically 
and is subject to sanctions.”); Falconer v. Lehigh Hanson, Inc., No. 4:11-CV-373, 2013 WL 
2:11 CV 1377, 2012 WL 4960919, at *5 (W.D. La. Oct. 17, 2012)(“ The court also advises that 
any counsel who ‘ghost-writes’ pleadings is treading on dangerously thin ice. The Court warns 
any attorney providing ghostwriting assistance that it constitutes unethical conduct.”) 
29, 2010).

B. State LEOs

Several state legal ethics departments have issued opinions condoning ghostwriting in 
various forms. For instance, the Mississippi Bar issued Ethics Opinion 261 on June 21, 2018, 
opining on two questions: “(1) Is it ethical for a lawyer to prepare documents for pro se 
litigants?” and (2) “If the answer to question 1 is yes, is the preparing lawyer required to disclose 
either the name of the preparer or that the document was prepared by a lawyer?” Addressing 
the first question, the opinion drew immediately from Model Rule 1.2 as adopted in that state, noting 
that Rule 1.2 expressly permits limited scope representations of a client, commonly referred to as 
unbundled legal services. Important caveats apply: First, “is that the lawyer does represent the 
client to the extent of the limited scope representation, and the full panoply of ethical obligations 
(including the obligation of confidentiality under Rule 1.6) apply to the representation. Second, 
a lawyer’s ethical obligations under Rule 1.4 require that the lawyer ensure that the client fully 
understands what it means to limit the scope of representation to discrete aspects of the 
representation and the consequences of the limited representation.”

As to the second question, the Mississippi LEO dismissed the Rule 8.4(c) concern as to 
whether there was a deception on the Court, the deception being that the court is led to believe 
that the party has received no professional help at all, when in reality a lawyer has provided some 
assistance. While expressing sensitivity to these concerns, the LEO did not believe that a 
lawyer’s undisclosed limited representation is a deception as contemplated by Rule 
8.4(c). Perhaps naively to some, the LEO stated that a “court presented with a lawyer-drafted 
document and a pro se litigant appearing to defend or argue that document would be aware of the 
nature of a lawyer’s involvement. If not, the court can always inquire from the litigant whether a 
lawyer assisted in preparing the document. The unlikely event that a court will be misled into 
providing leniency to a pro se litigant under such circumstances” did not outweigh the strong 
public policy set out in the Comment to Rule 1.2, encouraging lawyers to provide limited scope 
representation without having to enter an appearance. The LEO was concerned that lawyers will 
be “dissuaded from providing limited representation if required to disclose their involvement.”
In addition, Virginia LEO 1874 (July 28, 2014) was broader, and addressed not only Virginia’s Rule 8.4(c), but also its Rule 3.3. Specifically, the LEO concluded by stating,

[T]he Committee does not believe that nondisclosure of the fact of legal assistance is dishonest so as to violate Rules 3.3 or 8.4(c). Whether it is dishonest for the lawyer to provide undisclosed assistance to a pro se litigant turns on whether the court would be misled by failure to disclose such assistance. The lawyer is making no representation to the tribunal regarding the nature or scope of the representation, and indeed, may be obliged under Rule 1.6 not to reveal the fact of the representation. Absent an affirmative statement by the client that can be attributed to the lawyer that the documents were prepared without legal assistance, the lawyer has not made any false statements of fact to the court prohibited by Rule 3.3, nor has been dishonest within the meaning of Rule 8.4(c). The non-disclosure of the lawyer’s behind-the-scenes assistance is not material to the court’s determination of the merits of the pro se litigant’s position or case and therefore the court is not misled by the non-disclosure.

While this Committee opines that undisclosed assistance to a pro se litigant is permissible under the Rules of Professional Conduct, if a lawyer agrees to prepare a lawsuit for a pro se litigant, he or she must do so competently and may not prepare one that is frivolous. See Rules 1.1 and 3.1. Preparing a lawsuit for a person to file pro se requires that the lawyer make a sufficient inquiry of the facts and research of applicable law to ensure that the pleading contains claims that are not frivolous. Further, depending on the complexity of the case and the sophistication of the limited scope client, the preparation of a lawsuit for the limited scope client may not be an appropriate means by which to accomplish the client’s objectives. See Rule 1.2. When limited scope representation is considered for a pro se litigant, the lawyer must meet the “consultation” requirement of Rule 1.2 by explaining to the client the advantages and disadvantages of limited scope versus full representation.

This Committee concludes that the Rules of Professional Conduct do not prohibit undisclosed assistance to a pro se litigant. However, lawyers who undertake to prepare or assist in the preparation of a pleading for a pro se litigant may advise the pro se litigant to insert a statement to the effect that “this document was prepared with the assistance of a licensed and active member of the Virginia State Bar.” Because the fact of the lawyer’s assistance may be confidential under Rule 1.6(a), the lawyer should not include such a statement if the client objects to revealing that fact.

Virginia LEO 1874 concluded by stating “[t]his opinion is advisory only and is not binding on any court or tribunal.” The court in In re Tucker, 516 B.R. 340, 344 (Bankr. W.D. Va. 2014), promptly declined to follow it, stating “[t]he Court accepts the Debtor’s testimony that she received no undisclosed assistance on the Motion. However, given the nature of the Motion and the manner in which it was drafted, it raised the suspicion of having been ‘ghost-written.’ The Virginia State Bar recently released Legal Ethics Opinion 1874 (‘LEO 1874’) on the subject of ‘ghost-writing’ for pro se litigants, finding it to be not objectionable in certain circumstances. To the extent that the practicing bar may intend to rely on LEO 1874 in the future
to ‘ghost-write’ in this Court, all counsel should be aware that this Court takes a different view. This Court agrees with those courts that find, at a minimum, the practice of ghost-writing transgresses counsel’s duty of candor to the Court and such practice is expressly disavowed. See, e.g., Chaplin v. DuPont Advance Fiber Sys., 303 F. Supp. 2d 766, 773 (E.D. Va. 2004) (“[T]he practice of ghost-writing will not be tolerated in this Court.”); In re Mungo, 305 B.R. 762, 767–70 (Bankr. D. S.C. 2003).”

C. Case Law

The most notable case arising after the ABA’s ethics opinion is In re Liu, 664 F.3d 367 (2d. Cir. 2011). In Liu, the attorney at issue was referred to the Second Circuit grievance committee for preparing documents on appeal for pro se litigants without disclosing her involvement. The grievance committee found that Liu had engaged in conduct “unbecoming” of a member of the bar and recommended a public reprimand. The Second Circuit adopted the Committee recommendations, except it did not adopt the finding that Liu violated her duty of candor to the court. Liu examined the ABA 2007 ethics opinion, as well as modifications to ethics opinions in the State of New York, and noted the confusing state of the law on ghostwriting and the changing legal landscape. Specifically, the court stated “[i]n light of this Court’s lack of any rule or precedent governing attorney ghostwriting, and the various authorities that permit that practice, we conclude that Liu could not have been aware of any general obligation to disclose her participation to this Court. We also conclude that there is no evidence suggesting that Liu knew, or should have known, that she was withholding material information from the Court or that she otherwise acted in bad faith. The petitions for review now at issue were fairly simple and unlikely to have caused any confusion or prejudice. Additionally, there is no indication that Liu sought, or was aware that she might obtain, any unfair advantage through her ghostwriting. Finally, Liu’s motive in preparing the petitions to preserve the petitioners’ right of review by satisfying the thirty-day jurisdictional deadline demonstrated concern for her clients rather than a desire to mislead this Court or opposing parties. Under these circumstances, we conclude that Liu’s ghostwriting did not constitute misconduct and therefore does not warrant the imposition of discipline.” Id. at 377.

However, in In re Hood, 727 F.3d 1360 (11th Cir. 2013), the Bankruptcy Court held that attorneys, who failed to sign a Chapter 13 petition filed on behalf of a debtor, acted as ghostwriters, violated the Florida Rules of Professional Conduct and thus perpetrated fraud on the court. The district court affirmed that decision. However, the appeals court found that the attorneys were not subject to discipline by the court and reversed the District Court’s ruling affirming the Bankruptcy Court’s sanctions. The Florida Rules of Professional Conduct provide that a lawyer shall not make a false statement of fact or engage in conduct involving dishonesty or misrepresentation. The Florida rules do, however, permit limited scope representation. The Court noted, “[i]f the lawyer assists a pro se litigant by drafting any document to be submitted to a court, the lawyer is not obligated to sign the document. . . . But the lawyer must indicate ‘Prepared with the assistance of counsel’ on the document to avoid misleading the court, which otherwise might be under the impression that the person, who appears to be proceeding pro se, has received no assistance from a lawyer.” Id. at 1363-364 (internal citations and quotations omitted). The Court then cited to the definition of “draft” according to Black’s Law Dictionary, “[t]o write or compose,” and held as follows:
It is apparent to us that under the plain language of the rule, Appellants did not “draft” a document for [the debtor]. . . . They did not “write or compose” the preformatted Chapter 13 petition. . . . To the contrary, Appellants recorded answers on a standard fill-in-the-blank Chapter 13 petition based on [the debtor’s] verbal responses. Moreover, [the debtor] personally signed the petition. . . . Regardless, a Chapter 13 petition stands in stark contrast to a ghostwritten pro se brief, such as the brief drafted by the undisclosed attorney in Duran, 238 F.3d at 1273, and noted by the court in Ellis, 448 F.2d at 1328. A legal brief is a substantive pleading that requires extensive preparation; much more than is necessary for the completion of a basic, fill-in-the-blank bankruptcy petition.

To that end, the Chapter 13 petition at issue is comparable to the documents filed by undisclosed counsel in Liu. . . . Similar to Liu, we see no fraudulent intent . . . by Appellants. Rather, they were attempting to assist [the debtor] with the completion of a straightforward pro se Chapter 13 petition for which there was no unfair advantage to be gained. . . . A Chapter 13 petition is a publicly available form that is designed in a manner that lends itself to a pro se litigant. [The debtor] could have personally completed the petition at issue in the exact same manner and likely obtained the same result. . . . Appellants’ conduct was not fraudulent.

Id. at 1364-365.

But, the needle has only moved so far. In In re Ruiz, 515 B.R. 362 (Bankr. M.D. Fla. 2014), the court held that a law firm could not “unbundle” services and only represent the debtor before and after the filing of case, but not formally appear in the case, sign the petition or appear with debtor at the section 341 meeting of creditors. The court held that counsel had the responsibility to appear with debtor at hearings after it had met with the debtor, advised him on the proper bankruptcy chapter to file and prepared the petition and other documents for filing. Attorneys cannot provide services for consultation and preparation of the petition but then cause the debtor to file pro se. The court stated, “The Law Firm cannot evade their responsibilities under Local Rule 9011-1 by doing all the work and then giving the Debtor the papers to file falsely pretending he is acting pro se.” Id. at 365. The court then concluded that “a limitation on representation that excludes attendance at the meeting of creditors and other fundamental duties is not reasonable under the circumstances . . . .” Id. at 367.

The purpose of our Local Rules . . . is to make sure that lawyers do not abandon a client during an on-going case or proceeding. In this respect, the judges in the Middle District of Florida consistently have interpreted the Local Rules as meaning “in for a penny, in for a pound!” An attorney cannot do some, but not all, of the tasks a debtor needs, unless they ask the Court to withdraw and the Court agrees. The Law Firm must sign the Debtor’s petition and is governed by Local Rule 9011–1. They cannot limit their services by agreement but must seek approval from the Court before they can “unbundle” or reduce their responsibilities.

Id. While the attorneys relied on Hood in support of their position, the court found that Hood was inapplicable, that the attorneys here did more than simply “fill in the blanks” when they advised the debtor on the type of bankruptcy he should file, on what exemptions he should claim and assisted him in completing the Statement of Financial Affairs and other schedules. The court
ultimately held that their attempt to limit the scope of services in this manner violated the Florida Rules of Conduct and required them to disgorge the attorney’s fee received.

In re Dreamplay, Inc., 534 B.R. 106 (Bankr. D. Md. 2015), involved a Court’s show cause order against an attorney who was not admitted to practice in that court but acted as a “ghost” attorney to a creditor in the case under a “limited representation agreement” without either pro hac vice status or a proper license to practice in Maryland.

Rule 9011 provides that every paper filed in a bankruptcy case, “shall be signed by at least one attorney of record in the attorney’s individual name. A party who is not represented by an attorney shall sign all papers. Each paper shall state the signer’s address and telephone number. . . .” The Rule’s express language underscores its primary purpose: to insure that a paper’s author take responsibility for what the paper says and to hold the author accountable for statements made within the paper’s four corners. See Rule 9011(b) and (c); In re Mungo, 305 B.R. 762, 768 (Bankr. D. S.C. 2003). Mr. Raynor [the attorney] admitted (as did Mr. DeLuca [the creditor]) that he assisted in the preparation of legal papers filed in this case on Mr. DeLuca’s behalf. Accordingly, and while he was not the attorney “of record” solely because he declined to formally seek pro hac vice status or otherwise expressly enter his appearance, his decision to try and maintain an ambiguous posture, by giving advice and preparing documents but intentionally not signing them, constitutes a violation of Rule 9011.

Id. at 119. The court noted that the creditor referenced the attorney’s assistance in certain pleadings in footnotes appended to the creditor’s signature block where additional “boldface misrepresentations as to [the creditor’s] ‘pro se’ status were also included . . . .” Id. at 113. This discussion then followed:

Mr. DeLuca did make Mr. Raynor’s representation known through the footnotes. However, operating under the belief that Mr. DeLuca was proceeding in a genuine pro se fashion, the Oversigned at first did not notice the footnotes. They should have been noticed and the Oversigned accepts responsibility for the failure to do so. When no action was taken by the Court at the very beginning of the case, Mr. DeLuca and Mr. Raynor could have concluded that the Court was not concerned.

. . .

Nevertheless, Mr. Raynor is personally responsible for conducting himself in a lawful manner and an attorney who actively represents a client in a case is bound to do so in the manner required by law and procedure. It cannot be done from the Twilight Zone of shadowy, deflected responsibility where a lawyer is able to point the finger of blame at his client or otherwise duck and dodge when called to account for either advice or statements. The process of uncovering who is responsible for the specific representations included in a paper, and the advice given a client (when relevant and not privileged), cannot be reduced to a guessing game. Moreover, whether “ghostwriting” may ever be deemed permissible in this Circuit, that would not excuse an out of state, unadmitted attorney from practicing law without either a license or pro hac vice approval. Especially so in this case where Mr. Raynor advised Mr. DeLuca that it would be appropriate for Mr. DeLuca to try and torpedo
the Debtor’s reorganization by violating the automatic stay through the seizure of the liquor license. Mr. Raynor would like to be able to do this under the guise of “assistance” and accept no responsibility for his incompetent, grossly erroneous advice. To put it mildly, that sort of chaos does not enhance the administration of justice. It would allow any attorney anywhere to dive into a case, no matter the jurisdiction, with free rein and no attendant responsibility. If the Court had realized at the beginning that it was Mr. Raynor who was doling out “free advice” calculated to upend the reorganization, then he would have been heavily sanctioned . . . . However, because of the Court’s error in not noticing the footnotes, no monetary sanctions will be levied at this time.

Id. at 120-121. The Court barred the attorney from ever practicing law in that court, ordered him to submit the opinion to the Nebraska Supreme Court Counsel for Discipline, and ordered that all papers filed on the creditor’s behalf that the attorney participated in the preparation of be stricken and vacated from the record.

In re Smith, Case Nos. 12-11603, 12-11857, 2013 WL 1092059 (Bankr. E.D. Tenn. Jan. 30, 2013), involved an attorney who was awaiting reinstatement to practice in bankruptcy court after being suspended by the Tennessee Supreme Court. While still suspended, counsel undertook to represent debtors and assisted with preparation of all documents required for filing. However, the debtors signed the petitions stating they were not represented by counsel, even though counsel’s office filed the skeleton petitions for the debtors in the Clerk’s Office. After counsel was readmitted to practice, she filed a notice of appearance in the cases disclosing her representation and electronically filed the remaining documents. Counsel took the position that she was allowed by the Tennessee Rules of Professional Conduct to limit the scope of her representation and that the scope of her employment included everything except using the electronic case filing system and presumably appearing before the court before she was reinstated. The United States Trustee, on the other hand, contended that counsel’s instructions to her clients that they sign their petitions to reflect that they were not represented by counsel was part of a scheme to avoid the consequences of her suspension and was an effort to defraud the court. The court, finding that counsel committed ethical violations, ruled as follows:

Although the court finds a limitation of representation does not per se violate [counsel’s] professional obligations, the manner in which she attempted to limit her representation did result in an ethical violation. First, her limitation was ineffective. Second, she did not obtain her clients’ informed consent to such a limitation. Third, and most importantly, the court finds that the limited representation as [counsel] has portrayed it was not reasonable under the circumstances of these two cases. Second, the court finds that the nondisclosure of an attorney’s participation is a breach of the attorney’s duties of candor to the tribunal. This court holds that directing a client to make an affirmative misrepresentation about attorney participation is an act of dishonesty. Further, the court finds that a misrepresentation about attorney participation is a material misrepresentation in a bankruptcy proceeding. The court also notes that these holdings on disclosure of attorney participation appear to be ones of first impression in this court. The court also acknowledges that the issue of whether nondisclosure of attorney involvement is an ethical violation is the subject of academic discussion and legal controversy between bar associations seeking to provide citizens with more representation and
courts seeking to ensure fairness and candor in litigation. While [counsel] directed her clients to make an affirmative misrepresentation to the court and she failed to disclose her participation in the cases, the court finds that she did not knowingly breach her duty to the tribunal based on the state of the case law and applicable ethics opinions regarding disclosure of attorney participation. The court also finds that [counsel] violated Fed. R. Bankr. P. 9011 by presenting the petitions for an improper purpose.

Id. at *2. However, the court stated that it “is hesitant to find that ghostwriting is improper under any circumstance in light of the position taken in the [Tennessee Board of Professional Responsibility] 2007 Formal Opinion, which allows nondisclosure of the identity of the attorney where the attorney is only assisting with a leading pleading and the scope of services has been appropriately limited.” Id. at 22. The court sanctioned counsel by requiring her to complete six hours of continuing legal education on professionalism and ethics, to reimburse any expenses incurred by the debtors as a result of having to obtain new counsel or attend multiple meetings of creditors and to pay attorney’s fees and expenses up to $1,000 to the chapter 13 trustee and to the United States Trustee. The court, however, acknowledging the changing ethics rules on this subject, found that counsel did not knowingly violate the rules of professional conduct and only admonished counsel that nondisclosure of attorney participation in a bankruptcy proceeding is a violation of the duty of candor to the court. The court further noted,

In the future, the requirement of disclosure should be clear for any attorney considering whether to ghostwrite pleadings and present them to this court. If an attorney drafts a pleading for filing with this court, or assists a debtor with drafting a pleading or completing the answers to any form knowing that it is going to be filed with the court and presented as the debtor’s work, the attorney must be disclose that assistance. Because the court has found that his or her identity is material to the proper administration of the bankruptcy case, he or she must also disclose his or her identity. If the attorney has limited the scope of his or her representation, the disclosure and participation in the case should be consistent with any representation agreement reached with the client. If there is any limitation of the scope of bankruptcy representation, the attorney must obtain the informed consent of the client to the limitation. The scope of the representation should be in writing in order to comply with the requirements of 11 U.S.C. §§ 526 and 528. Finally, the attorney should be prepared to demonstrate that the limitation is reasonable under the circumstances of the case.

Id. at 24.

IV. Where is Ghostwriting in Bankruptcy Headed?

Despite the push for unbundling, many courts are still resistant to the concept, especially as it pertains to ghostwriting. Old habits die hard. Perhaps those states that allow ghostwriting with disclosure of an attorney’s identity coupled with a limited-scope representation that will not require court permission to withdraw might be a middle ground. Florida, Maine, Nevada, Washington and Wyoming have moved in that direction. Ostergard, 92 Neb. L. Rev. at 676. Overall, the current status of the law on ghostwriting may best be summed up by Zach Mosner, an Attorney General from Washington State. In an ABI Journal article from a few years ago,
Mosner stated:

In the end, when the court asks, “Who ya gonna call?” to account for actions in the case, will the client be left on his own? Or will the ghostwriting lawyer behind the curtain be forced to step out and account for the fact that although he/she might be a good person as the Wizard insisted, he/she may not be a particularly good lawyer. In the end, it may take both the vigilance of all parties in the case and renewed attention to these issues in each state’s [Rules of Professional Conduct] to ensure that the system as a whole copes with the twin issues of unbundling and ghostwriting.

A thorough and well-prepared Chapter 7 bankruptcy case is a time-consuming process for the attorney and his or her staff members. My experience over 25 years of practicing consumer and commercial debtor work causes me to estimate that the average attorney time for the most simple Chapter 7 case with a low maintenance client ranges from 3 hours to 5 hours, allocated as follows:

- Initial consultation: 30 minutes to 60 minutes
- Review of drafts and general responses to inquiries from staff and client: 30 minutes
- Signing of petition: 45 minutes to 60 minutes
- Preparation for and attendance of 341 hearing: 45 minutes to 90 minutes
- Post-petition (without reaffirmation or motion for relief): 30 minutes to 60 minutes

A thorough and experienced legal assistant spends even more time preparing the documents necessary for the process, communicating with the client and trustee and remitting the necessary information to the participants. My legal assistant, with more than 20 years of experience, estimates that she spends between 6.5 hours to 9.5 hours on a simple Chapter 7 case completing the following tasks:

- **Gathering information and documents from client**: 1 hour to 4 hours. This depends upon on how organized and tech savvy the client is. If the client can pull the bank statements, insurance documents, DMV transcripts, credit report, tax returns, pay advices through online transactions it takes about an hour. If the assistant has to help them download their land records, contact their HR department for benefits and pay advices or log on to the bank accounts and pull the statements for them and figure out what their monthly expenses are and search VA Judicial courts for civil matters it can take longer.

- **Inputting into the software program**: 2 hours. This depends upon how thorough the client is in answering the questionnaire. If they guess and it does not make sense, the assistant will “audit” their bank statements for transactions that are routine for monthly expenses and/or out of the normal purchases. The assistant also reviews their assets with the client.

- **Final preparation for final signing**: 1 hour

- **Electronic Filing of Bankruptcy case**: 15 minutes

- **Post-petition transmittals to client**: 30 minutes using form letters

- **Post-petition transmittals to trustee**: 30 to 45 minutes. Most documents are saved in such a way during the work up process that they are easily uploaded to the Trustee’s website. During the uploading, the assistant will compare to the final schedules to ensure accuracy between the schedules and documents saved.
• **Filing of Homestead Deed**: 45 minutes. Homestead deeds are recorded electronically for most cities/counties and might take 45 minutes (scan, create a coversheet if needed, save, and upload to Simplifile).

The time estimates reflected above are based upon my experience in the most simple case with no reaffirmation agreements, motions for relief from stay or other complications. The time required in a case with motions, objections, assets and reaffirmations for both the attorney and the staff member increases considerably.

The Chapter 7 consumer attorney is competing with the petition preparer who is charging somewhere between $120.00 to $400.00 to prepare the petition in the debtor’s Chapter 7 case. As observed by so many Courts and through my own experience, many Chapter 7 debtors are attempting to navigate the Chapter 7 process without counsel. The national statistics reflect approximately 8% of Chapter 7 cases are *pro se*. A statistical report shows the growth of *pro se* filings in the Eastern District of Virginia, Fourth Circuit and the United States:

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To further support *pro se* filings, a debtor cannot obtain a waiver of the filing fee if he or she pays any compensation to an attorney. Thus, the debtor can often save the $335 filing fee by attempting to file *pro se*.

The Courts and bankruptcy experts struggle with ensuring “access to justice” for individuals who are not able to pay the full Chapter 7 professional fee prior to the filing. The legal and ethical implications for the consumer Chapter 7 attorney are complicated. The issues are further complicated by lawyers and law firms that take advantage of desperate debtors. Creativity abounds!

**Informal Survey of Chapter 7 Consumer Firms in My Area**

Over the course of the past several months, I “interviewed” about 15 different attorneys representing 15 different law firms in the area. Several of the attorneys I interviewed had experience with other law firms for which they had previously been employed. I inquired into the different methods the attorney or their firm might employ to get paid by that Chapter 7 debtor who simply could not come up with the entire filing fee:

• All of them said the best practice was to require full payment up front for the full panoply of issues that might arise in Chapter 7, excluding adversary proceedings or unusual litigation. They routinely take payments from the client over time and file the case once the total fees and costs is accumulated. The fees for filing the Chapter 7 would vary but the lowest fee mentioned was $699.00 plus costs.

• Many recounted stories of filing the bankruptcy without the receipt of the full Chapter 7 attorneys’ fee. The lawyer would rely upon the client’s promise to pay the balance
after the case. Many of the lawyers would go unpaid and after getting “burned” would discontinue reliance upon a client’s willingness to keep his or her promise after filing.

- Many of them noted other law firms that would use Chapter 13 as a method for obtaining fees or even increased fees for representing what should have been a Chapter 7 debtor. The lawyer would have stories of consulting with debtors, after dismissal of the failed Chapter 13, and achieving a quick discharge through Chapter 7. Very few attorneys recommended the filing of Chapter 13 in order to obtain payment of the Chapter 7 attorney’s fees. Many of the attorneys with whom I spoke expressly commented that it was unethical to put a client into Chapter 13 solely to finance attorneys’ fees paid or obtain an increased fee. A Craig’s List ad for our area states:

  Did the big Law Firm tell you that you could not file a Chapter 7? Did you know that they make more money if you file a Chapter 13? Maybe they were honest that you do not qualify to file a Chapter 7, but maybe they simply want more of your money. Let us give you a free consultation in which we will review your circumstances and tell you whether they were right or whether we can file a Chapter 7 for you and save you money. You have nothing to lose and everything to gain by getting this free second opinion.

- If a garnishment caused the debtor to lack resources, a few would take an assignment of garnished funds to ensure payment of the fees.

- One attorney mentioned a barter exchange, where the client sold something to the lawyer for cash, the cash was then used to pay the Chapter 7 attorneys’ fees. The exchange was disclosed in the bankruptcy papers.

- None would accept post-dated checks. Some recall that the practice of accepting post-dated checks had been routine many, many years ago. However, it has become unacceptable and rarely utilized.

- Many acknowledged instances where the client and attorney would discuss sources from which the attorneys’ fees could be paid (payday loans, home equity lines, credit cards, etc.). The lawyer was typically careful to advise the client that the lawyer could not recommend the client incur debt prior to the bankruptcy case. The lawyer would also advise the client that any loans made near the time of the bankruptcy filing would have to be paid post-petition. Having been advised, it was then the client’s decision whether to get the payday loan or take money off of a credit card.

- One attorney acknowledged that over the years he has, in various cases where the Debtor could not afford the up-front flat fee, allowed the Debtor to make a pre-petition down payment for the legal work associated with the Chapter 7 then accept the balance of the fee after the bankruptcy was filed. This was a practice that he had seen utilized by the senior attorney at his firm as he was starting practice. He knew that he could not enforce the post-petition payment obligation since it would be subject to the automatic stay and ultimately discharged. He disclosed it fully on the Statement of Compensation. Sometimes the client would pay and sometimes the client would not pay. He acknowledged the risk that he bore in this situation.
• None of the firms participated in “unbundling” or “bifurcated fee arrangements.” Several of the lawyers believe that the vast majority of the work in the case is done pre-petition; thus, there would be little to charge for in a bifurcated situation.

• Many of the high volume Chapter 13 firms would acknowledge charging some consumer Chapter 7 clients very, very low fees for Chapter 7. The pricing was more of a marketing decision, where the firm felt keeping the work in house would help generate Chapter 13 business down the road through referrals from these individuals. Due to their overhead structure, these volume firms could absorb the financial losses on these Chapter 7 cases more easily than a smaller law firm.

• None of the attorneys with whom I spoke participated in “factoring.” All of them were aware of an attorney practicing in our area who participated in a factoring type arrangement and had been subject to discipline by the Court.

• At least one attorney with whom I spoke continued to do business with and through Upright Law. This attorney has an excellent reputation in our community and does high quality Chapter 7 work for consumer and commercial debtors. He reviewed the legal opinions issued on Upright from the various jurisdictions and believes that the partnership arrangement is allowable. This attorney implements strong processes to ensure that the Debtors are provided competent representation. He uses the procedures for handling Chapter 7 cases that he has always utilized whether in an Upright case or for a case not generated through Upright.

• Many acknowledged that if the debtor was extremely sympathetic and the situation was very dire, the attorney would reduce the fee to try to make it more affordable for the Debtor.

Ethical Rules to Consider When Evaluating Compensation for a Consumer Chapter 7 Attorney

Virginia Rules of Professional Conduct

Rule 1.2 –

(b) A lawyer may limit the objectives of the representation if the client consents after consultation;

Rule 1.4 –

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

Rule 1.5 –

(a) A lawyer’s fee shall be reasonable. 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 fee is fixed or contingent.
(b) The lawyer’s fee shall be adequately explained to the client. When the lawyer
has not regularly represented the client, the amount, basis or rate of the fee
shall be communicated to the client, preferably in writing, before or within a
reasonable time after commencing the representation.

Rule 1.8 –
(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 can be reasonably understood by the client;
(2) the client is given a reasonable opportunity to seek the advice of independent
counsel in the transaction; and
(3) the client consents in writing thereto.

Rule 7.1 -
A lawyer shall not make a false or misleading communication about the lawyer or the
lawyer’s services. A communication is false or misleading if it contains a material
misrepresentation of fact or law, or omits a fact necessary to make the statement
considered as a whole not materially misleading.

The primary ethical issues for attorneys confronted with the creative management of
obtaining payment for Chapter 7 bankruptcy cases is the conflict that can arise and the necessity
that the lawyer’s representation as to the extent of the service provided in exchange for the fee
not be false or misleading. The attorney’s desire to be paid is in conflict with the advice the
attorney might give the client to avoid the payment and take full advantage of the bankruptcy
stay and discharge. The Courts and Ethics Committees have been grappling with the issues in
recent opinions.

**Bifurcated Fee Agreements**

It appears that Courts and other bankruptcy specialists are moving in the direction of
approving “unbundling” and “bifurcated fee agreements” in the Chapter 7 consumer context in
very limited contexts and subject to extensive disclosure and consent requirements. An April
In this recent option, the Court evaluated, among other things, a bifurcated fee agreement in a situation where “the Debtor lacked the funds to pay a pre-petition retainer for an attorney to represent him in a Chapter 7 case. Capstone Law offered the Debtor a bifurcated fee arrangement that involved no retainer for filing the petition, and then a post-petition fee agreement to pay $2,000 in ten monthly installments.” The Court evaluated whether it was legally and ethically permissible for an attorney to enter into this type of arrangement with a Chapter 7 client.

Capstone Law was approached by the Debtor who was on the cusp of having a default judgment entered against him. The Debtor had consulted with another law firm who quoted a $1,200 (plus costs) upfront fee for the Chapter 7 case. Capstone presented the Debtor with three options: (a) pay $2,400 upfront (which included the filing fee) for the entire Chapter 7; (b) sign a pre-petition agreement to pay $500.00 for the preparation of the petition, statement of SSN and application to pay the filing fee in installments (the “Initial Papers”), then the Debtor, after the filing, could chose to proceed pro se, hire another law firm to complete the case or enter into a post-petition agreement with Capstone Law to complete the case; or (c) sign a prepetition agreement to pay $0 for preparation of the Initial Papers, with the option to either proceed pro se, hire another attorney to finish the case or pay $2,400 (which included the filing fee) over 10 months at $240 per month. The Debtor chose option (c) – the “Zero Down Option.”

Capstone provided the Debtor with the following disclosures as part of the Debtor’s selection of the Zero Down Option:

- Pre-petition Agreement
- Two-Contract Disclosure
- Third party Disclosure and Consent

The Court made a factual finding that “the above-mentioned documents included a multitude of disclosures, explanations, and warnings regarding the fee arrangement, the bankruptcy process, the possible use of BK Billing as a third party to collect payments, and the importance of providing true, complete and accurate information” to the attorney.

The case was filed and the Debtor received a discharge. The case proceeded without incident. The U.S. Trustee moved to reopen the case and sought to have the Court hold the attorney in contempt and for the imposition of sanctions based upon the bifurcated fee arrangement.

At the beginning of the opinion, the Court noted the various “work arounds” used by attorneys and debtors when the debtor could not pay the up-front Chapter 7 attorneys fee and filing fee. These included:

- Filing Chapter 13 solely to finance attorney fees.
- Issuance by the Debtor to the attorney of post-dated checks
- Withdrawal by the Debtor of funds from retirement accounts
- Payment of the legal fees through a credit card or an advance against a home equity line of credit
The Court also noted the widespread utilization by Debtors of petition preparers and the increasing *pro se* debtors navigating through Chapter 7. The Court observed that “[u]nder either of these *pro se* options, the Chapter 7 consumer system becomes unnecessarily time-consuming and ineffective for debtors, creditors, trustees, and the Court.” In the opening pages of the Court’s opinion, Judge Anderson cites to numerous legal opinions and articles discussing the legal and ethical conundrum of “providing consumer debtors with competent legal representation.”

Those high-minded [applicable ethical canons with their] requirements and restrictions often result in greater prejudice to debtors who do not receive a discharge (or worse are denied a discharge under 727) simply because they are too poor to pay a retainer up front to procure the needed legal representation. . . . Lastly, these impediments are sometimes enforced against counsel based upon an assumption that debtors are unable to make rational decision about how best to manage their financial affairs and legal options. With appropriate disclosure, debtors can make informed decisions as to the risks and benefits of incurring a post-petition obligation in order to retain an attorney’s services.

The Court evaluated Utah’s Rules of Professional Conduct. It cited to a Utah Ethics Opinion which addressed “zero-down” bankruptcy filings, bifurcated fee agreements and the factoring of attorneys’ fees in Chapter 7s. The Court would not address whether unbundling (when the lawyer limits the scope of his or her engagement and the client gives informed consent) was allowable in the Utah bankruptcy court. It concluded that “the propriety of using bifurcated fees agreements in consumer Chapter 7 cases is directly proportional to the level of disclosure and information the attorney provides to the client, and the existence of documentary evidence that the client made an informed and voluntary election to enter into a post-petition fee agreement.” In the *Hazlett* case, the Court determined that the disclosures were sufficient, the documentary evidence was sufficient and the consent by the Debtor was informed and voluntary.

**Utah Ethics Opinion on Unbundling and Bifurcated Fee Agreements**

The *Hazlett* Court, in evaluating the legality of the Bifurcated Fee Agreement, relied upon a recent Utah Legal Ethics Opinion. In Opinion Number 17-06 (Revised), August 16, 2018, the Utah Ethics Advisory Opinion Committee opined, as to bifurcated fee agreements, that:

> In connection with the disclosures required under paragraph 2 above to avoid running afoul of Rule 7.1(a) of the Utah Rules of Professional Conduct [concerning whether an advertisement for a $99 Chapter 7 Bankruptcy], an attorney must disclose that her fees for post-petition work will be more substantial and not dischargeable in the consumer bankruptcy. The attorney cannot “unbundle” the filing of the petition unless it is reasonable under the circumstances to do so. Further, no case can be unbundled where prohibited by statute, case law or court rules.

The analysis of the Committee focused on whether the limitation was reasonable and on the level of disclosure provided to the client and whether the client’s consent was adequately informed. The Committee, in discussing unbundling, stated: “Indeed, propriety of unbundling a petition may be the *exception rather than the usual practice.*”
**Recommendation of ABI Bankruptcy Ethic Task Force on “Unbundling”**

The ABI Bankruptcy Ethics Task Force recently issued a “Best Practices for Limited Services Representation in Consumer Bankruptcy Cases” as part of the “Final Report of the ABI Commission on Consumer Bankruptcy” published by the American Bankruptcy Institute.6 The Task Force noted that state and federal bar associations along with the state and federal judiciary have focused more intently on solving the problem of “access to justice” for debtors confronted with large attorney fees to obtain competent Chapter 7 representation. The Task Force observed that some Courts are willing to embrace and have embraced limited scope representation while others prohibit it all together.

The Task Force cited to Model Rule of Professional Conduct 1.2(c) which states: “[a] lawyer may limit the scope of representation if the limitation is reasonable under the circumstances and the client gives informed consent.” Model Rule 1.0(h) provides that “reasonable” must be attuned to the “conduct of a reasonably prudent and competent lawyer.” The recommendation of the Task Force was limited to those jurisdictions where the Rules of Professional Conduct allow limited representation by an attorney.

For the consumer Chapter 7 debtor ineligible for legal aid but not able to pay the full Chapter 7 attorneys fee and costs, the Task Force issued a “Best Practices” statement declaring that “[b]est practices, at a minimum, require the following:

1) The initial client interview and counseling should make clear the expected scope of representation and the expected limited fee.

2) Attorneys counseling unsophisticated consumer debtors must be mindful, when gathering initial information to assess a case, to avoid the formation of the debtor's perception that a full-scale attorney-client relationship is being formed.

3) An engagement letter and informed consent should be prepared in plain language and carefully reviewed with the debtor. This letter must clearly and conspicuously set forth the services being provided, the services not being provided, and the potential consequences of the limited services arrangement.

4) The engagement letter must also clearly describe the fee arrangement, including a statement of how fees for additional services will be charged.

5) All documents and disclosures filed with the bankruptcy court should be done with full candor consistent with the attorney’s duty of confidentiality, disclosing the exact nature of the representation and the calculation of fees for services being provided.

6) In the event that withdrawal from the unbundled representation becomes warranted, attorneys must be mindful of protecting their client's interests to the fullest extent practical when exiting the case.

7) As is the case with all legal representation, if the attorney becomes aware of a legal remedy, problem, or alternative outside of the scope of his or her representation, the client must be promptly informed. The attorney has the further

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obligation to provide his or her client with a thorough explanation of the potential benefits and harms implicated, in order for the client to make an informed decision as to how to proceed.

**Compilation of Recent Publications and Articles**

**Discussing Financing and Payment of the Chapter 7 Attorneys Fees**


Alternative Fee Payment Arrangements in Consumer Cases:
The Good, the Bad and the Ugly

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Getting paid appropriately for the representation of consumer debtors has plagued bankruptcy attorneys since the inception of the bankruptcy system. As noted in a recent report from the ABI Commission on Consumer Bankruptcy, “How consumers pay for legal representation in bankruptcy is one of the most important issues facing the bankruptcy system. … A bankruptcy system that works only for those who can pay for legal representation does not further the American ideal of equal justice under law.” Final Report of the ABI Commission on Consumer Bankruptcy (the “Report”), at pages 89-90.

The payment dilemma was exacerbated in 2004, when the Supreme Court ruled in Lamie v. U.S. Trustee, 540 U.S. 526 (2004), that attorneys for Chapter 7 debtors could not be paid as an administrative expense from assets of the estate.

Traditionally, attorneys for debtors have obtained payment for their services through one of four ways: (a) an upfront payment for all services; (b) a small down payment with an unenforceable promise to pay the rest from a potentially grateful debtor; (c) a bifurcation of pre-petition and post-petition services, with the post-petition services to be delivered only upon post-petition payments; and (d) payment through a Chapter 13 filing, whether or not such a filing was in the best interests of the debtor. Report, at pages 90-92.

This presentation looks at the non-traditional ways that attorneys for debtors have sought compensation for their services, the disclosure requirements that apply, and the often unfortunate results that accompany those efforts.

Note: the material discusses matters related to cases pending before Bankruptcy Judge Paul Black, who also is presenting materials with this panel. These materials have been prepared without any consultation or discussion of any kind with Judge Black, and do not reflect any opinions of him.

I. The Ground Rules for Getting Paid in Bankruptcy

The authority of the bankruptcy courts to supervise the lawyers practicing before them is broad and inherent, and extends the supervision of the entirety of the relationship between the debtor and her attorney. See, e.g., Glatter v. Mroz (In re Mroz), 65 F.3d 1567, 1575 (11th Cir. 1995) (holding that bankruptcy court's imposition of sanctions was a proper use of its inherent power to control proceedings).

This expansive authority is part and parcel of the bankruptcy system, and has existed for over a century, since the adoption of the Bankruptcy Act of 1898, which included ---- From the
inception, the courts have been concerned that financially distressed debtors will either take advantage of their limited resources to protect their own interests against their creditors, or that the financially distressed debtors will be taken advantage of by their own attorneys, if the debtors are incapable of protecting their own interests.

A. The Bankruptcy Code’s Disclosure Requirements

No matter where the fees comes from, how much the fee is, or who pays it, the debtor’s attorney must disclose—openly, candidly, and completely—all of the circumstances surrounding the payment of her fee. Transparency in all matters pertaining to the payment of fees to a debtor’s counsel is enforced strictly, in order to prevent “the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure.” In re Wood, 210 U.S. 246, 28 S.Ct. 621, 52 L.Ed. 1046 (1908).

The disclosure requirements found in Section 329 and Rule 2016 are “mandatory, not permissive.” Turner v. Davis, Gillenwater & Lynch (In re Investment Bankers, Inc.), 4 F.3d 1556, 1565 (10th Cir.1993) (quoting In re Bennett, 133 B.R. 374, 378 (Bankr.N.D.Tex.1991). They demand that debtor’s counsel provide the bankruptcy court with “the precise nature of the fee arrangement” with the debtor. Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park–Helena Corp.), 63 F.3d 877, 881 (9th Cir.1995). The disclosure requirements are not the place to play games with the bankruptcy court: “Counsel's fee revelations must be direct and comprehensive. Coy or incomplete disclosures which leave the court to ferret out pertinent information from other sources are not sufficient.” In re Saturley, 131 B.R. 509, 517 (Bankr.D.Me.1991).

As the Bankruptcy Court noted in In re Sanchez, 372 B.R. 289, 304–05 (Bankr. S.D. Tex. 2007), “The three most important words in the bankruptcy system are: disclose, disclose, disclose.” The bankruptcy system requires that the lawyers practicing in it be compensated in a manner that allows them to do their jobs; but courts will punish those lawyers who fail to live up to their disclosure obligations.

The information disclosed by counsel must be scrupulously accurate both in the papers filed with the bankruptcy court, and in the oral representations to the court. In In re Ryan, 517 B.R. 905, 908 (Bankr. E.D. Wis. 2014), the debtor’s law firm disclosed that it was charging a $3,500 fee, of which none had been paid, and repeated this assertion in the debtor’s statement of financial affairs; in truth, the debtor had previously paid fees of $950, in addition to the filing fee and credit counseling fee. These errors, admitted in a hearing before the court, were sufficient to prevent debtor’s counsel from receiving any further compensation in the case, whether from the debtor or the estate.

The disclosures of the debtor’s counsel must include any discounts given by the attorney or commissions received by a processing agent. In re Wright, 591 B.R. 68, 92 (Bankr. N.D. Okla. 2018). In Wright, the debtor’s lawyer:

disclosed that he had agreed to accept $1,500 for legal services with a balance due of $1,425, when he actually had agreed to receive $855, plus $213.75 paid to escrow, from BK Billing. The statement is flat-out deceptive, whether or not that is what [the lawyer] intended. The disclosure conflates the total amount a debtor
agreed to pay for his services with the amount he agreed to accept for his services, even though those amounts differ by several hundred dollars in each of the BK Billing Cases.

Id. Again, the failure to be completely open, candid and transparent in all dealing with regard to the attorney-client fee arrangement cost the debtor’s lawyer dearly.

B. What Fees and Fee Arrangements Are Subject to Disclosure

Section 329 provides that an attorney representing a debtor must disclose all compensation paid or promised, “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.” 11 U.S.C.A. § 329 (a).

Fed. R. Bankr. P. 2016 sets forth additional obligations:

2016(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 14 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 14 days after any payment or agreement not previously disclosed (emphasis added). Highlighted above are the clauses in Rule 2016 which have presented (at least in the case law) the most trouble for debtor’s lawyers seeking to be paid in an alternative fashion.

C. The Requirement for Accurate and Complete Information

Counsel must be proactive in disclosure: being open, candid and forthcoming with all of the details of the payment arrangements with the debtor. “Debtor's counsel [must] lay bare all its dealings ... regarding compensation.... Counsel's fee revelations must be direct and comprehensive. Coy, or incomplete disclosures ... are not sufficient.” Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park–Helena Corp.), 63 F.3d 877, 881 (9th Cir.1995) (alterations in original). “An attorney who fails to comply with the disclosure requirements of § 329 and Rule 2016(b) forfeits any right to receive compensation for services rendered on behalf of the debtor and may be ordered to return fees already received.” In re Smitty's Truck Stop, Inc., 210 B.R. 844, 848 (B.A.P. 10th Cir. 1997).

D. What Must Be Disclosed: The Two Prongs of Section 329(a)

Section 329(a) contains a two prong analysis about whether a fee paid or promised to be paid must be disclosed: the first prong consist of fees “in connection with” the bankruptcy case, but the second prong expands that disclosure requirement to include fees paid “in contemplation of” the filing of the bankruptcy case. Since the over-arching principles of Section 329 are
disclose, disclose, disclose,” the phrases “in connection with” and “in contemplation of” should be read expansively. Thus:

- Fees paid for the defense of foreclosure suits and to restructure debts may be subject to disclosure. *In re Garcia*, 456 B.R. 361, 363 (N.D. Ill. 2011)
- Fees rendered for the prevention of bankruptcy must be disclosed. *In re Prudhomme*, 43 F.3d 1000, 1004 (5th Cir.1995)
- But, fees paid to a divorce attorney (though intertwined with the bankruptcy) were exempt from disclosure. *In re Swartout*, 20 B.R. 102, 106 (Bankr.S.D.Ohio 1982)
- And, fees paid to defend criminal charges associated with a collapsed business were exempt from disclosure. *In re Bressman*, 327 F.3d 229, 240 (3rd Cir.2003).

E. Court’s Duty to Inquire

The bankruptcy court has an independent duty to review fees for reasonableness. *In re Eckert*, 414 B.R. 404, 410 (Bankr. N.D. Ill. 2009). While this independent duty exists even in the absence of any objection to fees, *In re Lexington Hearth Lamp and Leisure, LLC*, 402 B.R. 135, 139-140 (Bankr. M.D.N.C. 2009), it often can be triggered by a Chapter 7 or 13 trustee, a creditor, the U.S. Trustee, or by the debtor herself.

II. Alternative Fee Arrangements and Their Treatment by Selected Courts

When the debtors are without the resources to pay their counsel, enterprising counsel have looked to other sources of funds for that payment. Possible sources of payment have been (a) property already owned by the debtors, but encumbered by liens; (b) other lawyers or law firms, in fee sharing arrangements; (c) factoring a receivable from the debtor with a third party; (d) creating sham claims in the bankruptcy case, held by a related party and to be paid by the estate; (e) collecting payments post-petition through post-dated checks; and (f) using the proceeds from pre-petition Fair Debt Collection Practices Act (“FDCPA”) claims to fund the bankruptcy filing.

Note: the practice of unbundling services is addressed in other materials presented as part of this seminar.

A. Payment of Debtor’s Attorney Fees from a Secured Party’s Collateral

In the past five years, some debtors’ counsel have contracted with third party towing companies in what was a clever (if not completely thought out) attempt to pay debtor’s attorney’s fees either directly from a secured creditor, or from the proceeds of an attempted sale of the secured creditor’s collateral. When something sounds too good to be true, it almost always is. The scheme operates this way:

Debtor’s counsel would recommend to a prospective debtor that the debtor turn over the debtor’s late model, heavily encumbered vehicle to a towing and storage company for safekeeping, until the secured creditor could pick it up. According to the pitch, if the debtor did this, the debtor would both be free of the burden of take care of the vehicle and of the burden of paying any attorneys’ fees (which would be paid by the towing company).
The towing company would in turn haul the vehicle several states away, and then send the secured creditor a bill for towing and storage charges. These charges, according to the towing company, were a priority lien on the vehicle. If the secured creditor did not concede to the blackmail demand from the towing company and ransom quickly its collateral, the vehicle would be sold at auction, “purportedly in conformity with state law and supposedly free of the creditor's lien.” *In re White*, No. 16-72114-JHH, 2018 WL 1902491, at *2 (Bankr. N.D. Ala. Apr. 19, 2018), aff’d sub nom. *Law Sols. of Chicago LLC v. Corbett*, No. 1:18-CV-00677-AKK, 2019 WL 1125568 (N.D. Ala. Mar. 12, 2019).

Once the secured creditor had paid the ransom, or the vehicle had been sold at auction, the towing company would transmit a sufficient portion of the proceed to the law firm, which would then file a petition for the debtor, without the debtor paying a cent for filing fees or legal fees. By some reports, well over a hundred bankruptcy cases were filed using this particular method for fee payment.

What could go wrong?

Bankruptcy courts who have examined this method of fee payment have uniformly rejected it as an appropriate way of financing a Chapter 7 bankruptcy filing. The Bankruptcy Court for the Northern District of Alabama harshly criticized this practice, finding that it was “an intentional conversion of the secured creditors’ collateral and likely a crime in the State of Alabama.” *Id.* This practice, according to the *White* decision, “exposed [the firm’s] s clients not only to possible civil and criminal liability, but also to claims by secured creditors for nondischargeability of debts owing to them under Code § 523(a)(6).” *Id.* Sanctions against the attorneys and law firms promoting this practice have ranged from disgorgement of fees, to sanctions, to the suspension of the right to practice law in that particular bankruptcy court.

Another method of financing a Chapter 7 filing via property already owned by a debtor is the use of redemption financing. In this approach, the debtor would redeem a vehicle, and include in the financing for that redemption an amount sufficient to pay the outstanding fees of the lawyer. While this method does provide payment to the attorney, it also leaves the debtor saddled with significant post-petition debts, often at very high interest rates; see, for example, *In re Blevins*, 2019 WL 575664, at *1 (Bankr. N.D. Tex. Feb. 12, 2019), where the debtor paid $600 to his attorney, through a redemption loan accruing interest at 23.99% per annum. Whether this is appropriate for an attorney to recommend to a client must be considered on a case-by-case basis.

**B. Fee Sharing with Remote Lawyers or Lawyers in Another State**

In an effort to cut the costs of preparing and filing bankruptcy petitions, attorneys are attempting to the possible efficiencies made available by the internet to outsource or offload the information gathering process to other attorneys or firms located out of state, but accessible via email, Skype, or other remote contact methods.

In the bankruptcy context, however, this arrangement is fraught with peril, for the Bankruptcy Code and Rules closely regulate the parties with whom a lawyer may share or split fees.
If compensation is to be shared with another lawyer who is not a member, partner, or regular associate in the same law firm, then that other attorney “must separately obtain court approval of their retention and fees.” Collier on Bankruptcy ¶ 504.02[3] (Richard Levin & Henry J. Sommer eds. 16th ed.). The definitions of the terms “firm” and “regular associate” are found in Bankruptcy Rule 9001, which specifies that a “‘Firm’ includes a partnership or professional corporation of attorneys or accountants” and that a “‘Regular Associate’ means any attorney regularly employed by, associated with, or counsel to an individual or firm.” Rule 9001(6) and (10). These definitions have led to creative attempts to create “firms” or to employ “regular associates” in manners which facially appear to comply with the Code and the Rules.

A Chicago-based debtors’ rights law firm created a nationwide “Firm” by attracting numerous “partners” in dozens of states around the country. Some judges and other bankruptcy professionals have questioned whether this model qualifies as a “Firm” within the meaning of Rule 9001(6), and whether it is simply a mechanism for the concealment of unlawful fee splitting. See, e.g., Jacobs v. Law Sols. Chicago LLC, 2018 WL 3954163, at *1 (Bankr. M.D. Ala. Aug. 13, 2018). The Bankruptcy Court for the Northern District of Texas noted that the local “partner” for this firm “could not actually identify the partnership,” was not “an owner or equity holder” in the firm, and “had no voting rights” in the firm. In re Blevins, 2019 WL 575664, at *2 (Bankr. N.D. Tex. Feb. 12, 2019). The Blevins court made no findings regarding the structure being used by debtor’s counsel, but confined itself to simply a disgorgement of the fees paid.

A Louisiana bankruptcy court was less charitable, characterizing that law firm as little more than a “referral service” and a “marketer of legal services.” See, Law Sols. Chicago LLC v. United States Tr., 592 B.R. 624, 638 (W.D. La. 2018), aff’d sub nom. Matter of Banks, 770 F. App’x 168 (5th Cir. 2019).

Better practice, when affiliating an out-of-state firm and attempting to use the single firm model for disclosing and applying for compensation, would be to address specifically those issues raised by the Blevins and other courts: Do you know who your partners are and what your firm name is? Are you an equity holder with voting rights? And is your relationship based upon a shared practice of law, or is it simply a sham to save on disclosure costs?

An additional concern when an attorney associates with out-of-state counsel is whether the actions taken by the counsel will constitute the unauthorized practice of law, if the out-of-state counsel is not a member of the local bar. Note, for example, that the Eight Circuit Bankruptcy Appellate Panel has held that “actions taken in legal proceedings by non-attorneys are a nullity.” In re Drevlow, 221 B.R. 767, 769 (8th Cir. B.A.P. 1998). The use of the term nullity, as opposed to more forgiving terms such as “reviewable” or “voidable,” should give every lawyer pause.

Out of state practice can also create issues when a law firm develops a significant practice in another state, only to have its only in-state lawyer leave for greener pastures. That happened to a Nebraska lawyer, who employed a lawyer licensed in Iowa. When the Iowa-licensed associate left, the Nebraska lawyer hastily arranged a hand-shake deal with another Iowa lawyer. Problems arose when the two lawyers differed on the terms of their oral agreement,
which in turn spilled over into disclosure issues in Bankruptcy Court. *In re Petersen*, 2018 WL 4203653, at *1–2 (Bankr. S.D. Iowa Aug. 23, 2018).

C. Factoring Your Receivables

Firms will often factor their receivables, selling the right to collect in the future to a third party for less than full payment immediately. While this is neither uncommon nor unethical in most circumstances, there are complications in the bankruptcy context.

A lawyer must know the terms of his factoring arrangement, including how much he is charging the client, and how much the lawyer is receiving from the factor. And then the lawyer must make a full disclosure of all of those numbers both to the client and the court. In the matter of *In re Wright*, 591 B.R. 68, 92 (Bankr. N.D. Okla. 2018), the disclosures by debtors’ counsel was “grossly misleading and indicative of a wanton disregard—*to the point of negligence*—for the level of candor required under § 329.” The lawyer told the court that he had “agreed to accept $1,500 for legal services with a balance due of $1,425” (which were likely the amounts to be paid by the client) but the lawyer had actual cash receipts from the factor of $1,068.75. The court found these statements to be “flat-out deceptive.”

D. Sham Proofs of Claim (This Is Never a Good Idea).

Attempting to collect unpaid fees through the filing of a proof of claim by a straw man did not go well in an Illinois bankruptcy case. In the matter of *In re Ezell*, 502 B.R. 798, 800–01 (Bankr. N.D. Ill. 2013), a debtor’s lawyer was presented with the problem of obtaining payment for past due attorneys fees associated with previous failed bankruptcy cases for the debtor. Instead of making a full, open and candid disclosure of the prior fees left unpaid, the debtor’s lawyer tried a different, and ultimately unsuccessful, path. Counsel assigned his prior debt to another attorney, who in turn filed a proof of claim for $2,341.40 as an assignee of a breach of contract claim. Unfortunately for the attorney filing the proof of claim, the bar date had passed; but as luck would have it, the debtor’s counsel (and the true holder of the claim) not only failed to object to the claim but successfully asked the court to extend the bar date to allow the claim.

When the debtor ultimately testified that she did not know the attorney filing the claim, the scheme crashed. The Court found that the debtor’s lawyer had violated Illinois conflict of interest rules, had breached his fiduciary duty to his client, and had practiced a fraud upon the court. The result was that the lawyer had to disgorge all fees and to pay a $10,000 sanction to the bankruptcy court clerk for the time and expense incurred by the U.S. Trustee. *Id.* at 814-18.

Had the lawyer disclosed the existence of the unpaid fee at the inception of the case and sought court permission for the filing and collecting of that fee (after court approval of its reasonableness), it is entirely possible that this matter would have had a very different outcome. *See, e.g., In re Gutierrez*, 309 B.R. 488, 501 (Bankr. W.D. Tex. 2004)(“the attorney who has represented a debtor in a prior chapter 13 case will not be disqualified from representing the debtor in a subsequent case simply by virtue of the existence and assertion of a claim for unpaid fees from the previous case.”).
E. Collection of Fees Post-Petition

In Chapter 13 cases, most attorneys will have at least a portion of their fees paid post-petition, with local rules often giving preference to attorney fee payments over other payments such as mortgages and car payments.

But granting this priority to attorney fee payments creates an ethical duty on the part of the lawyer to disclose to the client (and obtain consent in writing) to the conflict of interest which is created by that priority payment, at least according to the bankruptcy court in *In re Carr*, 584 B.R. 268 (Bankr. N.D. Ill. 2018).

The *Carr* court considered whether or not the debtor’s attorneys had any fiduciary obligations to their clients in the timing of the post-petition fees, and whether or not seeking payment of fees, on an accelerated basis, was in violation of that duty. Because the accelerated payment of those fees had a negative effect on the debtor’s car payments, with a further effect on the debtor’s ability to retain his car if his case were dismissed, the court held that there was in fact “a minimum duty to disclose the negative ramifications of an early dismissal on the interests of the debtor prior to or simultaneously with entering into the retention agreement.” Thus, the debtor’s attorney, in his retention agreement, had to disclose in writing (and obtain informed consent to) all of the risks associated with paying attorneys' fees ahead of or concurrently with the debtors’ auto lenders, including what would happen in an early dismissal of the chapter 13 case. *Id.* at 278.

In Chapter 7 cases, courts continue to be split on whether prepetition fees can be collected in any manner without violating the automatic stay. *Compare, In re Hines*, 147 F.3d 185 (9th Cir.1998)(allowing collection of fees post-petition on a quantum meruit basis) with *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1128 (7th Cir. 2003)(the discharge is an absolute bar to repayment). The ability to collect fees post-petition, through the use of post-dated checks, depends also on the district and circuit. *Compare, In re Waldo*, 417 B.R. 854 (Bankr. E.D. Tenn. 2009) (disgorgement of fees paid by post-dated checks) *with Hines* (holding that it was not a violation of stay for attorney to cash post-dated checks in payment of fees).

F. Pre-Petition Causes of Action

One ingenious method of generating a source for payment of fees was the use of settlement proceeds from collection-related lawsuits. The court in *In re Foster*, 586 B.R. 62, 69 (Bankr. W.D. Wash. 2018) considered whether the use of the proceeds from a settlement of a Fair Debt Collection Practices Act claim could be used to pay for bankruptcy counsel fees and what disclosure would be required under 11 U.S.C. § 329 and Bankruptcy Rule 2016(b). The bankruptcy court found that although the settlement itself was not causally connected to the bankruptcy filing and thus was not “in connection with” the bankruptcy, because the law firm had obtained and applied the fees “in contemplation” with the bankruptcy case full disclosure was required in the Rule 2016(b) statement. *Id* at 83-84. As a consequence, however, because the firm failed to disclose those fees, the firm had made “untrue and misleading statements in violation of 11 U.S.C. § 526(a)(2).” *Id.*
Advanced Hot Topics in Consumer Bankruptcy
Advanced Hot Topics in Consumer Bankruptcy

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United States Trustee Program
Enforcement Actions

Adam D. Herring, Associate General Counsel for Consumer Law, U.S. Dep’t of Justice, Executive Office for U.S. Trustees

I. Role and Standing of United States Trustees

a. United States Trustees are “bankruptcy watchdogs to prevent fraud, dishonesty, and overreaching.”

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b. Standing derives from the United States Trustees’ duties set out in 28 U.S.C. § 586 and the general standing conferred by Section 307 of the Bankruptcy Code. (United States Trustees “may raise and may appear and be heard on any issue in any case or proceeding” under title 11, except that they may not file plans in chapter 11 cases).

II. Combating Abuse by Debtors

a. Relevant statutes

i. Section 707(a)—Permits dismissal of chapter 7 cases “for cause.”

ii. Section 707(b)(2)—Provides for dismissal of cases filed by debtors for whom a presumption of abuse arises under the “means test” enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). Only applies to debtors with primarily consumer debts. Debtors may rebut the presumption of abuse by demonstrating “special circumstances.”

iii. Section 707(b)(3)—Allows dismissal of abusive based on bad faith or the totality of the circumstances, even where the presumption of abuse does not arise.

iv. Section 727(a)—Sets out the 12 bases for denial of a discharge to a chapter 7 debtor, including (but not limited to) the debtor’s transfer, destruction, or

2 11 U.S.C. §§ 101 et seq. References to the “Code”, “Bankruptcy Code,” or “Section” are to Title 11 unless otherwise noted. References to the Bankruptcy Rules are to the Federal Rules of Bankruptcy Procedure.
concealment of property; failure to maintain adequate books and records; and refusal to obey court orders. A debtor’s discharge may be revoked under section 727(d) for certain reasons (and under strict time limits), including for fraud discovered after entry of the discharge.

b. USTP Enforcement Activity

i. In the last three fiscal years, the USTP filed about 1,400 motions under section 707(b) with a success rate exceeding 98%.

1. In fiscal years 2017 and 2018, the USTP declined to file a motion to dismiss in about 63% of presumed abusive cases, often because the debtor has demonstrated a recent job loss, continuing medical expenses, or other circumstances.

2. Declinations have increased from less than 35% in FY 2006. The increase in declinations suggests that the objective criteria of the means test are well established, and most debtors’ attorneys avoid filing presumed abusive cases except in appropriate circumstances.

3. Coupled with the USTP’s prudent exercise of its enforcement responsibilities, the means test is meeting its statutory objective without creating unnecessarily harsh results.

ii. USTP has filed almost 1,000 complaints to deny discharge under section 727 in each of the last three fiscal years, with about a 98% success rate.

III. Combating Abuse by Attorneys and Other Professionals

a. Statutory framework

i. Section 329(b)—cancellation of fee agreements and disgorgement of compensation that exceeds the reasonable value of services.

ii. Sections 526-528—imposing requirements on “debt relief agencies;”
noncompliance may lead to cancellation of retention agreement, civil

A debt relief agency is “any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration” with certain exceptions. 11 U.S.C. § 101(12A). “Bankruptcy assistance” is “any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors’ meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title.” 11 U.S.C. § 101(4A). An
penalties, and injunctive relief. Attorneys are debt relief agencies if they otherwise qualify under the statutory definition.4

iii. Bankruptcy Rules 2016(b), 2017—debtors’ attorneys are required to timely, and fully, disclose compensation arrangements. The bankruptcy court may examine debtor’s transactions with counsel.

b. USTP has long been engaged in civil enforcement efforts to combat the harm created by the small number of consumer debtor lawyers who place their interests ahead of their clients’ interests, ignore obligations imposed by the Code, Rules, and rules of professional conduct, and engage in fraud or intentional misconduct. Last year, we brought nearly 600 formal enforcement actions (and acted informally in an additional 2,100 instances).

c. Examples of Enforcement Actions

i. The USTP obtained meaningful sanctions against a firm for seriously mishandling a client’s simple bankruptcy case, causing a lengthy delay before filing and even two dismissals. The firm appealed to the Fifth Circuit, which affirmed the sanctions imposed by the Bankruptcy Court and described the firm’s conduct as “appalling.”5

ii. The USTP has also taken action in cases involving improper bifurcation and “factoring” of chapter 7 debtor attorney’s fees.

1. Bifurcation is premised on splitting (“bifurcating”) representation of the debtor into “pre-petition” and “post-petition” retention agreements. Generally, the “pre-petition” agreement purportedly covers only representation for basic pre-petition services, including filing of a skeletal petition, for a nominal (or even no) fee. All other services, including preparation of the schedules and statement of financial affairs, representation at the §341 meeting, and traditional post-petition matters are covered by a second “post-petition” agreement, executed after the case has been filed. In theory, the debtor is under no obligation to sign the “post-petition” agreement, and can proceed with the case pro se or by hiring other counsel.

“assisted person” is “any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $192,450.” 11 U.S.C. § 101(3).


2. Bifurcation is designed to circumvent the substantial case law holding that pre-petition fees owing as of the petition date are a pre-petition date, subject to the automatic stay and discharge, by creating a post-petition obligation for much (or all) of the fees for the case.\(^6\)

3. Factoring is a variation on bifurcation under which the attorney assigns the right to collect the full amount owing under the post-petition fee agreement (generally payable in monthly installments) to a finance company in exchange for a discounted, lump sum payment.

4. While case law may varyingly permit these sorts of alternative fee arrangements, USTP enforcement focuses on cases involving failures to perform adequate due diligence, making false or misleading disclosures to the client and court, or inflating fees to offset the cost of third-party financing.

5. As the result of one civil enforcement action brought by the USTP, an attorney employing a factoring model was ordered to disgorge all fees in 17 cases, among other sanctions, for misconduct including filing “grossly misleading” fee disclosures and misleadingly designating fees for pre-petition services as post-petition in order to collect them, the court described as a “fraud both on the debtor and the Court.”\(^7\)

6. In another factoring case, the bankruptcy court upheld a bifurcated fee model over the USTP’s objection, but in so doing found that such a model is only permissible if (1) the lawyer’s dealings with the client were based on the client’s best interests; (2) all fees charged for post-petition services were reasonable and did not include fees for pre-petition services; (3) the arrangement was fully disclosed in the lawyer’s Rule 2016(b) statement; and (4) the lawyer complies with local rules governing substitution or withdrawal if the client elects not to proceed with the lawyer post-petition. Additionally, the court found that fees charged were reasonable on a lodestar basis and did not reflect a markup to offset the discount paid to the lawyer by the factoring company.\(^8\)

IV. Combating Abuse by Creditors

a. USTP civil enforcement efforts have addressed a range of Code and Rule violations by both secured and unsecured creditors, including robo-signing of documents filed in court with the signature of a person who did not review the

\(^6\) See Rittenhouse v. Eisen, 404 F.3d 395 (6th Cir. 2005); Bethea v. Robert J. Adams & Assocs., 352 F.3d 1125 (7th Cir. 2003); Hessinger and Assocs. v. U.S. Trustee (In re Biggar), 110 F.3d 685 (9th Cir. 1997); but see Gordon v. Hines (In re Hines), 147 F.3d 1185 (9th Cir. 1998).

\(^7\) In re Wright, 591 B.R. 68 (Bankr. N.D. Okla. 2018).

\(^8\) In re Hazlett, No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019).
document, billing debtors for amounts not owed, violating the discharge injunction, and failing to protect debtors’ personally identifiable information.

b. For example, last year the Bankruptcy Court for the Northern District of Georgia approved a national settlement between the USTP and a high-volume unsecured creditor, requiring the creditor to pay $5 million to remediate robo-signed proofs of claim filed in consumer bankruptcy cases in connection with more than 71,000 credit card accounts. These proofs of claim were signed, under penalty of perjury, by employees of a third party vendor who had not reviewed or lacked knowledge of the contents of the proofs of claim, or were filed using the electronic credentials of vendor employees who did not review the claim. The creditor self-reported the errors to the USTP after it took over servicing of the accounts from third parties.

V. Civil Enforcement in Consumer Cases—Protecting Systemic Integrity

a. The USTP’s civil enforcement priorities protect the integrity of the bankruptcy system for the benefit of its stakeholders—including debtors, creditors, and the public.

b. In addressing professional misconduct in particular, the USTP is concerned about the coopting of proper concern for access to justice for consumer debtors by bad actors to legitimize inappropriate business models and substandard performance.

c. USTP civil enforcement actions have a significant impact. In fiscal year 2018 alone, the USTP took more than 30,000 enforcement actions with a potential monetary impact of over $2.8 billion; since fiscal year 2003, when the USTP began tracking results, the Program has taken more than 781,000 actions with a potential monetary impact in excess of $21 billion.
Chapter 13 Confirmation Issues: Excess Income and Equity in Real Estate

When Too Much of a Good Thing Complicates Confirmation

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(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—

(I) the holder of such claim retain the lien securing such claim until the earlier of—

(aa) the payment of the underlying debt determined under nonbankruptcy law; or

(bb) discharge under section 1328; and
(II) if the case under this chapter is dismissed or converted without completion of the plan, such lien shall also be retained by such holder to the extent recognized by applicable nonbankruptcy law;

(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; and

(iii) if—

(I) property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts; and

(II) the holder of the claim is secured by personal property, the amount of such payments shall not be less than an amount sufficient to provide to the holder of such claim adequate protection during the period of the plan; or

(C) the debtor surrenders the property securing such claim to such holder;

(6) the debtor will be able to make all payments under the plan and to comply with the plan;

(7) the action of the debtor in filing the petition was in good faith;

(8) the debtor has paid all amounts that are required to be paid under a domestic support obligation and that first become payable after the date of the filing of the petition if the debtor is required by a judicial or administrative order, or by statute, to pay such domestic support obligation; and

(9) the debtor has filed all applicable Federal, State, and local tax returns as required by section 1308.

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day period preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

(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—

(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 applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

(2) For purposes of this subsection, the term “disposable income” means current monthly income received by the debtor (other than child support payments, foster care payments, or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended…

(4) For purposes of this subsection, the “applicable commitment period”—

(A) subject to subparagraph (B), shall be—

(i) 3 years; or

(ii) not less than 5 years, if the current monthly income of the debtor and the debtor’s spouse combined, when multiplied by 12, is [above median].

(B) may be less than 3 or 5 years, whichever is applicable under subparagraph (A), but only if the plan provides for payment in full of all allowed unsecured claims over a shorter period.

(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.

II. Excess Income-

a. Issues:

i. Can an above-medium debtor be required to pay 100% of unsecured claims in fewer than 60 months simply because they have the ability to do so?
ii. Can confirmation be conditioned on a requirement that the debtor never seek to modify to reduce the dividend below 100%? Or be denied a discharge if they do?

b. Typical Fact Pattern: Debtors are “above median” income, 60-month applicable commitment period, available disposable income would allow Debtors to pay 100% in less than 60 months, Debtors propose plan that provides for 100% divided to unsecured creditors over 60 months, Trustee objects and requests confirmation to be conditioned on special provisions concerning future modifications and granting of a discharge.

c. Case Law Overruling Trustee’s Objection and Confirming 60-month 100% Plans without Conditions:
   i. Martinez v. Viegelahn, 581 B.R. 486 (W.D. Tex. 2017)—The Bankruptcy Court entered a confirmation Order that contained language prohibiting the Debtors from filing a modified plan that paid less than 100% dividend and conditioned the debtors discharge on paying all allowed claims in full. The Debtors appealed, arguing that the inclusion of the conditional language is improper because Debtors’ Chapter 13 Plan fully satisfied the confirmation criteria of 11 U.S.C. § 1325, and since confirmation of the Plan was mandatory thereunder, the bankruptcy court lacked the authority to impose additional conditions. Debtors further argued that the conditional language directly contravenes 11 U.S.C. § 1329 of the Bankruptcy Code because it impermissibly narrows the instances in which the Debtors may exercise their right to modify their plan. By contrast, Trustee argued that the inclusion of such conditional language was within the broad powers granted to the bankruptcy court in 11 U.S.C. § 105 of the Bankruptcy Code. The District Court held under 11 U.S.C. § 105(a), it was within the bankruptcy court’s broad judicial discretion to determine that the Chapter 13 plan would be better served if the conditional language was added, and such language did not
contravene the requirements of 11 U.S.C. § 1325; However, by including the conditional language that clearly prohibited modification because the total payout was required to be the same, the bankruptcy court directly contravened the debtors’ right to modify a plan under 11 U.S.C. § 1329(a)(1), and thus the language was vacated; The ability to modify a Chapter 13 Plan Order at a later date is expressly provided to debtors, creditors, and trustees in § 1329, and to order that a plan cannot be modified to change the applicable discharge rate directly, as the conditional language did here, contravenes § 1329(a)(1).

ii. In re McGehan, 495 B.R. 37 (Bankr D. Colo. 2013)—Two consolidated cases where the debtors in each case proposed to pay in five years what they could easily have paid in less than three years. The Trustee objected to confirmation on allegations of lack of good faith. The Court concluded that with the addition of Section 1325(b)(1) to the Bankruptcy Code, “the amount of the Debtors’ repayment, standing alone, is an insufficient basis for finding a lack of good faith” (emphasis in original). The Court found the debtors proposed their plans in good faith even though they proposed to pay in five years what they could easily have paid in less than three years, because in enacting the “ability to pay” test under Section 1325(b)(1), “Congress drew a bright line and determined that debtors can overcome objections to confirmation by committing all of their disposable income or paying all claims in full. There is no requirement that debtors do both.” In re McGehan, 495 B.R. at 44 (emphasis in original). In addition, “[j]ust as consideration of the amount of debtors’ proposed payments has been narrowed by § 1325(b)(1), so too has consideration of the length of debtors’ plans been narrowed by the enactment of § 1325(b)(4)” due to the enactment of BAPCPA. Accordingly, the Court found that by proposing 5-year
commitment periods, the above-median debtors in _McGehan_ had done all that was required of them by Section 1325(b)(4).

**iii. In re Conklin,** 2018 Bankr. LEXIS 1001 (Bankr. D. Colo. Mar. 28, 2018)—Court held that Section 1325(b)(1)(A) and (B) are in the disjunctive; the plain language of the Code provides the Court can confirm the Plan upon an objection if the Plan **either** commits all disposable income during the commitment period **or** provides for 100% distribution under the plan on all claims. The Court confirmed a plan over the Trustee’s objection that provided for 100% distribution to unsecured creditors over a five-year period, proposed by above-median debtors who had net disposable income of almost $2,500 per month but were proposing plan payments of $1,000 per month for the first 14 months, followed by $1,370 per month for 46 months.

**iv. In re Boisjoli,** 591 B.R. 468 (Bankr. D. Colo. 2018)—Debtors were “above median” income debtors with a combined monthly income of $8,886.47 and monthly expenses of $6,225.53 for monthly net income of $2,660.94. The Debtors’ plan proposed to pay 100% of all timely filed unsecured, general non-priority claims over 60 months as follows: $1,094.00 for month 1; $1,222.00 per month for months 2 through 4; $1,028.00 per month for months 5 through 59; and $1,034.00 for month 60. The Trustee objected and argued that the Debtors’ full disposable income should be committed to plan payments at the outset. In the alternative, the Trustee requested that if the Court did not order higher plan payments and thus decrease the duration of the Plan, the Court should impose modifications in order to mitigate the risk of loss to the creditors, such as adding provisions to the Plan requiring concurrent payments to general unsecured creditors, or limiting Debtors’ ability to obtain a Chapter 13 discharge if they fail to pay 100% of the unsecured claims as proposed, or prohibiting Debtors from
seeking to modify the Plan at a later date to reduce the dividend to unsecured creditors. The Court found that Debtors complied with Section 1325(b)(1)(A) by proposing a 100% plan. It stated Sections 1325(b)(1)(A) and (B) are in the disjunctive, separated by the word “or.” Because Debtors proposed a 100% plan in accordance with Section 1325(b)(1)(A), they are not required to apply all of their projected disposable income received during the applicable commitment period to make payments to unsecured creditors pursuant to Section 1325(b)(1)(B). The Court refused to condition Debtors’ ability to seek a discharge or a plan modification upon a promise they pay all creditors in full, stating that imposing such conditions or provisions directly contravenes other provisions of the Bankruptcy Code, and is prohibited under the Supreme Court’s holding in Law v. Siegel, 571 U.S. 415, 134 S. Ct. 1188, 188 L. Ed. 2d 146 (2014).

d. Caselaw Sustaining Trustee’s Objection and Imposing Conditions on Confirmation:

i. Molina v. Langehennig, No. SA-14-CA-926, 2015 U.S. Dist. LEXIS 167933 (W.D. Tex. Dec. 10, 2015)–The Bankruptcy Court entered a confirmation order that contained the following language:

The Plan as currently proposed pays a 100% dividend to unsecured claims. The Debtors shall not seek modification of this Plan unless said modification also pays a 100% dividend to unsecured claims. Additionally, should this Plan ever fail to pay a 100% dividend to unsecured claims, the Debtors will modify the Plan to continue paying a 100% dividend. If the Plan fails to pay all allowed claims in full, the Debtors will not receive a discharge in this case.

The Debtors appealed, arguing that the inclusion of the conditional language is improper because the Debtors’ Chapter 13 Plan fully
satisfied the confirmation criteria of 11 U.S.C. § 1325, and since confirmation of the Plan was mandatory thereunder, the bankruptcy court lacked the authority to impose additional conditions. The Trustee argued that the inclusion of such conditional language was within the broad powers granted to the bankruptcy court in 11 U.S.C. § 105 of the Bankruptcy Code. The District Court affirmed the lower court’s order and held that the use of 11 U.S.C. § 105(a) was not an abuse of discretions and the court did not exceed its equitable powers when it included the disputed language in the confirmation order. The District Court found the Debtors’ argument pertaining to section 1325 unpersuasive, since the plan was ultimately confirmed.

ii. In re McCarthy, 554 B.R. 388 (Bankr. W.D. Tex. July 22, 2016)—An above median income Chapter 13 debtor was not required under 11 U.S.C. § 1325(b)(1) to pay all his disposable income to the trustee, as long he proposed a plan that provided for payment of all allowed unsecured claims in full during the five years the plan would be in effect, and a plan that allowed the debtor to keep $768 per month could be confirmed because it required the debtor to pay 100% of all allowed claims. The trustee’s request that the debtor be required to amend his plan to include a provision which stated that he would not receive a discharge if he did not pay all allowed unsecured claims in full and a provision which prohibited him from modifying his plan unless the plan continued to provide for full payment of allowed unsecured claims was reasonable, and § 1325(b)(1) did not prohibit the court from imposing those conditions on the debtor.

iii. In re Crawford, No. 15-53097-CAG, 2016 Bankr LEXIS 2695 (Bankr. W.D. Tex. July 22, 2016)—The Court held that above median income Chapter 13 debtors were not required under 11 U.S.C. § 1325(b)(1) to pay all their disposable income to the
trustee as long they proposed a plan that provided for payment of all allowed claims in full during the five years the plan would be in effect, and a plan that allowed the debtors to keep $1,097 per month could be confirmed because it required the debtors to pay 100% of all allowed claims. In addition, the trustee’s request that the debtors be required to amend their plan to include a provision which stated that they would not receive a discharge if they did not pay all unsecured claims in full and a provision which prohibited them from modifying their plan unless their plan continued to provide for full payment of unsecured claims was reasonable, the Court had authority under § 105 to include these requirements in the confirmation order, and § 1325(b)(1) did not prohibit the court from imposing those conditions on the debtors.

e. What will the Fifth Circuit Say?

i. Brown v. Viegelahn, 2019 U.S. Dist. LEXIS 10348 (W.D. Tex. Jan. 22, 2019)—The Bankruptcy Court conditioned confirmation of the Debtor’s plan on his inclusion of the following language: “The Plan as currently proposed pays a 100% dividend to unsecured claims. The Debtor shall not seek modification of this Plan unless said modification also pays a 100% dividend to unsecured claims. Additionally, should this Plan ever fail to pay 100% dividend to unsecured claims, the Debtor will modify the Plan to continue paying a 100% dividend. If the Plan fails to pay all allowed claims in full, the Debtor will not receive a discharge in this case,” the so called-Molina language. The Debtor appealed. The trustee argued that section 105(a) gave the bankruptcy court the power to require such language in order to protect unsecured creditors from the potential failure of the debtor’s plan. The debtor countered that, where his plan satisfied section 1325(b)(1), the court had no power to impose further conditions, and that the Molina language deprived him of his statutory right to modify
as contemplated by section 1329. The District Court for the Western District of Texas, on its own motion, certified an appeal to the Fifth Circuit to resolve the dispute among lower courts concerning the *Molina* language. The district court reasoned that the appeal involved an issue of law for which there was no controlling opinion, and for which there were conflicting lower court opinions.

### III. Equity in Real Estate

a. **Issue:** While § 1322(b)(8) provides that a plan “may” provide for the sale of property through a Chapter 13, what factors should be considered in determining if a plan that proposes to sell real estate at some point during the life of the plan can be confirmed?

b. **Typical Fact Pattern:** Debtors own one or more parcels of real estate that they believe has significant equity (though the amount of equity is often debatable), the real estate would be sold by a Chapter 7 Trustee if a Chapter 7 were filed, Debtors wish to control the sale of the real estate, Debtors income is not sufficient to fund a plan that would allow them to pay what is required to meet the “best interest of creditors” test without selling a portion of the real estate. Alternatively, the Debtors may wish to prevent a secured creditor from obtaining relief from stay as to a property for which the debtors have defaulted pre-petition, which the debtors believe there is significant equity, and propose to cure the default by selling the property and using the funds to satisfy the secured claim and provide additional plan funding.

c. **Considerations:**

   i. **Good Faith:** Section 1325(a)(3) of the Bankruptcy Code requires that a plan be proposed in good faith. There is no definition of “good faith.” Courts tend to consider numerous factors when asked to decide whether a plan is proposed in good faith. In addition, a debtor’s good faith in proposing a chapter 13 plan must be determined on a case by case basis, considering the totality of the
surrounding facts and circumstances. In evaluating a debtor’s good faith, Courts are guided by the eleven factors established in *Flygare v. Boulden*, 709 F.2d 1344 (10th Cir. 1983), in addition to any other relevant circumstances. Those factors include:

1. the amount of the proposed payments and the amount of the debtor’s surplus;
2. the debtor’s employment history, ability to earn and likelihood of future increases in income;
3. the probable or expected duration of the plan;
4. the accuracy of the plan’s statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court;
5. the extent of preferential treatment between classes of creditors;
6. the extent to which secured claims are modified;
7. the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7;
8. the existence of special circumstances such as inordinate medical expenses;
9. the frequency with which the debtor has sought relief under the Bankruptcy Reform Act;
10. the motivation and sincerity of the debtor in seeking Chapter 13 relief;
11. the burden which the plan’s administration would place upon the trustee.

*Flygare*, 709 F.2d at 1347-48 (quoting *United States v. Estus (In re Estus)*, 695 F.2d 311, 317 (8th Cir. 1982)). The applicability of many of these factors have been questioned in light of the more recent changes to section 1325. Nonetheless, they are instructive when addressing a good faith issue. The weight to be given each of these factors will vary based on the relevant facts and circumstances of each case.

ii. **Best Interest of the Creditors:** Section 1325(a)(4) of the Bankruptcy Code imposes what is known as the “best interest of creditors test.” This requirement ensures that a Chapter 13 plan
provides unsecured creditors with at least as much return as they would receive in a Chapter 7 liquidation. A debtor can satisfy the best interest of creditors test and “buy out” non-exempt, prepetition assets by paying their value to the Trustee over the life of the plan.

iii. **Feasibility:** Section 1325(a)(6) of the Bankruptcy Code requires that a plan be feasible to be confirmed. In evaluating the feasibility of sale plans, courts have considered evidence related to (a) the amount of the creditor’s claim, if there is debt on the property; (b) the state of the market for the subject asset; (c) current sale prospects; (d) the existence and maintenance of any equity cushion; (e) the terms of the debtor’s listing agreement, including the listing price for the subject asset and plans for marketing it; and (f) whether or not the plan includes a default or “drop dead” remedy either to relieve the lien holder from the automatic stay or to convert the case to another chapter if the sale does not close by the end of the proposed cure period. See e.g., *In re Mastel*, No. 09-60784-13, 2010 Bankr. LEXIS 164; 2010 WL 234971, *5-*6 (Bankr. D. Mont. Jan. 15, 2010) (listing considerations); *In re Erickson*, 176 B.R. 753, 756-57 (Bankr. E.D. Pa. 1995) (listing possible considerations and citing considerations listed by court in *In re Newton*, 161 B.R. 207, 217-18 (Bankr. D. Minn. 1993), as well taken); *In re Crawford*, No. 11-24158, 2012 Bankr. LEXIS 1163, 2012 WL 930281 (Bankr. D. Colo. Mar. 19, 2012).

d. **Relevant Case Law:**

i. *In re Bassett*, 413 B.R. 778 (Bankr. D. Mont. 2009)—The debtor’s cure-by-sale Chapter 13 plan, which had a “drop dead” date in approximately 18 months from confirmation, was feasible, although sale prospects for real estate generally at that time in the debtors’ county were poor, where (1) the plan proposed to sell both the debtors’ residence and their restaurant business; (2) the debtors testified that they had an interested buyer searching for financing to
purchase the restaurant business, and this testimony was uncontroverted; (3) while the entire nation was in a recession, there was no record evidence to establish that sale prospects would remain poor through the plan’s “drop dead” date; (4) the first-position lienholder enjoyed an equity cushion as of the drop dead date of at least $355,000; and (5) the second-position lienholder had an equity cushion on the drop dead date in the amount of $161,000.

ii. *In re Lynch*, No. 1-08-46308-dem, 2009 Bankr. LEXIS 1863; 2009 WL 1955748 (Bankr. E.D.N.Y. July 6, 2009)–The Chapter 13 debtor’s proposed plan, under which he would make $150 monthly payments for 35 months and a final large payment in the 36th month, was not feasible. The debtor’s only sources of income to make the $150 monthly payments were claimed $750 monthly contributions by his children and the same amount received monthly from rental properties, but the debtor failed to provide any evidence as to the commitment and stability of either income stream. Moreover, the debtor intended to fund the final large payment by the sale of one or both of the two real properties that he owned in Maryland, but the plan specified neither the specific property to be sold nor the time frame in which a sale would be consummated.

iii. *In re Snyder*, 420 B.R. 794 (Bankr. D. Mont. 2009)–The debtor’s proposed plan, which would cure her mortgage payment defaults through the sale of her residence, was feasible, so long as she amended the plan so as to reduce the “drop dead” date to September 16, 2010, as a realtor testified that the average time on the market for homes in the area and price range of the debtor’s residence was 111 days. The only evidence in the record, the court said, was that the debtor was current on her monthly plan payments and that she would be able to make her monthly payments for the remaining plan term of less than one year. Code § 1322(b)(8) allows a plan to be partially funded through the sale of property of the estate...
or property of a debtor, but issues of good faith, feasibility and adequate protection arise when a plan proposes only token monthly payments to the secured creditor. Because the debtor’s plan proposed $100 monthly plan payments, and nothing to the secured claims until the sale, the debtor had the burden of producing evidence as to past marketing efforts, the state of the market for the subject asset, current sale prospects, the existence and maintenance of the market for the subject asset, the existence and maintenance of any equity cushion, and all other circumstances that bear on whether the creditor will see its way out of the case financially whole. The court found that the debtor satisfied her burden of proof as to all these factors by her own testimony and that of the realtor, who testified that the market for homes in the debtor’s “Rattlesnake” areas of Missoula was steady and improving. Taking into account interest accruing on creditor’s claims through September 16, 2010, the court determined that the debtor had an equity cushion of $44,104, which offered adequate protection to secured creditors.

iv. *Bertrand v. Countrywide Home Loans Inc. (In re Bertrand)*, No. 4:08-ap-00949-JMM, 2010 WL 1740906 (Bankr. D. Ariz. Apr. 29, 2010)—The debtors did not establish that their Chapter 13 plan, which proposed to pay a mortgage debt of over $500,000 by the end of the plan term by “sale or refinance,” was feasible, where no person testified that financing was available, whether a commitment had been made by a lender, whether the debtors would be perceived to be creditworthy, that the current Arizona real estate depression would improve, or that refinancing would be easy to accomplish for an approximate $500,000 loan.

v. *In re Launderville*, No. 11-61117-13, 2011 Bank. LEXIS 4003; 2011 WL 4900022 (Bankr. D. Mont. Oct. 14, 2011)—The Chapter 13 debtors’ plan, which proposed to subdivide their ranch into nine separate residential parcels and sell those parcels, was feasible and
proposed in good faith, where the debtors had almost $80,000 in equity in the ranch even prior to its subdivision, and the plan provided that, if the parcels were not sold within two years, the debtors would surrender the remaining parcels to their principal secured creditor.

vi. *In re Van Winkle*, No. 11-13861-j13, 2012 Bankr. LEXIS 798; 2012 WL 404956 (Bankr. D. N.M. Feb. 8, 2012) – The debtor’s Chapter 13 plan, which proposed to sell either his condominium or his horse ranch by the end of 2012, and to sell both properties by the end of 2013, was feasible, where realtors testified that both properties should sell within those time frames.

vii. *In re Orris*, No. 11-34782, 2012 WL 764440 (Bankr. N.D. Ohio Mar. 8, 2012) – The Chapter 13 debtor did not establish that his cure-by-sale plan was feasible, where the debtor was only a partial owner of the real property proposed to be sold to fund the plan. The debtor’s deceased mother had owned a 66.5% interest in the property, and no probate proceedings had been held with regard to the mother, so that the debtor did not have the power to transfer title to the property to a buyer. While the debtor’s plan proposed that he would make increased monthly plan payments if the property were not sold, the court was unable to determine that the debtor’s financial resources would permit him to make the plan payments that would be required.

viii. *In re Crawford*, No. 11-24158-SBB, 2012 Bankr. LEXIS 1163; 2012 WL 930281 (Bankr. D. Colo. Mar. 19, 2012) – In evaluating the feasibility of cure-by-sale Chapter 13 plans under Code § 1325(a)(6), courts have considered evidence related to (a) the amount of the creditor’s claim; (b) the state of the market for the subject asset; (c) current sale prospects; (d) the existence and maintenance of any equity cushion; (e) the terms of the debtor’s listing agreement, including the listing price for the subject asset and plans for
marketing it; and (f) whether or not the plan included a default or "drop dead" remedy either to relieve the mortgagee from the automatic stay or to convert the case to another chapter if the sale did not close by the end of the proposed cure period. Concluding that the debtor’s plan was “close to ready for confirmation,” the court said that, before the plan could be confirmed, the debtor needed to include a default provision that addressed what would happen if the property did not sell within the plan period. Specifically, the debtor should include a provision allowing the Chapter 13 trustee to liquidate the real estate through a court-approved process, or a provision requiring the debtor to convert her case to Chapter 7 if the property did not sell within a specified time.
In Rem Relief from the Automatic Stay
Recent Cases by Circuit

Honorable Klinette H. Kindred, USBC, E.D. Va.

In rem relief from the automatic stay was first codified in the 2005 Amendments to the Bankruptcy Code. 11 U.S.C. § 362 (d)(4) provides:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay— …

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a scheme to delay, hinder, or defraud creditors that involved either—

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable State laws governing notices of interests or liens in real property, an order entered under paragraph (4) shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.


The Bankruptcy Code further provides that the filing of a bankruptcy petition does not operate as a stay against any act to enforce any lien against or security interest in real property following entry of the order under subsection (d)(4) as to such real property in any prior case under this title, for a period of two years after the date of entry of such order, except that the debtor, in a subsequent case under this title, may move for relief from such order based upon changed circumstances or for other good cause shown, after notice and a hearing. 11 U.S.C. § 362(b)(20).
The Bankruptcy Technical Corrections Act of 2010, Pub. L. No. 111–327, 124 Stat. 3557 (the “BTCA”) amended section 362(d)(4) by replacing “hinder and defraud” with “hinder or defraud” making the subsection consistent with other Code provisions that use the phrase ‘hinder, delay or defraud’. This change eases the burden of proof for lenders as they are no longer required to allege fraud in order to seek in rem relief.

1. **First Circuit: Maine, New Hampshire, Massachusetts, Rhode Island, and Puerto Rico**

Courts have taken a wholistic approach in determining whether in rem relief is warranted. A court can infer an intent to hinder, delay, or defraud creditors based solely upon serial filings without the need for an evidentiary hearing. *In re Anderson*, 594 B.R. 509, 515 (Bankr. D. Me. 2018). In this case, the debtor had filed five cases in total. *Id.* Facts from which courts will extrapolate a scheme to hinder or delay include not only how many cases make up the “multiple filings” element, but case resolution. Relevant inquiries include: “Were the prior cases dismissed without confirmation, or without discharge? Were the debtor's prior cases 'strategically timed' vis-a-vis potentially adverse state court action? Is there evidence of a change in circumstances necessitating the filings? Did the debtor have a legitimate belief she could reorganize, in each case? Is there a ‘tag-team’ pattern of serial filings by each co-debtor?” *Id.*

However, a creditor must have constitutional standing to move for in rem relief under section 362(d)(4). For instance, in a recent Massachusetts case, a motion for relief in rem was filed after a dismissal order had taken effect and the bankruptcy court denied the lender’s motion as moot holding the creditor lacked constitutional standing to seek relief from stay after the bankruptcy had been dismissed. *In re Harris*, 595 B.R. 115 (Bankr. D. Mass. 2019).

2. **Second Circuit: Vermont, Connecticut, and New York**

The most recent case in the Second Circuit analyzing in rem relief is *In re McKenzie*, No. 19-10130, 2019 WL 1750910, at *4 (Bankr. S.D.N.Y. Mar. 25, 2019). This unpublished decision involved a debtor who had filed four bankruptcies, three of which were strategically timed days before the foreclosure sale of the property. His previous cases were dismissed because the debtor failed to attend the meeting of creditors or failed to file information, as
required under 11 U.S.C. § 521(a)(1). In this case, he had made no post-petition payments; and, at the time of the hearing, the total amount of pre-petition and post-petition debt owed to the lender exceeded $710,071.94. The debtor also misled the court by indicating that only one previous bankruptcy filing had been filed within the past eight years, when he had filed three previous bankruptcies within the last eight years. Id. The court reasoned that the debtor had not made a good faith attempt at prosecuting his bankruptcy petitions and concluded he had demonstrated a clear pattern of repeat filings concerning the property that were a part of a scheme to hinder, delay, or defraud the Lender, so in rem relief was granted. Id.

3. **Third Circuit: New Jersey, Pennsylvania, Delaware, and the Virgin Islands**

The Third Circuit takes one of the more pro-consumer positions when it comes to serial filings. It has held that the mere existence of “multiple bankruptcy filings do[es] not alone justify relief unless they are part of such a scheme because strategically timing a bankruptcy to stay foreclosure proceedings can be a legitimate tactic within a debtor’s arsenal. *In re Olayer*, 577 B.R. 464, 468–69 (Bankr. W.D. Pa. 2017).

However, multiple filings without the ability or the intention to reorganize is evidence of bad faith. Id. The court suggested that serial filings compounded by a lack of payments, “highly-questionable plan,” and “tag team” approach to individual filings by a husband and wife may warrant in rem relief. Id.

More recently, one court within the Third Circuit held where a lender successfully carries the burden of proof to show that transfers of all or part ownership of an interest in real property was made without its consent, the court will grant relief because the “scheme … implie[d] a level of insidiousness and deceitfulness.” *In re City of Pittsburgh Prop. Dev., Inc.*, 580 B.R. 130, 134 (Bankr. W.D. Pa. 2018) (granting in rem relief based on the debtor’s transfers and inability to rebut the presumption of a scheme).

4. **Fourth Circuit: Maryland, West Virginia, Virginia, North Carolina, and South Carolina**

The most recent case from the Fourth Circuit is *In re Mohammad*, 596 B.R. 34 (Bankr. E.D. Va. 2019). The case was filed as a chapter 11 and was preceded by two prior chapter 13 cases within eight years. The first chapter 13 was filed in 2010 and involved the debtor and his spouse. During that case the lender got relief from the stay. The debtors received their discharge
in early 2016. Six months after the case was closed Mr. Mohammad filed his second chapter 13, but that case was dismissed a few months later when the court determined that the debtor’s secured debt exceeded the debt limits established in 11 U.S.C. § 109(e) because of the arrears that had accumulated on the mortgage. In the chapter 11 case, the lender was granted in rem relief when the court held that a series of three bankruptcy filings (two filed on the eve of foreclosure), together with an unabated six-year default in payments constituted a scheme to hinder and delay the creditor from exercising its rights against the property. The case was dismissed in January 2019 after the debtor lost an appeal in the District Court. Two months later, his wife, filed for chapter 13 relief and her case was recently dismissed on the trustee’s motion because she too was ineligible to be a chapter 13 debtor under 11 U.S.C. § 109(e).

5. **Fifth Circuit: Mississippi, Louisiana, and Texas**

In *U.S. Bank National Association v. Jefferson*, 314 F. Supp. 3d 768 (S.D. Tex. 2018), the lender/owner foreclosed on the property and thereafter filed a petition against the former homeowners in state court for forcible detainer. Before the trial, the homeowners filed for bankruptcy. This was the debtors’ fourth bankruptcy. In rem relief was granted when the debtors failed to appear at the hearing and the case was subsequently dismissed for failure to pay installment fees. Thereafter, the debtors filed a Notice of Removal of the forcible detainer action to the U.S. District Court, but the case was remanded because the debtors failed to establish federal question jurisdiction or diversity jurisdiction. The court also imposed an injunction enjoining the debtors from filing future Notices of Removal in the related county court case without first obtaining leave from the Chief Judge of the Southern District Texas because the last Notice of Removal filed was virtually identical to the prior Notice that had been remanded. The court also cautioned the debtors that future frivolous attempts at removal could result in monetary sanctions. *Id.* at 784.

6. **Sixth Circuit: Ohio, Michigan, Kentucky, and Tennessee**

*In re Lee*, 467 B.R. 906, 909 (B.A.P. 6th Cir. 2012) is an Ohio case where the Bankruptcy Appellate Panel (“BAP”) held that in rem relief was properly granted in the debtor’s third bankruptcy case. Ohio is a judicial foreclosure state. The debtor originally defaulted on her mortgage in July 2008. A year later the lender initiated a foreclosure action in state court. Then, the debtor filed her first chapter 13 which stayed the state court action. After the case was
dis missed, the foreclosure action resumed but was stayed again when the debtor filed her chapter 7 case. The creditor was granted relief from the stay without objection in that case and resumed its state court foreclosure action by filing a Motion to Reactivate Proceeding. The Motion was granted; however, the action was stayed when the debtor filed her chapter 11 petition. At this point the debtor had made no payments on the loan since July 2008. The court determined that the debtor had intentionally allowed her previous cases to be dismissed by failing to comply with the necessary requirements including payment of filing fees for the purpose of hindering and delaying the creditor from foreclosing.

7. **Seventh Circuit: Indiana, Illinois, and Wisconsin**

    *In re Mendiola*, 573 B.R. 758 (Bankr. E.D. Wis. 2017) is a Wisconsin case. That court characterized in rem relief as an extraordinary remedy that is available only in limited situations where the creditor must have a secured claim in the property and the debtor’s bankruptcy petition is part of a scheme to delay, hinder, or defraud creditors involving either a transfer of an interest in the property or multiple bankruptcy filings affecting the property. *Id.* at 765.

    The debtor argued that his bankruptcy records merely demonstrated a series of repeated filings and “screw-ups” on his part. *Id.* at 762. The court determined that the creditor began its first foreclosure action after the debtor’s first bankruptcy was dismissed. The next two cases were filed to thwart foreclosures. After the fourth case was dismissed, the lender obtained a default judgment of foreclosure which was immediately followed by the debtor’s fifth and sixth bankruptcy case filings. *Id.* The court held that in rem relief was warranted because the debtor had filed six cases in six years; that four of the six cases were dismissed within eight months of being filed; and that most of the dismissals resulted from the debtor’s failure to make plan payments. *Id.* The court also found that during the six-year period since the first case filing, the debtor and his spouse collected thousands of dollars of rental income on the property but had failed to pay the lender which implied a scheme to defraud the creditor.

    In *In re Washington*, No. 17-24473, 2017 WL 4180145 (Bankr. E.D. Wis. Sept. 20, 2017), also a Wisconsin case, the court followed the reasoning in *Mendiola*, but declined to grant in rem relief. It held that although the debtor had filed three previous bankruptcy petitions, the circumstances of his last filing did not rise to the level of showing a scheme to delay, hinder or
defraud the lender because the debtor provided for surrender of the property in his chapter 13 plan and did not oppose the lender’s motion for relief from stay. Id.

8. **Eighth Circuit: Minnesota, Iowa, Missouri, Arkansas, Nebraska, North Dakota, and South Dakota**

   In *Behrens v. U.S. Bank National Association (In re Behrens)*, 501 B.R. 351, 355 (B.A.P. 8th Cir. 2013), *aff’d*, 566 F. App’x 547 (8th Cir. Aug. 14, 2014), the BAP affirmed the bankruptcy court’s order granting in rem relief where the debtor and his wife had filed five bankruptcy cases and had not made a payment to the lender since a date in 2009 prior to the commencement of the first foreclosure action. *Id.*


   In *In re 4th Street East Investors, Inc.*, 474 B.R. 709 (Bankr. C.D. Cal. 2012), the court granted in rem relief where the creditor proved that the transfer of property to the debtor post-petition was part of a “scheme” to delay or hinder its remedies against the property by implicating the automatic stay even though the debtor was not part of the scheme. In this case, the debtor’s schedules and statements were properly filed and he attended the meeting of creditors; however, relief under 11 U.S.C. § 362(d)(4) was appropriate because, as of the time when the scheme was implemented, the debtor’s filing of the petition was part of a scheme by the transferor to delay, hinder or defraud. The Court stated:

   Based on the foregoing, this case is consistent with the pattern in so-called “hijacked” or “dumping” cases—i.e., cases in which a transferor of property, acting without the debtor’s participation or acquiescence, seeks to implicate the automatic stay for the transferor’s own benefit by purporting to transfer property into a random bankruptcy estate, or by back-dating or falsifying a grant deed to make it appear that such a transfer has occurred.

   *Id.* at 711.

   The court also granted in rem relief where the lender proved a 5% interest in the property was transferred to a chapter 13 debtor which may have been executed without the debtor’s knowledge or consent. *In re Vazquez*, 580 B.R. 526 (Bankr. C.D. Cal. 2017). The court held that it did not need to have in rem jurisdiction over the property in order to have jurisdiction to grant relief to the lender. *Id.*
10. **Tenth Circuit: Colorado, Wyoming, Utah, New Mexico, Oklahoma, and Kansas**

Judge Howard Talisman determined the mere fact that a bankruptcy filing has the effect of hindering or delaying a scheduled foreclosure does not rise to the level of a “scheme” as the term is used in section 362(d)(4). *In re Hutchins*, No. 16-10262 HRT, 2016 WL 3573966, at *3 (Bankr. D. Colo. June 23, 2016). He reasoned the term suggests something more than a purpose to exercise a legal right – the filing of a bankruptcy petition – that has the effect of delaying a foreclosure. The court determined that proof of a scheme in this context must involve a wrongful motive or intent. *Id.* In *Hutchins*, the debtors had filed 4 bankruptcy petitions. They received a chapter 7 discharge in the first case. Two years later they stopped paying the mortgage and two years after that, they filed a chapter 13 case. During this case, they dismissed their counsel and filed a pro se adversary proceeding again to challenge the lender’s claim on the grounds that the lender’s records indicated that some unknown third party had paid the mortgage in full and therefore the lender’s lien should be released. *Id.* The court rejected the debtors’ argument as implausible and the case was dismissed for failure to file an amended plan. The third case was dismissed for failure to obtain credit counseling. In the fourth case, the debtors filed a plan that wholly ignored the mortgage lender’s claim for arrearages on the same theory rejected by the court in the adversary proceeding conducted in the second bankruptcy. The court noted that the debtors had offered other frivolous challenges of the lender’s claim in state court proceedings with no success between bankruptcies. The court ruled that the debtors’ offer of the same arguments rejected by the state court and the bankruptcy court in the adversary proceeding was enough evidence of a wrongful motive and justified in rem relief. *Id.*

11. **Eleventh Circuit: Georgia, Florida, and Alabama**

*In re Danley*, 540 B.R. 468 (Bankr. M.D. Ala. 2015) is the most recent reported case from the Eleventh Circuit granting in rem relief to the lender. The debtor, Ms. Danley filed four bankruptcy petitions over seven-and-a-half years, three of which stayed active foreclosure proceedings. The first was dismissed for failure to file monthly operating reports, and the second was dismissed for failure to make post-confirmation payments or pay quarterly fees. The third case was voluntarily dismissed on the debtor’s motion after a plan could not be confirmed over the creditors’ objections. The court found bad faith in all three cases, noting Ms. Danley should have known the third case was “hopeless” as a chapter 13 endeavor because she had nearly
$900,000 of debt and only $3,000 of monthly income. *Id.* at 475. The court also found that the debtor’s late-filed schedules, statement of financial affairs, and payment advices—in addition to their failure to disclose her gross income—constituted bad faith in the fourth case. *Id.* at 468.

### 12. DC Circuit

The latest case from the DC Circuit involving in rem relief is *In re Norris*, No. 17-00009, 2017 WL 2889655, at *1 (Bankr. D.D.C. July 6, 2017). This was the debtor’s third chapter 13 filing in four years and at least one of the cases was filed on the eve of a foreclosure. *Id.* When this case was filed, the mortgage arrears had climbed to $433,689.88. All of the cases were dismissed for failure of the debtor to file required documents. Judge S. Martin Teel granted the lender’s in rem motion for relief by entering an order that not only lifted the stay but directed that:

> This relief order shall apply to and be binding upon the Property granting prospective in rem relief from any bankruptcy stay, whether under § 362 or § 1301 of the United States Bankruptcy Code, in all future bankruptcies filed within a period of 180 days following the date of this order.

*Id.* at *1.

### Conclusion

Generally, in rem matters are highly fact intensive and require a review of all the circumstances surrounding the subject property and related bankruptcies. All circuits grant in rem relief where the debtor has filed more than one bankruptcy if they find there is a scheme to stop the lender from exercising its rights against real property. The scheme must involve successive filings within a few years by one debtor or multiple debtors, or a transfer of an interest in the property for less than true value without the lender’s consent. The scheme may also involve other proceedings regarding the property in state court. In cases where those proceedings are determined to be frivolous or baseless courts will weigh them as part of a scheme to hinder or delay the creditor. A lender need not prove the debtor committed fraud in order to gain in rem relief.
Filing Proofs of claim and 3001(c)
Fed. R. Bankr. P. 3001

(c) Supporting information

(2) Additional requirements in an individual debtor case: sanctions for failure to comply

In a case in which the debtor is an individual:

(A) If, in addition to its principal amount, a claim includes interest, fees, expenses, or other charges incurred before the petition was filed, an itemized statement of the interest, fees, expenses, or charges shall be filed with the proof of claim.

(B) If a security interest is claimed in the debtor's property, a statement of the amount necessary to cure any default as of the date of the petition shall be filed with the proof of claim.

(C) If a security interest is claimed in property that is the debtor's principal residence, the attachment prescribed by the appropriate Official Form shall be filed with the proof of claim. If an escrow account has been established in connection with the claim, an escrow account statement prepared as of the date the petition was filed and in a form consistent with applicable nonbankruptcy law shall be filed with the attachment to the proof of claim.

(D) If the holder of a claim fails to provide any information required by this subdivision (c), the court may, after notice and hearing, take either or both of the following actions:

(i) preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or
(ii) award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure. (emphasis added)
In re Taylor, 655 F.3d 274, 278-79, 285-88 (3d Cir. Aug. 24, 2011) (Fuentes, Smith, Van Antwerpen) [Mortgage lender, attorney and law firm are sanctioned for inaccurate representations in stay relief motion and response to claim objection; Bankruptcy Rule 9011 reaches attorney’s blind reliance on client’s computer-generated misinformation.]

In re Washington, 587 B.R. 349, 352–56 (Bankr. C.D. Cal. July 25, 2018) (Houle) [Notwithstanding discharge of personal liability in prior Chapter 7 case, after stripping off wholly unsecured junior lien an allowed unsecured claim results that must be paid through the Chapter 13 plan. “Because there is no in personam liability on the underlying debt, it could be argued that there is no unsecured claim after the § 506(a) valuation. If there is no unsecured claim, however, the debtor would be ineligible to use § 1322(b)(2) to avoid the lien.”]

In re Morgan, No. 18-24459-bhl-13, 2019 WL 548532, at *2–*3 (Bankr. E.D. Wis. Feb. 11, 2019) (Ludwig) [Plan provision for payment of secured creditor is not a substitute for proof of claim in a district in which the form plan states that all creditors must file timely claims to be paid through the plan. The debtor’s desire to pay secured creditor through the plan does not overcome creditor’s failure to timely file a proof of claim.]

In re Clevinger, No. 14-32840, 2018 WL 4223251, at *3–*4 (Bankr. N.D. Ohio Sept. 5, 2018) (Whipple) [Reconsideration of disallowance of claim not appropriate; although notice of claim objection did not comply with addressing protocol in Bankruptcy Rules prior to effective date of new Rule 3007(a)(2)(A), creditor had actual notice of objection and failed to explain why it did not timely respond.]

Shoemake v. SN Servicing Corp., 586 B.R. 741, 742–45 (M.D. Tenn. July 12, 2018) (Crenshaw) [Disallowance of mortgage servicer’s proof of claim because the claim was filed by an entity that was not identified or connected to the loan by any of the attachments was a procedural” disallowance tantamount to the failure of the actual mortgagee to file a proof of claim, and as a result, the lien was unaffected by disallowance and can be collected by successor servicer after completion of payments and discharge without violating automatic stay, confirmed plan or discharge injunction. Section 506(d) was not implicated because the mortgage claim was not disallowed on the merits and the real mortgage holder never filed a proof of claim—only the prior servicer that was not connected to the loan did.]

Mortgages and Discharge

§ 1328. Discharge

(a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, 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. (emphasis added)

In re Van Pelt, 599 B.R. 1, 4–7 (Bankr. E.D. Ky. Apr. 11, 2019) (Schaaf) [Surrender of real property does “provide for” the mortgage obligation and results in discharge of debt; continued reporting of the obligation to the credit reporting agencies was a violation of the discharge injunction.]

Dukes v. Suncoast Credit Union (In re Dukes), 909 F.3d 1306, 1310–22 (11th Cir. Dec. 6, 2018) (Pryor, Carnes, Conway) [Confirmed plan that paid mortgage directly by the debtor did not “provide for” the mortgage and debtor’s personal liability for deficiency after foreclosure was not discharged; confirmed plan could not be interpreted to provide for discharge of mortgage because modification was prohibited by § 1322(b)(2). Confirmed plan stated that mortgage would be paid directly by the debtor.]

In re Rivera, 599 B.R. 335, 339–47 (Bankr. D. Ariz. Mar. 29, 2019) (Wanslee) [Because direct payment of mortgage installments was not payment “under the plan” for purposes of § 1328(a), plan is complete and debtors are entitled to discharge notwithstanding default in direct payments to mortgagee; trustee’s motion to dismiss under § 1307(c)(6) is denied.]

Matter of Kessler, 655 F. App’x 242 (5th Cir. 2016) [Post-petition payments required to be made directly to debtor’s mortgagee were payments under debtor’s Chapter 13 plan that had to be paid in order for debtor to receive discharge.]

In re Gonzales, 570 B.R. 788 (Bankr. S.D. Tex. 2017) [Maintenance payments that Chapter 13 debtors agreed to make directly to mortgagee, while making periodic payments to Chapter 13 trustee to pay off prepetition mortgage arrearage under their cure-and-maintenance plan, were “payments under the plan,” which debtors had to complete in order to be statutorily eligible for Chapter 13 discharge]

In re Hadfeg, 585 B.R. 208, 210–14 (Bankr. S.D. Fla. May 1, 2018) (Mark) [Citing United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260, 130 S. Ct. 1367, 176 L. Ed. 2d 158 (Mar. 23, 2010), and § 1327(a), confirmed plan that stated condo association’s prepetition arrearage was $5,000 to be paid in full precluded association from collecting additional $33,480 prepetition arrearage it claimed four years later. Association did not object to confirmation and did not file proof of claim.]
What are the components of a pre petition arrearage?

1. Principal and Interest payments due and not paid as of the date of the bankruptcy filing. This does NOT include the escrow portion of the payment.
2. Fees and Costs paid by the servicer that remain unpaid as of the date of the bankruptcy filing.
3. Taxes and insurance advanced by the servicer that remain unpaid as of the date of the bankruptcy filing.
4. The amount required in the escrow account as required by RESPA to maintain a "cushion" for the projected 12 months.
5. Less the funds on hand or in suspense account.

Form B410A - Proof of Claim
Mortgage Attachment Part 1

<table>
<thead>
<tr>
<th>Mortgage and Case Information</th>
<th>Part 1: Mortgage and Case Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case number</td>
<td></td>
</tr>
<tr>
<td>the names of Debtor 1 and Debtor 2</td>
<td></td>
</tr>
<tr>
<td>last 4 digits of number used to identify the mortgage</td>
<td></td>
</tr>
<tr>
<td>the creditor's name</td>
<td></td>
</tr>
<tr>
<td>the servicer's name, if applicable</td>
<td></td>
</tr>
<tr>
<td>the method used to calculate interest on the debt (i.e., fixed accrual, daily simple interest, or other method)</td>
<td></td>
</tr>
<tr>
<td>Case number:</td>
<td></td>
</tr>
<tr>
<td>Debtor 1:</td>
<td></td>
</tr>
<tr>
<td>Debtor 2:</td>
<td></td>
</tr>
<tr>
<td>Last 4 digits to identify:</td>
<td></td>
</tr>
<tr>
<td>Creditor:</td>
<td></td>
</tr>
<tr>
<td>Servicer:</td>
<td></td>
</tr>
<tr>
<td>Fixed accrual/daily simple interest/other:</td>
<td></td>
</tr>
</tbody>
</table>
Form B410A - Proof of Claim  
Mortgage Attachment  Part 2

Total Debt Calculation
the principal balance on the debt the interest due and owing
any fees or costs owed under the note or mortgage and outstanding as of the date of the bankruptcy filing
Any escrow deficiency for funds advanced the amount of any prepetition payments for taxes and insurance that the servicer or mortgagee made out of its own funds and for which it has not been reimbursed

Part 2: Total Debt Calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal balance</td>
<td></td>
</tr>
<tr>
<td>Interest due</td>
<td></td>
</tr>
<tr>
<td>Fees, costs due</td>
<td></td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced</td>
<td></td>
</tr>
<tr>
<td>Less total funds on hand</td>
<td></td>
</tr>
<tr>
<td>Total debt</td>
<td></td>
</tr>
</tbody>
</table>

Form B410A - Proof of Claim  
Mortgage Attachment  Part 3

Arrearage as of the Date of the Petition

Mortgage Proof of Claim Attachment

If you file a claim secured by a security interest in the debtor's principal residence, you must use this form as an attachment to your proof of claim. See separate instructions.

Part 1: Mortgage and Case Information  Part 2: Total Debt Calculation  Part 3: Arrearage as of Date of the Petition  Part 4: Monthly Mortgage Payment

Part 5: Loan Payment History from First Date of Default

<table>
<thead>
<tr>
<th>Date</th>
<th>Contractual Funds</th>
<th>Amount</th>
<th>Contractual Funds</th>
<th>Amount</th>
<th>Contractual Funds</th>
<th>Amount</th>
<th>Contractual Funds</th>
<th>Amount</th>
<th>Contractual Funds</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Balance After Amount Received or Incurred

<table>
<thead>
<tr>
<th>Amount</th>
<th>Amount</th>
<th>Amount</th>
<th>Amount</th>
<th>Amount</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Page 760 of 1015
Form B410A - Proof of Claim  
Mortgage Attachment  
Part 3

**Arrearage as of the Date of the Petition:**

Insert the amount of the principal and interest portion of all prepetition monthly installments that remain outstanding as of the petition date.

The escrow portion of prepetition monthly installment payments should NOT be included in this figure.

<table>
<thead>
<tr>
<th>Part 3: Arrearage as of Date of the Petition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest due:</td>
</tr>
<tr>
<td>Prepetition fees due:</td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced:</td>
</tr>
<tr>
<td>Projected escrow shortage:</td>
</tr>
<tr>
<td>Less funds on hand:</td>
</tr>
<tr>
<td>Total prepetition arrearage:</td>
</tr>
</tbody>
</table>

---

Form B410A - Proof of Claim  
Mortgage Attachment  
Part 3

**Arrearage as of the Date of the Petition:**

Insert the amount of fees and costs outstanding as of the petition date. This amount should equal the *fees/charges balance* as shown in the last entry in Part 5, Column P.

<table>
<thead>
<tr>
<th>Part 3: Arrearage as of Date of the Petition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest due:</td>
</tr>
<tr>
<td>Prepetition fees due:</td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced:</td>
</tr>
<tr>
<td>Projected escrow shortage:</td>
</tr>
<tr>
<td>Less funds on hand:</td>
</tr>
<tr>
<td>Total prepetition arrearage:</td>
</tr>
</tbody>
</table>
**Form B410A - Proof of Claim**

**Mortgage Attachment**

**Part 3**

**Arrearage as of the Date of the Petition:**

Insert any escrow deficiency for funds advanced

This amount should be the same as the amount of escrow deficiency stated in Part 2

<table>
<thead>
<tr>
<th>Part 3: Arrearage as of Date of the Petition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest due:</td>
</tr>
<tr>
<td>Prepetition fees due:</td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced:</td>
</tr>
<tr>
<td>Projected escrow shortage:</td>
</tr>
<tr>
<td>Less funds on hand:</td>
</tr>
<tr>
<td>Total prepetition arrearage</td>
</tr>
</tbody>
</table>

**IMPORTANT**

The escrow deficiency amount (i.e., the negative balance in the escrow account on the day the case was filed) is ordinarily the starting balance for the escrow analysis.

Although not spelled out in the instructions, it has been determined that because the escrow deficiency is being listed on a separate line in Part 3, the escrow account needs to be brought up to zero prior to running the escrow analysis.
Form B410A - Proof of Claim
Mortgage Attachment    Part 3

### Part 3: Arrearage as of Date of the Petition

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest due</td>
<td></td>
</tr>
<tr>
<td>Prepetition fees due</td>
<td></td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced</td>
<td></td>
</tr>
<tr>
<td>Projected escrow shortage</td>
<td></td>
</tr>
<tr>
<td>Less funds on hand</td>
<td></td>
</tr>
<tr>
<td>Total prepetition arrearage</td>
<td></td>
</tr>
</tbody>
</table>

**Arrearage as of the Date of the Petition:**

Insert the projected escrow shortage as of the date the bankruptcy petition was filed (should be based on and consistent with escrow analysis performed as of the date of the petition under Rule 3001).

The calculation should include 1/6 of the anticipated annual charges against the escrow account or 2 months of the monthly pro rata installments due by the borrower as calculated under RESPA guidelines.

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Form B410A - Proof of Claim
Mortgage Attachment    Part 3

**Arrearage as of the Date of the Petition:**

The shortage is the difference between the actual amount in the escrow account and the required amount.

The amount actually held should equal the amount of a positive escrow account balance as shown in the last entry in Part 5, Column O.
Form B410A - Proof of Claim  
Mortgage Attachment   Part 3

**Arrearage as of the Date of the Petition:**

**IMPORTANT**
The escrow portion of missed prepetition mortgage payments will not be recovered as a separate line item

<table>
<thead>
<tr>
<th>Part 3: Arrearage as of Date of the Petition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest due:</td>
</tr>
<tr>
<td>Prepetition fees due:</td>
</tr>
<tr>
<td>Escrow deficiency for funds advanced:</td>
</tr>
<tr>
<td>Projected escrow shortage:</td>
</tr>
<tr>
<td>Less funds on hand:</td>
</tr>
<tr>
<td>Total prepetition arrearage:</td>
</tr>
</tbody>
</table>

Form B410A - Proof of Claim  
Mortgage Attachment   Part 4

**Monthly Mortgage Payment:**
The Total Monthly Payment is the sum of the principal and interest, monthly escrow, PMI, and other amounts (e.g., credit life insurance)
The monthly escrow should not include any shortage or deficiency from Part 3

<table>
<thead>
<tr>
<th>Part 4: Monthly Mortgage Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; interest:</td>
</tr>
<tr>
<td>Monthly escrow:</td>
</tr>
<tr>
<td>Private mortgage insurance:</td>
</tr>
<tr>
<td>Total monthly payment:</td>
</tr>
</tbody>
</table>
Form B410A - Proof of Claim
Mortgage Attachment Part 5

The B410A form requires a home mortgage creditor to provide a loan history starting with the first date of default.

This is the first date on which the borrower failed to make a payment in accordance with the terms of the note and mortgage unless the note was subsequently brought current with no principal, interest, fees, escrow payment, or other charges “immediately payable”
Form B410A - Proof of Claim
Mortgage Attachment Part 5

Loan Payment History from the First Date of Default
Beginning with the First Date of Default, enter:
- the date of the default in Column A
- amount incurred in Column D
- description of the charge in Column E

<table>
<thead>
<tr>
<th>Part 5: Loan Payment History from First Date of Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>Date</td>
</tr>
</tbody>
</table>

Form B410A - Proof of Claim
Mortgage Attachment Part 5

Loan Payment History from the First Date of Default
Beginning with the First Date of Default, enter:
- the date of the default in Column A
- amount incurred in Column D
- description of the charge in Column E
- principal balance, escrow balance, and unapplied or suspense funds balance as of that date in Columns M, O, and Q, respectively
New Rule 3002.1

Rule 3002.1. Notice Relating to Claims Secured by Security Interest in the Debtor's Principal Residence

(a) In general, this rule applies in a chapter 13 case to claims (1) that are secured by a security interest in the debtor's principal residence, and (2) for which the plan provides that either the trustee or the debtor will make contractual installment payments. Unless the court orders otherwise, the notice requirements of this rule cease to apply when an order terminating or annulling the automatic stay becomes effective with respect to the residence that secures the claim.

(b) Notice of payment changes; objection

(1) Notice
The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice of any change in the payment amount, including any change that results from an interest-rate or escrow-account adjustment, no later than 21 days before a payment in the new amount is due. If the claim arises from a home-equity line of credit, this requirement may be modified by court order.

(2) Objection
A party in interest who objects to the payment change may file a motion to determine whether the change is required to maintain payments in accordance with § 1322(b)(5) of the Code. If no motion is filed by the day before the new amount is due, the change goes into effect, unless the court orders otherwise.

(c) Notice of fees, expenses, and charges
The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice itemizing all fees, expenses, or charges (1) that were incurred in connection with the claim after the bankruptcy case was filed, and (2) that the holder asserts are recoverable against the debtor or against the debtor's principal residence. The notice shall be served within 180 days after the date on which the fees, expenses, or charges are incurred.

(d) Form and content
A notice filed and served under subdivision (b) or (c) of this rule shall be prepared as prescribed by the appropriate Official Form and filed as a supplement to the holder's proof of claim. The notice is not subject to Rule 3001(f).

(e) Determination of fees, expenses, or charges
On motion of a party in interest filed within one year after service of a notice under subdivision (c) of this rule, the court shall, after notice and hearing, determine whether payment of any claimed fee, expense, or charge is required by the underlying agreement and applicable nonbankruptcy law to cure a default or maintain payments in accordance with § 1322(b)(5) of the Code.
(f) Notice of final cure payment
Within 30 days after the debtor completes all payments under the plan, the trustee shall file and serve on the holder of the claim, the debtor, and debtor's counsel a notice stating that the debtor has paid in full the amount required to cure any default on the claim. The notice shall also inform the holder of its obligation to file and serve a response under subdivision (g). If the debtor contends that final cure payment has been made and all plan payments have been completed, and the trustee does not timely file and serve the notice required by this subdivision, the debtor may file and serve the notice.

(g) Response to notice of final cure payment
Within 21 days after service of the notice under subdivision (f) of this rule, the holder shall file and serve on the debtor, debtor's counsel, and the trustee a statement indicating (1) whether it agrees that the debtor has paid in full the amount required to cure the default on the claim, and (2) whether the debtor is otherwise current on all payments consistent with § 1322(b)(5) of the Code. The statement shall itemize the required cure or postpetition amounts, if any, that the holder contends remain unpaid as of the date of the statement. The statement shall be filed as a supplement to the holder's proof of claim and is not subject to Rule 3001(f).

(h) Determination of final cure and payment
On motion of the debtor or trustee filed within 21 days after service of the statement under subdivision (g) of this rule, the court shall, after notice and hearing, determine whether the debtor has cured the default and paid all required postpetition amounts.

(i) Failure to notify
If the holder of a claim fails to provide any information as required by subdivision (b), (c), or (g) of this rule, the court may, after notice and hearing, take either or both of the following actions:
1. preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or
2. award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure.

_CIT Bank, N.A. v. Griswold-Stanton (In re Griswold-Stanton), No. 2:16-CV-2722 JCM, 2018 WL 3489238, at *5–*6 (D. Nev. July 19, 2018) (Mahan) [The appellate court reversed the bankruptcy court leading to the conclusion that debtors’ attorneys will fare better by employing the sanctions of 3002.1 rather than the sanctions of 9011.]

_In re Melendez Vega, No. 16-08722 (ESL), 2019 WL 927006, at *2–*3 (Bankr. D.P.R. Feb. 22, 2019) (Lamotte) [Absent proof of specific facts requiring otherwise, mortgagee cannot charge a $50 fee for filing a notice of postpetition mortgage payment change consistent with Bankruptcy Rule 3002.1. Notice of payment change is a normal business function required by RESPA which is not compensable and does not normally require the services of an attorney.]_
In re Okafor, 595 B.R. 903, 907–10 (Bankr. W.D. Mo. Dec. 17, 2018) (Dow) [California attorney allowed reduced fee of $600 for review of plan and filing proof of claim in Chapter 13 case in Missouri. California attorney did not practice law unlawfully in Missouri because work was done in California and attorney did not make appearance in Missouri bankruptcy court. Requested fee of $900 was unreasonable.]

Clark v. Select Portfolio Servicing, Inc. (In re Clark), No. 17-01031-R, 2018 WL 6266179, at *6–*11 (Bankr. N. D. Okla. Nov. 26, 2018) (Rasure) [Mortgagee’s failure to respond to notice of final cure from trustee precludes mortgagee under Rule 3002(i) from presenting evidence that there is an arrearage based on a preconfirmation notice of payment change five years earlier. Mortgagee was bound by amount of payment in confirmed plan and cannot claim after discharge that its preconfirmation notice of payment change allows foreclosure after completion of payments and discharge.]

In re Thornburg, 596 B.R. 766, 771–72 (Bankr. M.D. Fla. Dec. 20, 2018) (Jennemann) [Chapter 13 debtor overcame presumption of validity of proof of claim for $324,664.89 and current holder of debt failed to prove amount due in excess of $50,000 the debtor admits. Outcome driven mostly by inconsistent and incomplete loan history supplied by creditor.]

Claims filed under Rule 3004

Rule 3004. Filing of Claims by Debtor or Trustee
If a creditor does not timely file a proof of claim under Rule 3002(c) or 3003(c), the debtor or trustee may file a proof of the claim within 30 days after the expiration of the time for filing claims prescribed by Rule 3002(c) or 3003(c), whichever is applicable. The clerk shall forthwith give notice of the filing to the creditor, the debtor and the trustee.

In re Lee, No. 16-30416, 2018 WL 2138774, at *2–*4 (Bankr. N.D. Ohio May 8, 2018) (Whipple) [Chapter 13 debtor’s objection to Ocwen’s amendment of proof of claim filed on behalf of Ocwen under Bankruptcy Rule 3004 is sustained. Ocwen cannot amend the debtor’s Rule 3004 claim 14 months after confirmation to change arrearage amount from $15,000 to $150,000.]

In re Barbour-Freeman, 590 B.R. 147 (Bankr. E.D. Mich. Sept. 10, 2018) (Shefferly) [Bankruptcy Rule 3004 is permissive: when mortgagee failed to file proof of claim, debtors’ attorney could have filed a claim for the mortgagee to stop the trustee from distributing accumulated funds to unsecured creditors. Debtors’ attorney was sanctioned for failure to file a claim for the creditor under rule 3004]

Shoemake v. SN Servicing Corp., 586 B.R. 741, 742–45 (M.D. Tenn. July 12, 2018) (Crenshaw) [Disallowance of mortgage servicer’s proof of claim because the claim was filed by an entity that was not identified or connected to the loan by any of the attachments was a procedural” disallowance tantamount to the failure of the actual mortgagee to file a proof of claim, and as a result, the lien was unaffected by disallowance and can be collected by successor
servicer after completion of payments and discharge without violating automatic stay, confirmed plan or discharge injunction. Section 506(d) was not implicated because the mortgage claim was not disallowed on the merits and the real mortgage holder never filed a proof of claim—only the prior servicer that was not connected to the loan did.]
I. What is 522(g)? How is it a hot topic and why do we care?

A. Background

In consumer bankruptcy, exemptions are the cornerstone protections for debtors, ensuring debtors may keep certain items of property deemed by law to be protected from creditors. Exemptions offer a public benefit, in that society does not benefit when a debtor is left with nothing after bankruptcy and instead becomes a burden on the public welfare system.

However, the Code defines certain limitations and exceptions that may affect a debtor’s right to claim an exemption. 11 U.S.C. § 522(g) is one of the trending code sections used in recent years to attempt to deprive a debtor of exempting property recovered by a trustee.

11 U.S.C. § 522 …

(g) Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if—

(1) such transfer was not a voluntary transfer of such property by the debtor; and

(B) he debtor did not conceal such property; or

(2) the debtor could have avoided such transfer under subsection (f)(1)(B) of this section.

In fact, 522(g) does not bar a debtor from claiming an exemption in recovered property. Section 522(g) provides that a debtor may exempt property that the trustee recovers if certain provisions are met. It has been said that, “Section 522(g) does not limit, but rather expands, a debtor’s exemptions.”

1 Judge Scott W. Dales of Grand Rapids, Mich.
B. Cases Involving 522(g) Require Careful Analysis.

We must be careful in our analysis of cases involving Section 522(g). Often times the initial review may cause a knee-jerk reaction to presume that property recovered may not be subject to the debtor’s exemptions. Debtors’ counsel must also conduct proper due diligence when representing a debtor to ensure the debtor’s understanding and representations concerning how title to property is held.

**Analysis:**

3. 11 U.S.C. § 105(a) and 544(b) – property without benefit to the estate should be abandoned back to the debtor.
5. 11 U.S.C. § 522(g) – Debtor may exempt property recovered if the debtor (1) could have exempted it, if it had not been transferred, if such transfer was not voluntary and debtor did not conceal such property.

Hypothetical A: Four years prior to the debtor filing a chapter 7 bankruptcy, Debtor and Debtor’s non-filing spouse purchased a residence together, held in joint tenancy. Debtor had a prior foreclosure and was unable to qualify for a home loan. Non-Filing spouse (“NFS”) qualified for the residential mortgage loan. Debtor and NFS reside in a community property state. The lender will not fund escrow on the purchase unless Debtor signs a quit claim deed or inter-spousal transfer deed to NFS. Debtor signs the deed transferring his interest to his NFS, escrow closes, and Debtor and NFS both move into the residence and continue to reside in the home with their children. Debtor and NFS’s incomes are deposited into a joint account and used to pay down the mortgage, pay the property taxes and maintain the home and family. Debtor owes a $500 credit card at the time of the transfer. Debtor is current on his credit card payments and is solvent.

Debtor then opens a business, which later fails and causes him to file for bankruptcy protection. NFS is not contractually liable on Debtor’s business debt. However, may be liable for the debt incurred during marriage under community property law, but NFS does not wish to file bankruptcy. Debtor files a chapter 7 and discloses the residence on Schedule A and exempts it with the community homestead exemption. On Schedule A Debtor further discloses that title is held in NFS’s name only and the mortgage is in NFS’s name only, but Debtor claims a community property interest. The homestead exemption is $175,000. The equity in the property is approximately $150,000.
Using the analysis steps above:

(1) **Property of the Estate?** We must first look to whether or not the residence is property of the bankruptcy estate. Section 541(a)(1) specifically includes all equitable interests of the debtor. Section 541(2) includes all community property interests of the debtor.

(2) **Exemptions?** Debtor has an equitable interest. Debtor claims the community property homestead exemption. However, Debtor transferred his title to his NFS. May he still claim an exemption? If Debtor cannot claim an exemption, may his NFS still claim her homestead exemption in the property? Assume the HSE applies to NFS’s interest, since a hypothetical lien creditor would receive nothing of value, the estate can recover and preserve nothing of value here.

(3) **Benefit to the Estate?** Even if the trustee is successful in recovering the property, there appears to be no equity for the estate based on Debtor’s schedules and BPO. But the trustee alleges the property value is higher and that the estate may receive $40,000 after the sale of the property. If the trustee must hire counsel to litigate, the trustee must litigate to recover the property and litigate the validity of any exemptions. After litigation will there be a benefit to the estate (i.e. a meaningful distribution to creditors)?

(4) **Recovery?** Problems with recovery – What are you recovering? The estate already has an equitable interest in the property. The estate already has a community property interest. The debtor only transferred his half of the property. Recovering only half of the property does not generate funds to the estate. Debtor was solvent when the transfer was made. Did Debtor have two interests in the property: (a) bare legal title, which was transferred; and (2) an equitable interest that was acquired after the bare legal title transfer was made? Does it make a difference? Since Debtor retained his equitable interest in the property, the value of the legal title he transferred was zero. Debtor’s spouse could not have received more than a 50% interest, as a consequence Trustee could only recover what was transferred away.

(5) **Exempt Recovered Property?** Here, Debtor could have exempted the residence if he had not transferred it. He met the requirements of the state law HSE and he did not conceal the property, it was fully disclosed. But, what do we do about the voluntary transfer question? Had Debtor not transferred to the NFS, the lender would not have funded the loan and there would be no property to speak of. Was that an involuntary transfer for purposes of 522(g)? Debtor and NFS didn’t have to buy the home, so could it be argued that it was a voluntary transfer? Trustee argues this is a voluntary transfer and therefore, Debtor may not exempt the recovered property.
Hypothetical B: Debtor’s bank accounts have been levied. Creditor received $10,000. Debtor seeks bankruptcy counsel who did not file the petition within the preference period to recover the funds. Debtor could have exempted the funds. Trustee discovers the potential malpractice claim against the debtor’s attorney and files suit against debtor’s counsel. Debtor amends his schedules to disclose and exempt the claim. The trustee objected to the exemption.

Using the analysis steps above:

1. **Property of the Estate?** Is the claim property of the estate? The injury to debtor, the malpractice claim, occurred prior to filing and is property of the estate under 541(a).

2. **Exemptions?** Debtor used the wildcard exemption to protect the claim.

3. **Benefit to the Estate?** There can only be a benefit to the estate here if the Trustee’s motion to disallow debtor’s exemption is granted. Will there be a meaningful distribution to creditors if Trustee litigates this issue?

4. **Recovery?** Problems with recovery – (a) There was no transfer. (b) Trustee argues that the transfer occurred when the debtor filed bankruptcy, alleging that Debtor transferred the cause of action to the trustee – this is rejected by the court because the court found that a transfer does not occur on the filing of a petition, it is a transfer that necessitates the use of avoiding powers. (c) Trustee argues that 522(g) applies to all property of the estate under 541(a)(1), but the court explained that there would never be any eligible property within the estate for the debtor to exempt on that theory.

5. **Exempt Recovered Property?** Here, there was no transfer to implicate 522(g). The debtor was able to simply amend the schedules to disclose the malpractice claim and exempt it.²

II. **522(g) Case Samples:**

A. In re Schmitt (See Attached) – Debtor made pre-petition payments to satisfy a bench warrant and then claimed it was exempt. Chapter 7 trustee objected to the exemption. However, the objection was overruled. The transfer was to the court officer to satisfy the bench warrant and avoid jail time. It was, therefore, an involuntary transfer. The transfer occurred by operation of law for purposes of 522(g).

B. In re Leach (See Attached) – Debtor transferred a vehicle when they have it to their daughter and daughter took possession for several years. Debtors maintained legal ownership of it and the daughter voluntarily returned possession of the vehicle to Debtors. There was no basis to deny debtor’s claim of exemption to the vehicle because the trustee did not recover the vehicle within the meaning of 522(g).

C. In re De Jesus Gomez, In re Aldana v. Stadtmueller (See Attached) Debtor could not claim an exemption in the vehicle under 522(g)(1)(A). The trustee satisfied the two prongs of 522(g)(1)(A). The court used a totality of factors concerning the vehicle’s surrender. The panel held that the Trustee was entitled to recover his fees and double costs from debtor’s attorney for the frivolous appeal.
In re: MICHAEL HAROLD DAWSON and PATRICIA ANN DAWSON, Debtors.

Case No. DG 16-04923
Chapter 7
Hon. Scott W. Dales

MEMORANDUM OF DECISION & ORDER

PRESENT: HONORABLE SCOTT W. DALES
Chief United States Bankruptcy Judge

After debtor Patricia Dawson (the “Debtor”) amended Schedule C to claim as exempt a cause of action against her former bankruptcy counsel (the “Cause of Action”), chapter 7 trustee Jeff A. Moyer (the “Trustee”) filed Trustee’s Objection to Amended Claim of Exemption (ECF No. 43, the “Objection”), seeking an order denying any exemption in the Cause of Action as contrary to 11 U.S.C. § 522(g).1 The Debtor opposes the Objection.

The court held a hearing on November 16, 2018, in Grand Rapids, Michigan, to consider the Debtor’s exemption and whether the Trustee has met his burden under Rule 4003(c) of persuading the court that the Debtor has not properly claimed it. The Debtor and the Trustee both appeared at the hearing through counsel. The Debtor’s former counsel also appeared through counsel, but only to monitor the hearing for any impact on the Trustee’s adversary proceeding against her and her firm.

1 Unless otherwise indicated, any reference in the text of this opinion to “§ __” points to a section within the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq. And, unless otherwise noted, a reference in this opinion to a “Rule” indicates reliance on a Federal Rule of Bankruptcy Procedure.
The court has considered the arguments presented at the hearing and in the Trustee’s Brief in Support of Objection to Amended Claims of Exemptions filed after the hearing (ECF No. 54, the “Post-Hearing Brief”), and will overrule the Objection.

By way of background, before the Debtor amended her exemption claims, the Trustee had filed a complaint against the Debtor’s former counsel alleging legal malpractice due to counsel’s alleged failure to file the Debtor’s petition in time to preserve a possible preference recovery (and exemption rights) under §§ 522(g) and 547. Through that adversary proceeding, the Trustee contends that if counsel had filed the Debtors’ bankruptcy petition in time, the Debtor could have exempted approximately $6,047.00 from a likely preference recovery against her judgment creditor, GFI, LLC, who garnished a deposit account at Portland Federal Credit Union. The Trustee alleges that because former counsel failed to file the bankruptcy petition within ninety days of the service of the creditor’s garnishment writ, she negligently foreclosed the Debtor from exempting the $6,047.00 that the Trustee, or the Debtor, might have avoided under § 547 and recovered under § 550. See 11 U.S.C. §§ 522(g-h), 547, and 550.

The parties to this exemption controversy agree that the Cause of Action qualifies as a prepetition asset to which the Trustee succeeded under § 541(a)(1) upon the commencement of the Debtor’s case. Bauer v. Commerce Union Bank, 859 F.2d 438, 441 (6th Cir.1988) (“… causes of action which formerly belonged to a debtor vest in the trustee for the benefit of the bankruptcy estate when the debtor files in bankruptcy under Chapter 7 of the Bankruptcy Code”), cert. denied, 489 U.S. 1079 (1989). They also agree that if the court overrules the Objection, the Cause of Action would, as a practical matter, belong to the Debtors rather than their bankruptcy estate,

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2 At the hearing, to address the court’s concerns about potential unfairness to the Debtor’s former bankruptcy counsel, the Trustee agreed that nothing in the court’s decision regarding this exemption controversy would bar her from arguing that the Cause of Action is not included within the property of the Debtor’s bankruptcy estate.
because its full value cannot be used to pay claims. See 11 U.S.C. § 522(c) and (k). Property without benefit to the estate should be abandoned back to the debtor, as the Trustee conceded during the hearing. 11 U.S.C. §§ 105(a) and 554(b).

Conceding that the court “may not refuse to honor the exemption absent a valid statutory basis for doing so,” the Trustee argues § 522(g) provides the statutory basis that precludes the Debtor from claiming the Cause of Action as exempt. He argues that the Debtor’s former counsel concealed the Cause of Action by not cooperating in the Trustee’s pre-suit investigation, and that the Debtor, as principal, is accountable for the acts of her former agents (the defendants in the adversary proceeding).

As the Supreme Court frequently says, the interpretation of any statute starts with the statutory text. Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S. 552, 558-59 (1990). Where the text is clear, the inquiry begins and ends there. Given the central role that § 522(g) plays in this dispute, the court begins with the text of the statute:

(g) Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if—

(1)(A) such transfer was not a voluntary transfer of such property by the debtor; and

(B) the debtor did not conceal such property; or

(2) the debtor could have avoided such transfer under subsection (f)(1)(B) of this section.

11 U.S.C. § 522(g) (emphasis added). In his Objection, during the hearing, and again in the Post-Hearing Brief, the Trustee contended that the Debtor’s former counsel concealed the Cause of

Action allegedly transferred by the Debtor, but when pressed he was unable to identify what transfer the Debtor effected—the obvious focus of the statutory text.

Last year, this court construed the text of § 522(g) and described its purpose as follows:

In effect, § 522(g) “provides a further opportunity for a debtor to claim an exemption in property that was not in the debtor's portfolio when the bankruptcy proceeding began” if the transfer was involuntary and the property was not concealed by the debtor. Stornawaye Financial Corp. v. Hill (In re Hill), 562 F.3d 29, 34 (1st Cir. 2009). If, however, the transfer was voluntary and the property is recovered by the trustee under the provisions enumerated in the statute, § 522(g) “prevents a debtor from claiming exemptions” in the recovered property. In re Kuhnel, 495 F.3d 1177, 1178–81 (2007) (holding that § 522(g) only applies to prohibit a claim of exemption when there has been “both a voluntary transfer, as well as a recovery”).

In re Mickens, 575 B.R. 797, 803 (Bankr. W.D. Mich. 2017) (declining to apply § 522(g) to homestead exemption claimed in property included within the estate on the petition date under § 541(a)(1)).

As Judge Boyd explained in Mickens, § 522(g) is “a rehabilitative statute, rather than a punitive one, . . . intended to further facilitate a debtor’s overall ‘fresh start’ by permitting her to exempt property that was transferred away and recovered by the trustee in certain circumstances.” Id., 575 B.R. at 808 (citations omitted).

In contrast to this view of § 522(g), which regards the subsection as expanding the universe of property subject to exemption, the Trustee regards § 522(g) as limiting exemptions generally, even exemptions claimed in property included within the estate on the petition date under § 541(a)(1), as he argues in the Post-Hearing Brief. The court rejects the Trustee’s narrow view of § 522(g) for several reasons.

Most generally, as a remedial or “rehabilitative statute,” § 522 should be “construed liberally.” In re Smith, 640 F.2d 888, 891 (7th Cir. 1981); cf. In re Wengerd, 453 B.R. 243, 247
(6th Cir. B.A.P. 2011) (construing Ohio exemption statute liberally in favor of exemption). Even without this maxim of statutory construction, the text of the statute does not support the Trustee’s reading.

The opening line—“[n]otwithstanding sections 550 and 551 of this title”—is the reader’s first signal that § 522(g) is designed to expand, not limit, a debtor’s exemption rights. It reveals that the point of the provision is to relax the restrictions in the two cited statutes that would otherwise preclude a debtor from claiming property as exempt.4 More specifically, by suspending §§ 550 and 551, § 522(g) ensures that debtors may exempt property that is not initially available for exemption, either as a legal or practical matter, because title or control of the asset is initially outside the bankruptcy estate. In this way, the text of § 522(g) expands, rather than limits, exemption rights which, in general, are determined as of the petition date when the rights of the parties to a bankruptcy proceeding are usually fixed. In re O’Brien, 443 B.R. 117, 130-31 (Bankr. W.D. Mich. 2011).

Of course, the expanded exemption right is not unlimited: if the debtor took steps to put the property beyond the reach of the trustee by voluntarily transferring and concealing it, the debtor cannot benefit when the trustee later unwinds the transfer, using the avoidance and recovery powers under chapter 5. This should come as no surprise.

The Trustee, however, seizes on the limiting language of § 522(g), arguing that the restrictions apply not just to property over which a trustee gains control using the chapter 5 powers, but to all property automatically included within the estate under § 541(a)(1). His argument invites the court to write out of the statute the references to § 550 and 551, and stands the text of § 522(g)

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4 Without this phrase, the property that a trustee recovers (or that is preserved) under §§ 550 and 551, respectively, would be off limits for exemption because, under these sections, recovery and preservation must be “for the benefit of the estate,” not the debtor.
on its head. He does this principally by identifying the transfer at issue as the transfer or conveyance that is said to occur by operation of law under § 541(a)(1). See Post-Hearing Brief at pp. 2 - 5. In addition to being at odds with Mickens and unsupported by any citation to case law, interpreting § 522(g) as a limitation on exempting any property included in the estate under § 541(a)(1) (not just recovered property) would render the exemptions under § 522(b) inapplicable in every bankruptcy proceeding. In addition to ignoring the opening proviso in § 522(g), the Trustee’s argument proves too much.

By identifying the transfer to which § 522(g) refers as the voluntary transfer of property into the estate automatically effected upon the filing of a petition, the Trustee ensures that no debtor in a voluntary case could ever satisfy § 522(g)(1), which authorizes exemptions only if the “transfer was not a voluntary transfer” of the property to be exempted. Indeed, in voluntary and involuntary cases alike, the Trustee’s argument would preclude any exemptions, though for a slightly different reason. This is because a debtor may claim an exemption under § 522(g) only “to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred. . . .” But if the “transfer” is the transfer into the estate (as the Trustee argues), no debtor could ever satisfy this aspect of § 522(g) because debtors may only exempt property that is included within the estate, and then only if the “property had not been transferred” into the estate in the first place (as § 522(g) requires the court to hypothesize). Consequently, whether the case is voluntary or involuntary, under the Trustee’s interpretation, there would never be any eligible property within the estate for the debtor to exempt.

Indeed, identifying the transfer as did the Trustee, and arguing that § 522(g) is a general limitation on all exemptions, would render the rest of the statute irrelevant: there would be no point

5 “No property can be exempted . . . unless it first falls within the bankruptcy estate.” Owen v. Owen, 500 U.S. 305, 308 (1991).
in inquiring whether the transfer was voluntary or whether the debtor concealed it because if the transfer did not occur as § 522(g) requires us to pretend, the debtor could not have exempted the transferred property in any event. The Trustee’s reading is tortured and leads to an absurd result.

The more natural view of the statute, and the one the court adopts, is that the “transfer” referred to in § 522(g) is the prepetition transfer (either of title or possession) that made it necessary for the trustee to exercise the chapter 5 avoidance and recovery powers enumerated in the section and to reel the property back into the estate, not the transfer that occurs upon the filing of a bankruptcy petition. See In re Mickens, 575 B.R. at 803.6

In a further effort to squeeze the Debtor’s exemption claim into § 522(g), the Post-Hearing Brief suggests that a trustee who sues on a state law cause of action is exercising the turnover power under § 542. The court, however, has doubts about this proposition as well, because it would transform an obviously non-core proceeding—a suit on a state law cause of action—into a core proceeding, and the Trustee has offered no authority for this proposition in his Post-Hearing Brief.7 Just as the court will not permit a label that a litigant applies to his lawsuit to transform a

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6 Even assuming the statutory text is not clear, as the Trustee posits by offering an alternative view, the legislative history of § 522(g) supports the court’s view of the statutory text and identifies the nature of the transfers to which it refers:

Subsection (g) gives the debtor the ability to exempt property that the trustee recovers under one of the trustee’s avoiding powers if the property was involuntarily transferred away from the debtor (such as by the fixing of a judicial lien) and if the debtor did not conceal the property. The debtor is also permitted to exempt property that the trustee recovers as the result of the avoiding of the fixing of certain security interests to the extent that the debtor could otherwise have exempted the property.


non-core into a core proceeding, neither will it permit clever labeling to restrict the Debtor’s exemption rights. Moreover, the policy that undergirds § 522(g)’s reference to § 542—preventing the unfairness of permitting a debtor who puts property beyond the trustee’s reach to benefit from the trustee’s efforts to recover the transferred and concealed property—is simply not implicated on the present record, where the parties both agree that the Cause of Action is automatically included within the estate. That the Trustee is attempting to transform the asset from an intangible, prepetition malpractice claim into cash does not change the fact that the estate already included the Cause of Action on the petition date. Moreover, the Trustee certainly cannot complain that he filed the adversary proceeding without knowing the Debtor might exempt the Cause of Action, because the parties discussed this possibility earlier this year when the Trustee was undertaking his pre-suit discovery against the Debtor’s former counsel. See Memorandum of Decision & Order dated June 21, 2018 (ECF No. 32) at p. 4 (noting former counsel’s argument that the Debtor could exempt the Cause of Action and deprive the Trustee of the benefit of a potential malpractice lawsuit).

Finally, although today’s decision does not rest on rejecting the Trustee’s allegations of concealment, the court is not persuaded that counsel’s resistance to pre-suit discovery earlier this year amounts to concealment of the Cause of Action by the Debtor. Indeed, as Debtor’s counsel argued during the hearing, former counsel may have concealed documents that would be useful to the Trustee in prosecuting the Cause of Action, but not the Cause of Action itself. The Cause of Action was obvious to this savvy trustee, probably as early as the first meeting of creditors, and it clearly prompted him to demand the documents. He was not on a fishing expedition, trolling for the unknown catch, but was seeking specific correspondence that he assumed existed and that
would support the malpractice claim he clearly had in mind at the time of the turnover demand, and now. It is disingenuous to argue otherwise.

Moreover, under agency principles, it is far from clear that a principal is chargeable with the acts of an agent who acts for the agent’s own interests, against the interests of her principal. See MCA Financial Corp. v. Grant Thornton, L.L.P., 687 N.W.2d 850, 857 (Mich. App. 2004) (discussing “adverse interest” exception to principal’s vicarious liability for agent’s acts when agent is acting solely in her own interest).

In any event, the court need not decide whether the Debtor is chargeable with her former counsel’s supposed “concealment” because the court has already rejected the Trustee’s interpretation of § 522(g). Because the Debtor may exempt the Cause of Action under § 522(b) and (d)(5) without implicating § 522(g) in any way, the court will overrule the Objection.

Finally, as the Trustee acknowledged on the record during the hearing, the court’s ruling in favor of the Debtor’s exemption renders the Cause of Action of inconsequential value or benefit to the estate under § 554, so the court will order the Trustee to abandon it to the Debtor.

NOW THEREFORE, IT IS HEREBY ORDERED that the Trustee’s Objection (ECF No. 43) is OVERRULED and the Cause of Action is ABANDONED to the Debtor.

IT IS FURTHER ORDERED that the Clerk shall serve a copy of this Memorandum of Decision & Order pursuant to Fed. R. Bankr. P. 9022 and LBR 5005-4 upon Michael Harold Dawson and Patricia Ann Dawson, Martin L. Rogalski, Esq., Jeff A. Moyer, Esq., and the United States Trustee (by First Class U.S. Mail).

END OF ORDER

IT IS SO ORDERED.
Dated December 7, 2018

[Signature]
Scott W. Dailes
United States Bankruptcy Judge
**In re Schmitt**

United States Bankruptcy Court for the Eastern District of Wisconsin

December 18, 2018, Decided

Case No. 18-21755-beh, Chapter 7

**Core Terms**

exemption, jail, property of the estate, bench warrant, documents, operation of law, involuntary, transferred, recovered, funds, garnishment, involuntary transfer, wages

**Case Summary**

**Overview**

HOLDINGS: [1] Where debtor had made a pre-petition payment to satisfy a bench warrant and then claimed it was exempt, Chapter 7 trustee's objection to the exemption was overruled because the debtor's transfer of funds to the court officer to satisfy the bench warrant and avoid jail time fell on the involuntary end of the spectrum. The transfer occurred by operation of law and was involuntary for purposes of **11 U.S.C.S. § 522(g)**.

**Outcome**

Trustee's objection to debtor's exemption overruled.

**LexisNexis® Headnotes**

**HN1**

Claims & Objections

The trustee bears the burden of proving that an exemption is not properly claimed. *Fed. R. Bankr. P. 4003(c)*.

**HN2**

Claims & Objections

Only property of the estate may be claimed as exempt. **11 U.S.C.S. § 522(b)(1)**.

**HN3**

Contents of Estate

Property of the estate is broadly defined to include all property interests of the debtor as of the commencement of the case. **11 U.S.C.S. § 541(a)(1)**. The Code also provides several means by which the estate may acquire property after the case is filed. For example, under **11 U.S.C.S. § 541(a)(3)**, property that the debtor does not possess on the date of filing may later become property of the estate if the trustee recovers the property using his avoidance powers—including the power to avoid preferential transfers under **11 U.S.C.S. § 547, 11 U.S.C.S. § 541(a)(3)**.

**HN4**

Claims & Objections

While the Code does not define the term "voluntary" for purposes of **11 U.S.C.S. § 522(g)**, bankruptcy courts have generally concluded that an involuntary transfer occurs when property is transferred by operation of law, such as by means of an execution of judgment, repossession, or garnishment.

**Counsel:** [**1**] For Wayne R Schmitt, Debtor: Michael R. Vanden Berg, Kaukauna, WI.

For Paul G. Swanson, Trustee: Nicholas L. Hahn, Steinhilber Swanson LLP, Oshkosh, WI; Paul G. Swanson, Oshkosh, WI.
Opinion

[*566] DECISION OVERRULING TRUSTEE'S OBJECTION TO DEBTOR'S EXEMPTION

What Wayne Schmitt faced was no Johnny Cash song. Not wanting to remain in jail, 74-year old Schmitt made a prepetition payment to satisfy a bench warrant. Shortly thereafter, the Chapter 7 trustee objected to debtor Schmitt's exemption of the payment, arguing that the payment was voluntary. Schmitt contended that the choice between payment or loss of liberty was involuntary. As described more fully below, the Court overrules the trustee's objection.

FACTUAL BACKGROUND


The Chapter 7 trustee objected to the debtor's exemption of the preference paid to Wolfinger, asserting that the debtor may not exempt funds voluntarily remitted to a creditor during the preference period. CM-ECF Doc. No. 12. The trustee cited Schmitt's testimony at the meeting of creditors that he made the payment involuntarily from funds loaned to him by a relative to satisfy a judgment and to cancel the bench warrant entered in Wolfinger's small claims action against him. Id. According to the public docket in the small claims action, available via an online database commonly known as CCAP (Consolidated Court Automation Programs), the bench warrant was canceled on February 28, 2018 due to payment in full of $3,713.38. The funds to make that payment came from several Calumet County Jail ATM loans from Alyce Head totaling $4,016. CM-ECF Doc. No. 12. On May 29, 2018, the debtor filed Amended Schedule E/F, which added a non-priority unsecured claim of Tom and Alyce Head in the amount of $4,016, incurred February 26, 2018, "borrowed $to pay warrant." CM-ECF Doc. No. 16, Line 4.22.

At a hearing on the trustee's objection to the debtor's exemption, the Court requested that the parties submit affidavits with additional facts or case citations. In response, the trustee filed an affidavit**3 attaching the CCAP Case Summary for Calumet County Case Number 2016SC000082, Wolfinger Water & Backhoe Service LLC vs. Wayne Schmitt, which includes the following pertinent entries:

02-28-2018 [Event:] Warrant/Capias/Commitment canceled for Schmitt, Wayne

Additional text: ARREST, judgment paid in full in the amount of $3,713.38

02-28-2018 [Event:] Cash bond posted

[Amount:] $3,713.38

...  


[Court official:] Froehlich, Jeffrey S.

Additional text: Pay judgment in full in the amount of $3,713.38 OR provide to Atty Wagener 2015 & 2016 returns, all bank account statements, property tax bills for all property owned individually and all corporate documents that the DE is a shareholder, partner or member of.

CM-ECF Doc. No. 19, at 3-4.

The debtor filed a copy of the October 2, 2017 Bench Warrant for Wayne Schmitt, which states:

TO ANY LAW ENFORCEMENT OFFICER:

Arrest and deliver to the sheriff the above named person because this person

...  

x Failed to: comply with the Order dated June 29, 2017 and specifically failed to produce tax returns for the years of 2015 and 2016, all bank account statements, property tax bills for all property owned individually and all corporate documents that the defendant is a shareholder, partner or member of.

This person may be released upon completion of [any] of the following conditions:

...  

x Paying the amount owed on the judgment $3,713.38.

1 Schedule E/F Line 4.23 lists a $3,500 debt incurred February 22, 2016 for goods and services from Wolfinger.
Performing the following conditions as authorized by the court: (All conditions under this section must specifically [sic] authorized by the court.) Deliver to Attorney Andrew Wagener, Bollenbeck Fyfe, S.C., W6260 Communication Court, Appleton, WI your tax returns for the years of 2015 and 2016, all bank account statements, property tax bills for all property owned individually and all corporate documents that the defendant is a shareholder, partner or member of. CM-ECF Doc. No. 21, at 5-6.

Mr. Schmitt also filed his own affidavit, which explains that at 74 years of age he suffers from various health issues. Affidavit of Wayne Schmitt, CM-ECF Doc. No. 21, ¶ 8. Schmitt's affidavit describes how two Calumet County Sheriff Deputies arrived at his home unannounced on February 26, 2018 and took him into custody with a bench warrant based on a contempt order. Once at the jail, they informed him that they wanted "his body or his money," [*5] provided him only the first page of the warrant, and gave him no other alternatives to satisfy the warrant. Id. at ¶¶ 3-5. Mr. Schmitt attested that he had previously mailed the required documents to satisfy the warrant and did not realize that the documents had not been received; consequently, he saw no other alternative to secure his release from jail than to pay the required amount. Id. at ¶¶ 6-7.

The trustee did not offer any facts to refute Mr. Schmitt's prior efforts to comply with the June 29, 2017 state court order to turn over documents.

At the request of the Court, on October 4, 2018, the parties submitted a stipulation with additional facts to supplement the record. According to that stipulation, the trustee had sent a demand letter to Wolfinger on September 12, 2018, requesting turnover of the $3,716 it received from the debtor. Neither the trustee nor Mr. Schmitt had recovered the payment, as of October 4. See CM-ECF Doc. No. 26.2

[*568] THE PARTIES' ARGUMENTS

The trustee asserts that a debtor may not claim an exemption in an avoidable preference if the debtor paid a debt voluntarily, because § 522(h) allows a debtor to avoid a transfer of property only if two conditions are met: (1) the transfer would be avoidable by the trustee and the trustee does not attempt to avoid the transfer; and (2) the debtor could have exempted the property under § 522(g), which allows a debtor to exempt property recovered by the trustee only if the debtor did not transfer the property voluntarily. The trustee also argues that a voluntary transfer is one accomplished of the debtor's own volition, as he asserts occurred here, because the creditor merely exercised its rights pursuant to ordinary, duly entered court orders. The trustee urges the Court to adopt a bright-line definition of a voluntary transfer as one made of the debtor's own volition in the absence of fraud or other unlawful conduct by a creditor.

Conversely, debtor Schmitt argues that the transfer of $4,016 is avoidable because all requirements of 11 U.S.C. § 522(g) are satisfied and the transfer was not voluntary. The transfer, he asserts, involved a heavy dose of coercion and was not of the debtor's own free will. Given the limited options of paying on the bench warrant or remaining in jail, the payment to satisfy the warrant should not be considered a voluntary act. CM-ECF Doc. No. 21.

DISCUSSION

The trustee's objection to the debtor's [*7] exemption of the payment implicates several subsections of 11 U.S.C. section 522 and Federal Rule of Bankruptcy Procedure 4003, both of which govern a debtor's exemptions from property of the estate. HNI[†] The trustee bears the burden of proving that the exemption is not properly claimed. Fed. R. Bankr. P. 4003(c); see also In re Hill, 566 B.R. 891 (Bankr. W.D. Mich. 2017) (objecting party has the burden of demonstrating that a transfer was voluntary, at which point the burden shifts to the debtor to demonstrate that the transfer was involuntary, but the ultimate burden of proof remains with the objecting party).

The trustee and the debtor focus their arguments on whether the payment was voluntary, and therefore capable of being exempted under sections 522(h) and (g). Those two sections of the Code provide:

In his response brief, the debtor claims that the total amount "paid" to free him from jail, after fees and costs for processing (over $300 in jail ATM fees), was $4,016, and that "the transfer of $4016 is avoidable" under section 522(g). But it is only the amount transferred to the creditor—$3,716—that is a potentially avoidable preference payment. The debtor provides no authority establishing his ability to recover from Wolfinger (and then exempt) any extra costs and fees Ms. Head incurred (on his behalf) in withdrawing money from the jail ATM. In any event, the amount of the debtor's claimed exemption is $3,716, so the Court considers only that amount.

2 Either the trustee or the debtor will continue pursuing the estate's right to recover the preference payment following issuance of this decision. CM-ECF Doc. No. 26, ¶ 9.
The debtor may avoid a transfer of property of the debtor or recover a setoff to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer . . .


[T]he debtor may exempt under subsection (b) of this section property that the trustee recovers under section 541(a)(3), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) [*569] of this section if such property had not been transferred, if—

(1)(A) such transfer was not a voluntary transfer of such property [*8] by the debtor; and
(B) the debtor did not conceal such property . . . .

11 U.S.C. § 522(g) (emphasis added).

Before considering whether the payment was voluntary, however, the Court first must consider a more fundamental question: whether the payment is property of the estate, because [HN2] only property of the estate may be claimed as exempt. See 11 U.S.C. § 522(b)(1) (“Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate . . . .”) (emphasis added); Heintz v. Carey (In re Heintz), 198 B.R. 581, 586 (B.A.P. 9th Cir. 1996) (It is a "well settled rule that property cannot be exempted unless it is first property of the estate.") (citing Owen v. Owen, 500 U.S. 305, 308, 111 S. Ct. 1833, 114 L. Ed. 2d 350 (1991)).

[HN3] Property of the estate is broadly defined to include all property interests of the debtor “as of the commencement of the case.” 11 U.S.C. § 541(a)(1). The Code also provides several means by which the estate may acquire property after the case is filed. For example, under section 541(a)(3), property that the debtor does not possess on the date of filing may later become property of the estate if the trustee recovers the property using his avoidance powers—including the power to avoid preferential transfers under section 547. See 11 U.S.C. § 541(a)(3) (property of the estate includes "[a]ny interest in property that the trustee recovers under section . . . 550 . . . of this title," which allows recovery of transfers [*89] avoided under section 547).

In this case, the debtor did not own or possess the payment itself on the filing date. And at least as of October 4, 2018, the payment had not yet been recovered, although the trustee has begun the process by making a demand for it. Because the debtor cannot exempt the payment until it becomes property of the estate under section 541(a)(3), the debtor's claimed exemption of the payment itself appears premature. See, e.g., In re Gillenwater, 479 B.R. 711, 716 (Bankr. W.D. Va. 2012); In re Bethea, 275 B.R. 127, 130-32 (Bankr. D.D.C. 2002); In re Woodin, 294 B.R. 436 (Bankr. D. Conn. 2003).

Despite the express limitation on the property interests a debtor may claim as exempt (and when), the Court recognizes a lack of clarity, and even conflicting advice from lower courts, about whether a trustee must object to an exemption of even non-estate property, to prevent allowance of the exemption by default. Compare Bethea, 275 B.R. at 132 ("[A] trustee should not be put to the burden of objecting to an exemption of property that was transferred prepetition and that is not yet estate property. . . . Once the trustee avoids a transfer, the debtor may amend her exemptions . . . and trigger a deadline for objection by the trustee under Fed.R. Bankr. P. 4003(b),") and Woodin, 294 B.R. at 439 ("The debtor's purported exemption of property that is not property of the estate is a nullity, not requiring a Rule 4003(b) objection.")., with In re Ealy, 355 B.R. 685, 689 (Bankr. N.D. Ill. 2006) (the [*10] debtor acquired by default an exemption in unrecovered prepetition garnished wages, even though she was not entitled to exempt the wages under state law, due to a lack of any timely objection to her exemption).

Based on this uncertainty, the trustee understandably took the "safer approach" here and filed an objection. See Woodin, 294 B.R. at 440 ([T]rustees risk costly delays and the uncertainty of litigation and [*570] appeals when they assume that failure to object to an imprecise and unsupported exemption claim will not result in automatic exemption . . . . By far the safer approach would be for trustees to take a conservative and skeptical view of exemption claims, and refuse to accept any claim of exemption that is not clearly legitimate on its face.") (quoting In re Clark, 266 B.R. 163, 171 (B.A.P. 9th Cir. 2001)). To resolve the trustee's objection, and also to provide guidance to these parties in pursuing the contemplated avoidance action under section 547, the Court will determine whether the debtor would be entitled to exempt the payment if the transfer is avoided, and the property brought into the estate (as either the trustee or debtor intend to do).

As noted above, the amount of the claimed exemption is not at issue. Mr. Schmitt and the trustee acknowledge
that [**11] the analysis of whether the debtor may exempt the property hinges on whether the payment was voluntary. The Bankruptcy Code does not define "voluntary," and there is little legislative history in this regard. As one bankruptcy court in the Western District of Wisconsin has explained:

The Bankruptcy Code is silent about what constitutes a voluntary transfer under 11 U.S.C. s 522(g). The legislative history of this section gives one example of an involuntary transfer (the fixing of a judicial lien), but provides no further illumination. Voluntary is defined in Black's Law Dictionary as:

Unconstrained by interference; unimpelled by another's influence; spontaneous; acting of oneself. Done by design or intention, purpose, intended. Produced in or by an act of choice. Resulting from choosing. The word, especially in statutes often implies knowledge of essential facts. Black's Law Dictionary 1746-47 (Rev. 4th ed. 1981). (Citations omitted.)

The one example given in the legislative history of 11 U.S.C. s 522(g) of an involuntary transfer (the fixing of a statutory lien) indicates that Congress intended to allow recovery of only those transfers beyond debtor's personal control.

Matter of Huebner, 18 B.R. 193 (Bankr. W.D. Wis. 1982) (wage assignment [**12] to avoid collection efforts by creditor, as distinct from garnishment, was voluntary).

**HN4** While the Code does not define the term, bankruptcy courts "have generally concluded . . . that an involuntary transfer 'occurs when . . . property is transferred by operation of law, such as by means of an execution of judgment, repossession, or garnishment.'" In re Hill, 566 B.R. at 894 (citations omitted). See also Via v. Colonial Am. Nat'l Bank (In re Via), 107 B.R. 91 (Bankr. W.D. Va. 1989) (concluding that payment made in response to legal coercion is not voluntary, issuance of garnishment summons resulted in debtor making coerced payments due to threat of losing her wages and the inherent threat to her employment through legal compulsion). In Via, the garnishment was the result of a legal judgment, and noncompliance (if possible) could mean loss of employment. To avoid withholding of her wages, the debtor took a loan from her mother to pay the garnishee creditor. She later sought to recover [**571] that payment as an involuntary transfer. The bankruptcy court agreed with the debtor that the pending loss of her wages was involuntary, by operation of law. Via is somewhat analogous to Mr. Schmitt's circumstances, because the debtor took an immediate loan to satisfy the debt, which arose by operation of law, [**13] to avoid harsher impending consequences.

The facts of Hill also are somewhat analogous to those in the present case. Mr. Hill had a state court judgment entered against him in 2011. It went unpaid, and in 2016, a court agent more like a bounty hunter, armed with a seizure order, arrived unannounced to seize the debtor's property. The agent began the encounter by threatening to shoot the debtor's dog. 566 B.R. at 892. To avoid that extreme measure as well as the immediate seizure of other property on his premises, Mr. Hill arranged with family members to gather some cash and pay several thousand dollars to the court agent. The court agent remained with Mr. Hill until the money was obtained. Not long after, Mr. Hill filed for bankruptcy, and claimed the payment (which he had since recovered) as exempt. The trustee objected to the exemption as a preferential transfer, and argued that because the debtor intentionally paid the funds to the court officer, the transfer was voluntary. The Hill court disagreed with the trustee, concluding that the transfer of funds by the debtor to a court officer, and ultimately to the judgment creditor, occurred by operation of law, and was therefore involuntary for purposes [**14] of section 522(g).

In another similar case not cited by the parties, an Oregon bankruptcy court addressed a Chapter 7 trustee's objection to an exemption claimed in an $8,500 bail bond deposit made to the county sheriff's office. In re Yarber, 522 B.R. 328 (Bankr. D. Or. 2014). The trustee argued that, by voluntarily transferring the otherwise exempt deposit, the debtors effectively waived their exemption claim. The Yarber court explained that because the Code does not define the term "voluntary," its interpretation varies depending on the facts presented. 522 B.R. at 330. The court compared two extremes—a voluntary grant of a security interest in a debtor's property versus an involuntary payment to a creditor to obtain release of a wage garnishment. With that spectrum in mind, the court concluded that the essential involuntariness of a transfer stemming from the threat of incarceration was even more compelling than an involuntary transfer in a garnishment case. Because there was nothing about the transfer of the bail bond deposit that was voluntary, other than the fact that the debtors made it, the Yarber court held that transferring the deposit to the sheriff's office in order to keep the debtor from being incarcerated on a criminal claim did not constitute [**15] a "voluntary" transfer for purposes of claiming an exemption.

In the instant case, two Calumet County Sheriff Deputies arrived at Mr. Schmitt's home unannounced and took him into custody with a bench warrant based on a contempt order. Once at the jail they informed him that they wanted "his body or his money," provided only the first page of the warrant, and
gave him no other alternatives to satisfy the warrant. Since he had previously mailed the documents required to satisfy the warrant (and did not realize that the documents had not been received), Mr. Schmitt saw no other means to secure his release from jail than to pay the judgment amount.

The *Via, Hill* and *Yarber* cases offer different factual scenarios, but each court concluded that an operation of law provoked an involuntary transfer of funds. The cases involving operation of law posing [*572] a risk to life or liberty are even closer to Mr. Schmitt's circumstance. In *Hill*, the property seizure order was the result of a legal judgment, and failure to pay would have meant immediate loss not only of the debtor's property but possibly the property of others who stored their items on his land, as well as the bodily threat to his dog. In [**16] *Yarber*, the threat of incarceration was the result of legal process, and failure to pay the bail would have meant immediate loss of liberty.

Here, Mr. Schmitt faced a predicament resulting from an operation of law. He thought he had complied with an earlier state court order to produce documents. Whether he was mistaken, or the documents were waylaid, or the bench warrant was issued in error, this Court will never know. But issued it was, and Mr. Schmitt faced immediate severe consequences: loss of liberty or loss of funds. He borrowed money and surrendered funds. As a result, the Court finds that Mr. Schmitt's transfer of funds to the court officer to satisfy the bench warrant and avoid jail time falls on the involuntary end of the spectrum. The transfer occurred by operation of law and was involuntary for purposes of section 522(g).5

Accordingly, if the payment is recovered and becomes property of the estate, the "involuntary" requirement of section 522(g) will not preclude the debtor from claiming the payment as exempt. Because the trustee's objection to the debtor's exemption is based solely on sections 522(g) and (h), the trustee's objection is overruled. Nothing in this decision should be interpreted as indicating [**17] any ruling on whether the payment may be recovered by the trustee or the debtor under sections 547, 550, or 522(h). The only issue addressed in this decision is the trustee's objection to the debtor's claimed exemption.

The Court will enter a separate order consistent with this decision.

Dated: December 18, 2018

By the court:

/s/ Beth E. Hanan

Beth E. Hanan

United States Bankruptcy Judge

End of Document

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5The Court recognizes that the situation Mr. Schmitt faced was presented in coarse language, "your body or your money," but, as tensions and exemptions run together at times, the use of such language is not necessarily coercive per se. This decision rests on an "operation of law" analysis, such that the Court need not consider whether the transfer was prompted by duress or coercion. See, e.g., *Hill*, 566 B.R. at 896 n.9.
In re Leach

United States Bankruptcy Court for the District of Idaho

December 20, 2018, Decided

Bankruptcy Case No. 18-00692-JMM

Reporter
595 B.R. 841 *; 2018 Bankr. LEXIS 4050 **

In Re: Larry Wayne Leach and Merinda Anne Leach, Debtors.

Core Terms
exempt, schedules, daughter, claim of exemption, transferred, model year, ownership, recovered, concealed, amend

Case Summary

Overview

HOLDINGS: [1]-Where debtors transferred a vehicle when they gave it to their daughter and left it in her possession for several years, despite continually maintaining legal ownership of it, and the daughter voluntarily returned possession of the vehicle to them, there was no basis upon which to deny debtors' claim of exemption to the vehicle because the trustee did not recover the vehicle within the meaning of 11 U.S.C.S. § 522(g).

Outcome

Objection to debtors' claim of exemption denied.

LexisNexis® Headnotes

Bankruptcy Law > Exemptions

HN2 Exemptions

11 U.S.C.S. § 522(g) provides that debtors may exempt property the trustee recovers if the debtor could have exempted the property had it not been transferred, so long as the transfer was involuntary and the debtor did not conceal it. The purpose of § 522(g) is to prevent a debtor from claiming an exemption in recovered property, which was transferred in a manner giving rise to the trustee's avoiding powers, where the transfer was voluntary or where the transfer or property interest was concealed.

HN3 Exemptions

11 U.S.C.S. § 522(g) requires that the property claimed exempt be transferred and then recovered. The Code defines transfer, in relevant part, as every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property. 11 U.S.C.S. § 101(54).

HN4 Contents of Estate

The definition of "transfer" under the Code is "extremely" broad. A transfer is a disposition of an interest in property. The definition of transfer is as broad as possible. Many of the potentially limiting words in current law are deleted, and the language is simplified. Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody, or control even if there is no transfer of title, because possession, custody, and control are interests in property.
Bankruptcy Law > Exemptions

**HN5** Exemptions

Exemption statutes are to be liberally construed in favor of debtors.

Bankruptcy Law > Exemptions > Claims & Objections

Bankruptcy Law > ... > Bankruptcy > Estate

Property > Contents of Estate

**HN6** Claims & Objections

Upon the filing of a bankruptcy petition, a bankruptcy estate is created that includes all legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C.S. § 541(a)(1). In order to shield property from the reach of the trustee, debtors are required to list the property they claim as exempt. Fed. R. Bankr. P. 4003(a). Once that is done, the Code imposes upon trustees the duty to object to claims of exemption that are improper. Rule 4003(b) provides trustees thirty days after the meeting of creditors is concluded or within thirty days after any amendment to the schedules is filed in which to object. Moreover, if a trustee or other party in interest fails to object within the time period allotted, the claim of exemption stands, even if there was no legal basis to support it. Trustees are only required to object if: 1) the value of the property claimed as exempt exceeds statutory limits, 2) the type of property being exempted is improper, or 3) the cited bankruptcy code provision does not support the exemption.

Bankruptcy Law > Exemptions

**HN7** Exemptions

A trustee is entitled to evaluate the propriety of the claimed exemptions based on three, and only three, entries on the debtor’s Schedule C: the description of the business equipment in which the debtor claimed the exempt interests; the Code provisions governing the claimed exemptions; and the amounts the debtor listed in the column titled value of claimed exemption.

Bankruptcy Law > Exemptions

**HN8** Exemptions

A debtor has a responsibility of clearly claiming exemptions. Indeed, in a bankruptcy system that processes millions of individual cases each year, trustees, creditors, bankruptcy courts, and others interested in the process should not have to speculate concerning debtor’s exemption intentions. The duty lies with debtors to accurately and clearly state their claimed exemptions. They may not shift this responsibility to trustees by requiring objections to inaccurate schedules based upon their knowledge, actual or imputed.

Counsel: [**1**] For Debtors: Patrick John Geile, FOLEY FREEMAN, PLLC., Meridian, Idaho.

Chapter 7 Trustee: Noah G. Hillen, Boise, Idaho.

Judges: JOSEPH M. MEIER, U. S. BANKRUPTCY JUDGE.

Opinion by: JOSEPH M. MEIER

**Opinion**

[*842] MEMORANDUM OF DECISION

**Introduction**

On August 31, 2018, the chapter 7 Trustee, Noah G. Hillen (“Trustee”), filed an objection to debtors’ Larry Wayne Leach and Merinda Anne Leach (“Debtors”) claim of exemption. Dkt. No. 25. The Debtors responded to the objection, and on October 30, 2018, the Court conducted an evidentiary hearing at which evidence, testimony, and argument were presented. Thereafter, the Court took the objection under advisement.

The Court has now considered all that was presented in connection with the objection, as well as the applicable law, and issues the following decision. Fed. R. Bankr. P. 7052; 9014.

[*843] Facts


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1 Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all rule references are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.
200. The Vehicle was titled in both Debtors' names. Id. Mr. Leach testified that the Debtors' intent in making the purchase was to allow their daughter to take the Vehicle with her to college the following month. They made all required payments, and they initially paid the insurance and registration [*2] on it. In May 2015, their daughter got married. Debtors decided to permit her to retain possession of the Vehicle at that time, but she began to pay her own insurance and registration on the Vehicle when it came due. Debtors did not change the title, so it remained in their names.

Debtors filed their bankruptcy petition on May 31, 2018. Dkt. No. 1. In their schedules, they listed ownership of several vehicles, including a 2000 Subaru Impreza. Ex. 204. Regarding the 2000 Impreza, they noted that they "Gave to Adult Daughter in 2014 - Title Still in Larry's Name. Location: 819 N. 21st Street, Boise, ID 83702." Id. On schedule C, Debtors claimed the 2000 Subaru Impreza as exempt in the amount of $7,000 pursuant to Idaho Code § 11-605(3). Dkt. No. 1. However, Debtors did not actually own a 2000 Subaru Impreza. Rather, the model year of the 2008 Vehicle was mistakenly listed on the schedules as "2000." Debtors did own a 2000 model year vehicle at one time, but it was a Daewoo Nabira, and they no longer owned that vehicle at the time of filing.3

The initial § 341 meeting of creditors was held on June 28, 2018, at which Debtors appeared and testified. Dkt. No. 18. At this creditors' meeting, the error in the schedules [*3] concerning the Vehicle was brought to light, and the mistake was explained. The meeting of creditors was later continued to July 12, 2018, and concluded on that date. Dkt. Nos. 18; 20. The deadline to file objections to Debtors' claims of exemption was set for thirty days after the conclusion of the meeting of creditors. Dkt. No. 2.

Following the conclusion of the meeting of creditors, Debtors did not amend their schedules to correct their admitted error. Nearly two months after the inaccuracy was discovered, on August 23, 2018, Trustee demanded, by letter, that Debtors turn over the Vehicle to him. Ex. 201. Shortly thereafter, on August 31, 2018, Debtors amended their schedules to correct the model year of the Subaru Impreza from 2000 to 2008 and to claim the Vehicle exempt in the amount of $7,000 under Idaho Code § 11-605(3). Ex. 205; Dkt. No. 23. That same day, Trustee objected to Debtors' claim of exemption in the Vehicle on the grounds that § 522(g) precludes such a claim. Dkt. No. 25. Debtors responded to the objection, raising several arguments. Dkt. No. 27.

Analysis and Disposition

Trustee contends the Code precludes Debtors' claim of exemption in the Vehicle. HN1 Pursuant to § 522(g), a debtor may exempt property the [**4] trustee recovers under sections 510(c)(2), 542, 543, 550, 551, or 553, if the debtor could have exempted such property under § 522(b) had the [*844] transfer not occurred, so long as the debtor neither voluntarily transferred the property nor concealed it.

It is Trustee's position that Debtors voluntarily transferred the Vehicle to their daughter, who retained possession of it for several years, including on the petition date, although they never changed the title. Because of this voluntary transfer, Trustee argues, § 522(g) precludes Debtors from claiming the Vehicle as an exempt asset once Trustee made a demand for it. Debtors disagree with Trustee, countering with several arguments.

A. Section 522(g)

HN2 Section 522(g) provides that debtors may exempt property the trustee recovers if the debtor could have exempted the property had it not been transferred, so long as the transfer was involuntary and the debtor did not conceal it. "The purpose of § 522(g) is to prevent a debtor from claiming an exemption in recovered property, which was transferred in a manner giving rise to the trustee's avoiding powers, where the transfer was voluntary or where the transfer or property interest was concealed." Rainsdon v. Farson (In re Farson), 387 B.R. 784, 798 (Bankr. D. Idaho 2008).

1. Transfer

HN3 Section 522(g) requires that the property claimed exempt be transferred and then recovered. [**5] The Code defines transfer, in relevant part, as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property...." § 101(54). In In re Farson, the debtor made payments to purchase her boyfriend's car. 387 B.R. at 788. This Court found there was no transfer for the purposes of § 101(54) because "there was no 'disposing of' or 'parting with' the [car] and hence no transfer. It remained in [the debtor's]
The Ninth Circuit observed that ID. at 798.

In contrast to the facts presented in Farson, here, Debtors parted with possession of the Vehicle for a time, even though they did not transfer the title. The text messages in evidence suggest that it was the daughter's understanding that she was in a position to give the Vehicle back when she chose to do so. For example, in the text message to Mrs. Leach, Debtors' daughter wrote, "We've decided we're going to buy a car.... So you guys can have your Impreza back. Thanks for letting us borrow it for a few years." Ex. 203. However, the documents and testimony offered demonstrate that Debtors intended that while their daughter could possess the Vehicle, ownership would always remain in them. Furthermore, as of the petition date, Debtors had not asked for the Vehicle back, despite their financial difficulties. See Id.

The Ninth Circuit observed that HN4 the definition of "transfer" under the Code is "extremely" broad. Bernard v. Sheaffer (In re Bernard), 96 F.3d 1279, 1282 (9th Cir. 1996) (emphasis in original). The panel in Bernard quoted the legislative history of § 101(54) to make its point:

A transfer is a disposition of an interest in property. The definition of transfer is as broad as possible. Many of the potentially limiting words in current law are deleted, and the language is simplified. Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody, or control even if there is no transfer of title, because possession, custody, and control are interests in property.


Based upon the foregoing, the Court agrees with Trustee that Debtors transferred the Vehicle when they gave it to their daughter and left it in her possession for several years, despite continually maintaining legal ownership of it. Having determined that a transfer occurred, the Court next considers whether Trustee "recovered" the property.

2. Recovery

Courts examining this issue have defined "recovery" broadly for the purposes of § 522(g). For example, in Glass v. Hitt (In re Glass), the debtor had transferred title to his residence to his son for "love and affection" prior to filing his chapter 7 petition. 164 B.R. 759 (9th Cir. BAP 1994), aff'd, 60 F.3d 565 (9th Cir. 1995). He did not list the residence as an asset in his schedules, nor did he disclose the transfer in his statement of financial affairs. Glass, 164 B.R. at 760. At the § 341(a) meeting of creditors, however, a creditor informed the trustee about the prepetition transfer of the residence, and the debtor thereafter amended his schedules to list an interest in the residence and claimed a homestead exemption therein. Id. The trustee objected to the debtor's homestead exemption claim on the basis of § 522(g) and stated his intention to seek avoidance of the conveyance as a fraudulent transfer under § 548. Id. at 761. However, even before the trustee had made a demand for turnover, the debtor's son reconveyed the residence to the debtor, stating "love and affection" as the consideration for the transaction.

The bankruptcy court overruled the trustee's objection, "holding [Mr.] Glass was entitled to sue to claim the homestead exemption under section 522(b) because the trustee did not direct any action against the transferee son to achieve reconveyance of the residence to the estate, and thus, the trustee did not 'recover' any property." Glass, 60 F.3d at 567. However, on appeal, the BAP reversed, stating:

we hold that where a debtor voluntarily transfers property in a manner that triggers the trustee's avoidance powers or the debtor knowingly conceals a prepetition transfer or an interest in property, and such property is returned to the estate as a result of the trustee's actions directed toward either the debtor or the transferee, the debtor is not entitled to claim an exemption under § 522(g)(1). It is not necessary for the trustee to commence a formal adversary proceeding or obtain a final judgment to prevail on an objection to a debtor's claim of exemption pursuant to § 522(g)(1).


In this case, Trustee knew that Debtors were the title owners of the Vehicle as of June 28, 2018, and Debtors were similarly aware of their mistake at that time. Trustee waited nearly two months, but when no effort was made to correct the schedules, he wrote a formal demand letter to Debtors informing them of the Vehicle's inclusion in their bankruptcy estate and stated their daughter's name and address so Trustee's auctioneer could pick the car up. Under Glass, this is very close to constituting a "recovery" under § 522(g).

However, the Vehicle was voluntarily returned to the Debtors shortly after July 8, 2018, not due to any action by Trustee, but because their daughter purchased a new car and no longer needed it, as demonstrated by the text messages in evidence. Moreover, as explained above, the transfer at issue was a transfer of possession only, and Debtors' daughter voluntarily
returned possession of the Vehicle to them. [*846] Thus, both legal title and possession rested with Debtors by the time Trustee wrote the demand letter. Additionally, under the broad definition of estate property under § 541(a), the Vehicle was already included in Debtors’ bankruptcy estate, as they legally owned it by virtue of the certificate of title. § 541(a) (property of the estate “is comprised of all the following property, wherever located and by whomever held: . . . all legal or equitable interests of the debtor in property as of the commencement of the case.”); In re Woods, 386 B.R. 758, 08.2 I.B.C.R. 61, 61-62 (Bankr. D. Idaho 2008). The original transfer of possession [*10] to Debtors’ daughter did not confer legal title to her under Idaho law. Idaho Code § 49-503 (“no person acquiring a vehicle from the owner, whether the owner is a dealer or otherwise, shall acquire any right, title, claim or interest in or to the vehicle until he has issued to him a certificate of title to that vehicle.”); Hopkins v. Shradley (In re Shradley), 03.1 I.B.C.R. 7, 8 (Bankr. D. Idaho 2003) (a party has “no cognizable ownership interest in a vehicle where no certificate of title [has] yet been issued in that party’s name.”). As such, the only “recovery” Trustee’s demand letter brought about was Debtors’ act of formally correcting the model year of the Vehicle on their schedules. Additionally, correcting the Vehicle’s model year on schedule C permitted Debtors to claim the Vehicle exempt as had always been their intent.

While it would not require a particularly expansive reading of Glass to conclude that the facts presented here constitute a recovery for the purposes of § 522(g), the Court is nevertheless mindful of the well-established standard that HNS[*13] exemption statutes are to be liberally construed in favor of debtors. In re Cantu, 515 B.R. 784, 786 (Bankr. D. Idaho 2014). As such, the Court interprets “recovers” within the meaning of § 522(g) to not include this [*11] instance, where Trustee’s actions did not result in the transferred interest being returned to the estate, and in fact occurred subsequent thereto. Moreover, the purpose behind § 522(g), which is to “prevent a debtor from claiming an exemption in recovered property which was transferred in a manner giving rise to the trustee’s avoiding powers, where the transfer was voluntary or where the transfer or property interest was concealed” is not frustrated here. Glass, 60 F.3d at 569.

In this instance, Debtors acted as many parents do, and provided their child with a car to drive, but retained legal ownership themselves. From the purchase date in 2014 to the present, Debtors kept the title to the Vehicle in their names and made no attempt to transfer legal title to their daughter through the Idaho Department of Transportation. Thus, unlike the facts in Glass, in this case there was no prepetition title transfer to the child via a legal instrument and a subsequent transfer back following the filing of the petition. There was also no attempt to conceal their actions. Indeed, Debtors endeavored to disclose the transfer on their schedules: they identified the Vehicle, unfortunately using an incorrect model year, claimed [*12] it exempt, but also declared under penalty of perjury in their statement of financial affairs that they “Gave to Adult daughter in 2014 - Title Still in Larry’s name.” While the Court finds that Debtors made a mistake in describing the same car by stating the wrong model year, they did acknowledge that they “gave” the Vehicle to their daughter.

Words have meaning. Debtors’ use of the word “gave” reflects an intent to transfer rights in some fashion, and it is undisputed that possession was transferred, even while ownership was not. Moreover, the payment of registration fees and insurance premiums by the daughter does not [*847] settle the issue. Those actions constitute payments only and reflect the Debtors’ and their daughter’s intention to shift some costs of possession. It did not confer ownership.

Here the undisputed evidence demonstrates Debtors intended to list the Vehicle on their schedules and claim it exempt, but a typographical error prevented them from actually doing so. In this case, the Court will not deny Debtors an exemption under these facts simply because it took action by the Trustee for their counsel to rectify his dilatory attitude toward amending their schedules.

Because [*13] Trustee did not recover the Vehicle within the meaning of § 522(g), there is no basis upon which to deny Debtors’ claim of exemption, and Trustee’s objection will be denied.

B. Debtors’ Timeliness Argument

Despite the Court’s holding as announced above, it will nevertheless briefly address Debtors’ argument that Trustee failed to act in a timely fashion. Specifically, Debtors contend that Trustee’s objection to their claim of exemption was untimely. They argue that because Trustee knew about the typographical error in the schedules as of the initial meeting of creditors, and because the amended schedules merely corrected that error, Trustee filed his objection too late. Implicit in that argument is the notion that Trustee was

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4 This case is a cautionary tale of how debtors and their counsel should be vigilant to carefully proofread schedules prior to filing, and timely amend them when errors are discovered. While not argued here, another risk faced by Debtors in failing to amend their schedules is it may create an argument that the asset was not administered under § 554(d). Inaction may have unintended consequences.
required to object to Debtors' claim of exemption in the schedules as incorrectly filed. The Court disagrees.

**HN6** Upon the filing of a bankruptcy petition, a bankruptcy estate is created that includes "all legal or equitable interests of the debtor in property as of the commencement of the case." § 541(a)(1). In order to shield property from the reach of the trustee, debtors are required to list the property they claim as exempt. Rule 4003(a). Once that is done, the Code imposes upon trustees the duty to object to claims of exemption that are improper. Id. Rule 4003(b) provides trustees thirty days after the meeting of creditors is concluded or within thirty days after any amendment to the schedules is filed in which to object. Moreover, if a trustee or other party in interest fails to object within the time period allotted, the claim of exemption stands, even if there was no legal basis to support it. Schwab v. Reilly, 560 U.S. 770, 782 n.7, 130 S. Ct. 2652, 177 L. Ed. 2d 280 (1992); In re Gardner, 417 B.R. 616, 09.4 I.B.C.R. 119, 120 (Bankr. D. Idaho 2009).

Trustees are only required to object if: 1) the value of the property claimed as exempt exceeds statutory limits, 2) the type of property being exempted is improper, or 3) the cited bankruptcy code provision does not support the exemption. Schwab v. Reilly, 560 U.S. 770, 782 n.7, 130 S. Ct. 2652, 177 L. Ed. 2d 234 (2010). Stated another way, the Supreme Court held that a trustee is:

entitled to evaluate the propriety of the claimed exemptions based on three, and only three, entries on [the debtor's] Schedule C: the description of the business equipment in which [the debtor] claimed the exempt interests; the Code provisions governing the claimed exemptions; and the amounts [the debtor] listed in the column titled "value of claimed exemption."

Id. at 785.

In Schwab, the Supreme Court described the trustee's duty when examining a debtor's schedules as looking for "warning flags" and facial validity. Id. at 789, 791. Indeed, Schwab expresses the opinion that trustees should be able to rely on the facial validity of claimed exemptions, and when they are unobjectionable under the Code, trustees are not required to object within the deadline prescribed in Rule 4003. Id. at 790-91, 794. Extrapolating from the decision in Schwab, Trustee in this case was entitled to rely on the description of the property in which Debtors initially claimed the exempt interest - a 2000 Subaru Impreza. As such, when scrutinizing Debtors' initial schedules in the case at bar, Trustee would have found no cause to object to the exemption of a "2000 Subaru Impreza" under the description of the property, the Idaho statute upon which the exemption was claimed, or the dollar amount of the exemption.

However, at the § 341 meeting of creditors, Trustee learned that the 2000 Subaru Impreza did not exist, but rather a 2008 Impreza was the vehicle Debtors actually owned. Debtors contend Trustee had a duty to object to the schedules at that point. The Court disagrees.

The Supreme Court in Schwab noted its decision levied no greater burdens on debtors than those already imposed by the Code: 

- "to state their claimed exemptions accurately and to conform such claims to statutory limits." Id. at 790 n.17. The Ninth Circuit has stated, "[b]ecause the time to object is relatively short, see Bankr. Rule 4003(b), it is important that trustees and creditors be able to determine precisely whether a listed asset is validly exempt simply by reading a debtor's schedules. Given that the debtor controls the schedules, we construe any ambiguity therein against him." Hyman v. Plotkin (In re Hyman), 967 F.2d 1316, 1319 n.6 (9th Cir. 1992); Morgan-Busby v. Gladstone (In re Morgan-Busby), 272 B.R. 257, 264-66 (9th Cir. BAP 2002) (same).

In Schwab, the Supreme Court held that:

For all of these reasons, the policy considerations [the debtor] cites support our approach. Where, as here, a debtor accurately describes an asset subject to an exempt interest and on Schedule C declares the "value of [the] claimed exemption" as a dollar amount within the range the Code allows, interested parties are entitled to rely upon that value as evidence of the claim's validity. Accordingly, we hold that [the trustee] was not required to object to [the debtor's] claimed exemptions in her business equipment in order to preserve the estate's right to retain any value in the equipment beyond the value of the exempt interest.

Schwab, 560 U.S. at 794-95. This Court has held similarly. See In re Wisdom, 478 B.R. 394, 399 (Bankr. D. Idaho 2012), aff'd, 490 B.R. 412 (D. Idaho 2013), aff'd sub nom.; Wisdom v. Gugino, 649 F. App'x 583 (9th Cir. 2016) ("**HN8** a debtor has a responsibility of clearly claiming exemptions.... Indeed, in a bankruptcy system that processes millions of individual cases each year, trustees, creditors, bankruptcy courts, and others interested in the process should not have to speculate concerning Debtor's exemption intentions."). In re Stromire, 94 I.B.C.R. 70 (Bankr. D. Idaho 1994) (a debtor's failure to cite Idaho exemption law with specificity is grounds to deny the debtor's claim of exemption).

The duty lies with debtors to accurately and clearly state their
claimed exemptions. They may not shift this responsibility to trustees by requiring objections to inaccurate schedules based upon their knowledge, actual or imputed.

[*849] Moreover, under these facts, Trustee would have no motive to raise any such objection. Under a plain reading of Debtors' initial schedules, they claimed an exemption in a 2000 Impreza, a vehicle they did not own. From the Trustee's perspective, such a claim could not in any way add to or diminish the bankruptcy estate, and did not prevent him from administering any of the estate's actual assets. Thus, he would have no motivation to object.

While this result may be seen as encouraging trustees to bury their[*18] heads in the sand, or worse, to wait in the weeds for Debtors' next move, such an outcome is somewhat more palatable under the facts presented in this case. All parties were aware of the inaccuracy in the schedules as of the date of the initial meeting of creditors. Yet, Trustee waited over six weeks after the conclusion of the second and final creditors' meeting before sending a demand letter, giving Debtors ample time to amend their schedules.

As such, the Court concludes that Trustee was not required to object to the claim of exemption in the 2000 Subaru Impreza in order to preserve the estate's right to retain any interest in the Vehicle. Rather, it was Debtors who had a duty to amend their schedules to clearly and unambiguously claim the Vehicle exempt. They did not do so until two months later, and after Trustee's demand, at which time Trustee timely objected.5

Conclusion

The requirements of §522(g) have not been met in this case. While Debtors transferred possession of the Vehicle, Trustee's actions did not constitute a recovery within the meaning of §522(g). Accordingly, Trustee's objection to Debtors' claim of exemption in the 2008 Subaru Impreza will be denied by separate order.

DATED: December [**19] 20, 2018

/s/ Joseph M. Meier

JOSEPH M. MEIER

U. S. BANKRUPTCY JUDGE

ORDER DENYING TRUSTEE'S OBJECTION TO DEBTORS' CLAIM OF EXEMPTION

For the reasons set forth in the Court's Memorandum of Decision filed herein, and for other good cause,

IT IS HEREBY ORDERED THAT Trustee's objection to Debtors' claim of exemption, Dkt. No. 25, be and is hereby DENIED.

DATED: December 20, 2018

/s/ Joseph M. Meier

JOSEPH M. MEIER

U. S. BANKRUPTCY JUDGE

5 As was noted above, Debtors raised other arguments, including their need for use of the Vehicle, as well as whether a meaningful distribution would occur if Trustee sold it. As the Court has concluded there was no recovery within the meaning of §522(g), these arguments are moot and will not be addressed.
**Aldana v. Stadtmueller (In re De Jesus Gomez)**

United States Bankruptcy Appellate Panel for the Ninth Circuit

October 25, 2018, Submitted Without Oral Argument; November 9, 2018, Filed

BAP No. SC-18-1089-FLS

**In re: GIL ALBERTO DE JESUS GOMEZ, III, Debtor.**

**GIL ALBERTO DE JESUS GOMEZ, III; FRANCISCO JAVIER ALDANA, Appellants, v. RONALD E. STADTMUELLER, Chapter 7 Trustee, Appellee.**

**Subsequent History:** [*1*] Ordered Published - November 20, 2018.

**Prior History:** Appeal from the United States Bankruptcy Court for the Southern District of California. Bk. No. 16-07502-LT7. Honorable Laura S. Taylor, Bankruptcy Judge, Presiding.

**Core Terms**

exemption, bankruptcy court, sanctions, Trustee's, recovered, recklessness, frivolous, bad faith, perfection, costs, security interest, declaration, scheduled, surrender, frivolous appeal, motion to compel, sanction order, concealed, vehicles, appears, oppose, tentative ruling, bankruptcy case, transferred, double, issues, powers

**Case Summary**

**Overview**

**ISSUE:** Whether bankruptcy court ("BC") erred in sanctioning debtor's attorney for recklessly and frivolously pursuing the exemption in a vehicle, in addition to repeatedly failing to respond to the court's inquiries and Trustee's filings. **HOLDINGS:** [1]-The arguments of appellants, debtor and his attorney, that ignored 11 U.S.C.S. § 522(g)(1) were frivolous and reckless, not a mere "difference of opinion"; [2]-BC did not err in holding that the Trustee satisfied the two prongs of § 522(g)(1)(A). Because the Trustee avoided the voluntary transfer under 11 U.S.C.S. § 550, debtor could not claim an exemption in the vehicle under § 522(g)(1)(A); [3]-BC did not err in considering the totality of factors concerning the vehicle's surrender; [4]-Among other matters, the panel held that the Trustee was entitled to recover his fees and double costs from debtor's attorney for the frivolous appeal.

**Outcome**

The panel affirmed and granted the Trustee's motion for sanctions against debtor's attorney.

**LexisNexis® Headnotes**

Bankruptcy Law > ... > Judicial Review > Standards of Review > Abuse of Discretion

Bankruptcy Law > Procedural Matters > Professional Responsibility

Civil Procedure > Sanctions

**HN1** Abuse of Discretion

The bankruptcy appellate panel reviews a sanctions order for abuse of discretion. Similarly, the bankruptcy court's choice of sanction is reviewed for abuse of discretion. Accordingly, the panel reverses only where the bankruptcy court applied an incorrect legal rule or where its application of the law to the facts was illogical, implausible, or without support in inferences that may be drawn from the record.

Bankruptcy Law > Procedural Matters > Professional Responsibility

Civil Procedure > Sanctions

**HN2** Professional Responsibility

A bankruptcy court has the inherent authority to impose sanctions for bad faith, which includes a broad range of willful improper conduct. Before the bankruptcy court imposes sanctions under its inherent authority, it must find either bad faith, conduct tantamount to bad faith, or recklessness with an additional factor such as frivolousness,
harassment, or an improper purpose. The bankruptcy court must make an explicit finding.

Bankruptcy Law > Exemptions

**HN3**

Exemptions

If the trustee recovers certain property prior to the debtor claiming an exemption, that property cannot be exempted; refer to 11 U.S.C.S. § 522(g). Section 522(g)(1) allows the debtor to exempt property that the trustee recovers under various sections of the Bankruptcy Code as long as the transfer was involuntary and the property was not concealed by the debtor. Conversely, a debtor may not exempt property that the trustee recovers under one of the enumerated provisions if the debtor voluntarily transferred or concealed the property.

Bankruptcy Law > Exemptions

**HN4**

Exemptions

Case law clearly states that a debtor cannot exempt property that the trustee recovers using his avoidance power. In Hitt, the court explained the contours of 11 U.S.C.S. § 522(g): Section 522(g), however, limits the ability of a debtor to claim an exemption where the trustee has recovered property for the benefit of the estate. Under § 522(g)(1), a debtor may claim an exemption where the trustee has recovered property pursuant to 11 U.S.C.S. §§ 510(c)(2), 542, 543, 550, 551 or 11 U.S.C.S. § 553 only if the property was involuntarily transferred and the debtor did not conceal the transfer or an interest in the property. Thus, under § 522(g)(1), a debtor may not exempt recovered property if the debtor voluntarily transferred such property or concealed the transfer or an interest in such property. After examining the language of the statute, the court reiterated: Accordingly, we hold that where a debtor voluntarily transfers property in a manner that triggers the trustee's avoidance powers or the debtor knowingly conceals a prepetition transfer or an interest in property, and such property is returned to the estate as a result of the trustee's actions directed toward either the debtor or the transferee, the debtor is not entitled to claim an exemption under § 522(g)(1).

Bankruptcy Law > Exemptions

Business & Corporate Compliance > ... > Secured

Transactions > Perfections & Priorities > Perfection

**HN5**

Exemptions

The perfection of a security interest is a "transfer" within the meaning of 11 U.S.C.S. § 101(54)(D). It is well established that, under bankruptcy law, perfection of an interest in property is considered a transfer separate and apart from the transfer of title. Under § 101(54)(D), a transfer of property is made at the time the transfer is perfected against a bona fide purchaser under applicable state law.

Civil Procedure > Pleading & Practice

**HN6**

Pleading & Practice

A third party's interpretation of the law is not binding on a court.

Civil Procedure > Sanctions > Baseless Filings > Bad Faith Motions

Civil Procedure > Sanctions > Baseless Filings > Frivolous Lawsuits

Civil Procedure > Sanctions > Baseless Filings > Vexatious Litigants

**HN7**

Bad Faith Motions

An award of sanctions requires more than recklessness alone. The Ninth Circuit has stated that sanctions are available for a variety of types of willful actions, including recklessness when combined with an additional factor such as frivolousness, harassment, or an improper purpose.

Civil Procedure > Appeals > Frivolous Appeals

Bankruptcy Law > Procedural Matters > Professional Responsibility

**HN8**

Frivolous Appeals

_Fed. R. Bankr. P. 8020_, which conforms to the language of _Fed. R. App. P. 38_, provides that: If the district court or bankruptcy appellate panel determines that an appeal is frivolous, it may, after a separately filed motion or notice from the court and reasonable opportunity to respond, award just damages and single or double costs to the appellee. _Fed._
R. Bankr. P. 8020(a). Under Rule 38, a frivolous appeal is one where the result is obvious or the appellant's arguments are wholly without merit. The court may impose sanctions to penalize an appellant or attorney who pursues a frivolous appeal and to compensate the appellee for the delay and expense of defending the appeal.

Civil Procedure > Appeals > Frivolous Appeals
Bankruptcy Law > Procedural Matters > Professional Responsibility

HN9 Frivolous Appeals

Fed. R. Bankr. P. 8020(a) is not susceptible to a "pure heart, empty head" defense. A finding of bad faith is not necessary to impose sanctions under Fed. R. App. P. 38. The court may impose sanctions if the appellant raises issues that are contradicted by long-established precedent. Case law has stated that on appeal, the U.S. Bankruptcy Appellate Panel for the First Circuit will consider whether an appellant's argument: addresses the issues on appeal properly; fails to support the issues on appeal; fails to cite any authority; cites inapplicable authority; makes unsubstantiated factual assertions; makes bare legal conclusions; or, misrepresents the record.

Counsel: Appellant Francisco Javier Aldana on the brief pro se and on behalf of appellant Gil Alberto De Jesus Gomez, III.
Ronald E. Stadtmueller, Pro se, on the brief.


Opinion by: FARIS

Opinion

[*700] FARIS, Bankruptcy Judge:

INTRODUCTION

This appeal illustrates what can happen when a debtor's lawyer asserts an exemption claim without performing adequate legal analysis. Because counsel claimed a baseless exemption and stubbornly refused to admit his error, counsel has incurred sanctions well in excess of the value of the property claimed exempt.

Chapter 7 debtor Gil Alberto de Jesus Gomez, III and his attorney, Francisco Javier Aldana (collectively, "Appellants"), appeal from the bankruptcy court's order sanctioning Mr. Aldana for improperly claiming an exemption on behalf of Mr. Gomez in a vehicle after appellee Ronald E. Stadtmueller, Chapter 7 Trustee (the "Trustee") avoided a lien and recovered the vehicle. The Appellants argue that they can exempt property at any time during a bankruptcy case and that they did not act in bad faith.

The Appellants misstate the statutory framework and a Supreme Court case. Their inaction and dilatoriness before the bankruptcy court give the lie to their claim of good faith. Their arguments are unsupported and frivolous. We AFFIRM.

The Trustee also filed a separate motion requesting sanctions against the Appellants for filing a frivolous appeal. We GRANT the request for fees and double costs as to Mr. Aldana.

We publish to explain how § 522(g) limits a debtor's right to claim exemptions in property after a trustee uses the avoiding powers to recover an interest in that property and that the Supreme Court's decision in Law v. Siegel, 571 U.S. 415, 134 S. Ct. 1188, 188 L. Ed. 2d 146 (2014), is inapplicable.

FACTUAL BACKGROUND

A. Mr. Gomez's bankruptcy case

On December 10, 2016, Mr. Gomez, through his counsel, Mr. Aldana, filed a chapter 7 petition. He scheduled a 2001 Ford Focus automobile as his personal vehicle and claimed an exemption for the full value of the car. He failed to disclose his ownership of a 2012 Chevrolet Malibu, which he allegedly purchased approximately two months earlier.

After remaining silent about the Malibu at two § 341(a) meetings of creditors, Mr. [*701] Gomez amended his Schedule [**3] A/B to include the Malibu, which he valued at $4,500. He listed Anayas Auto Sales as holding a $2,700

1 Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references are to the Federal Rules of Bankruptcy Procedure.

2 The Appellants' excerpts of record fail to include many important documents. We rely on the Trustee's excerpts and exercise our discretion to review the bankruptcy court's docket, as appropriate. See Woods & Erickson, LLP v. Leonard (In re AVI, Inc.), 389 B.R. 721, 725 n.2 (9th Cir. BAP 2008).
claim secured by the Malibu. He did not amend his Schedule C to claim the Malibu as exempt. The bankruptcy court granted Mr. Gomez his discharge.

The Trustee discovered that Anayas Auto failed to perfect its lien on the Malibu until after the petition date. The Trustee requested that Anayas Auto release its lien, but it did not do so. As a result, the Trustee initiated an adversary proceeding against Anayas Auto for avoidance and recovery of a postpetition transfer under § 549. Anayas Auto did not answer the complaint, and the Trustee obtained default judgment and a release of the lien.

The Trustee e-mailed Mr. Aldana to inform him of the default judgment against Anayas Auto and request that Mr. Gomez either surrender the Malibu to the Trustee's auctioneer or offer to purchase the vehicle. Mr. Aldana did not respond.

The Trustee also went to Mr. Gomez's residence to inquire about the Malibu. Mr. Gomez was not home, but a woman at the residence told the Trustee that she would tell Mr. Gomez to contact the Trustee about turning over the Malibu. Mr. Gomez did not contact the Trustee.

B. The motion [**4] to compel cooperation and turnover

The Trustee filed a motion to compel turnover of the Malibu ("Motion to Compel"). He stated that he had used his avoidance power under § 549 to obtain a release of Anayas Auto's lien, but despite repeated requests for Mr. Gomez to surrender the Malibu, Mr. Gomez had failed to do so. He requested that the court order immediate turnover of the Malibu.

On January 10, 2018, the bankruptcy court issued its tentative ruling stating its inclination to grant the Motion to Compel.

Later that day, Mr. Aldana contacted the Trustee to inform him that he had "just read" the Motion to Compel (even though the Trustee had filed and served the Motion to Compel six weeks earlier) and was puzzled by the court's ruling, because the Malibu was exempted. The Trustee left Mr. Aldana a voicemail informing him that Mr. Gomez did not exempt the Malibu and that the avoidance of a lien by the estate does not restore the property to the debtor. Mr. Aldana did not respond.

C. The Trustee's objection to claimed exemption

The Trustee filed an objection to Mr. Gomez's claimed exemptions in the Focus and Malibu ("Objection"). He argued that Mr. Gomez had not claimed the Malibu exempt prior to the Trustee's avoidance of Anayas Auto's lien, so Mr. Gomez could not claim the recovered property as exempt under § 522(g)(1). He also asserted that Mr. Gomez is only entitled to seek an exemption under either CCP section 703.140(b)(2) or section 704.010, but not both. Finally, he argued that Mr. Gomez amended Schedule C in bad faith because "[d]espite all of these pleadings, requests and explanation, filed over the course of many months, Attorney Aldana now files a tardy, improper and clearly objectionable amendment to further delay the administration of this estate." The Trustee requested that the bankruptcy court award him his fees and costs.

Mr. Gomez did not file an opposition to the Objection.

Both Mr. Aldana and the Trustee appeared at the telephonic hearing on the Trustee's Objection. The court sustained [**6] the Objection as to the Focus and Malibu and denied both exemptions. It continued the hearing on the issue of sanctions and stated that it "will consider granting compensatory sanction[s], for Trustee's expenses incurred in connection to the opposition to exemption, and coercive sanction[s] under [its] inherent authority . . . ." It allowed Mr. Aldana to file a response arguing against sanctions by February 22 and allowed the Trustee to respond by March 1.

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3 The Trustee alleged that Mr. Gomez purchased the Malibu on September 30, 2016. Although the Department of Motor Vehicles' ("DMV") records identify Anayas Auto as the lienholder on the Malibu, the DMV did not receive registration fees until almost two months after the petition date.

Mr. Aldana did not file a timely response to the sanctions query. The Trustee filed his brief on February 27 and requested sanctions because: (1) Mr. Aldana should have known that the lien avoidance action was for the benefit of the bankruptcy estate; (2) the Appellants refused to turn over the Malibu for liquidation; (3) prior to filing the Objection, the Trustee provided Mr. Aldana with legal authority supporting return of the Malibu to the estate and explaining why Mr. Gomez could not claim an exemption; (4) Mr. Aldana nevertheless amended Schedule C to claim the Malibu exempt; (5) Mr. Aldana improperly claimed the Malibu exempt under both CCP sections 703.140 and 704.010; (6) the Appellants did not oppose the Objection; and (7) Mr. Aldana did not [**7] bother to defend himself and respond to the court's inquiry regarding sanctions. Additionally, the Trustee sought coercive sanctions because "Mr. Aldana has repeatedly ignored and disregarded legal authority provided to him . . . [and] did not even acknowledge any need to respond to this Court's request for explanation as to why sanctions should not be assigned."

Later that same day, Mr. Aldana filed a tardy declaration in response to the Trustee's filing. He stated that he did not act in bad faith because he relied on the advice of a former chapter 7 trustee, Vincent Gorski, and Law v. Siegel, 571 U.S. 415, 134 S. Ct. 1188, 188 L. Ed. 2d 146 (2014), which he claimed stands for the proposition that "any property can be exempted up until the date of closing." He stated that he merely disagreed with the Trustee's interpretation of the law, which is not indicative of bad faith.

Mr. Aldana offered the declaration of Mr. Gorski, whom he had allegedly consulted regarding the exemption. Mr. Gorski stated that he advised Mr. Aldana that "the Debtor could modify his exemptions on property as claimed on Schedule C until the close of the bankruptcy case, including an exemption on the vehicle currently at [*703] issue." In particular, he testified that Law does not curtail [**8] a debtor's ability to claim an exemption if he did not participate in activities explicitly listed in § 522.

Prior to the continued hearing on the issue of sanctions, the bankruptcy court issued a tentative ruling stating that it was inclined to grant the request for sanctions based on its inherent powers. At the hearing, the court explained to Mr. Aldana (who admitted that he had not read the court's tentative ruling) that Mr. Gomez did not engage in activities indicative of bad faith. He stated that he merely disagreed with the Trustee's interpretation of the law, which is not indicative of bad faith.

Ultimately, the court adhered to its tentative ruling and sanctioned Mr. Aldana $1,475, the amount of the Trustee's fees and costs for opposing the Objection. It stated: I'm finding on your count recklessness, which means you didn't properly look at the law the way an attorney in your position should have. You didn't take warnings about the law the way an attorney in your position should have.

And it rises above the level of recklessness, because your positions are frivolous and because you also did so in a manner that, in a small-dollar estate, has huge impact. This is the sort of behavior that the court can't countenance.

The bankruptcy court entered the order ("Sanctions Order") adopting its tentative ruling in its entirety and sanctioning Mr. Aldana:

Mr. Aldana does not dispute that he received the Trustee's documents. He failed to oppose anything. Instead, he did an end run around his default and sought exemption as to the Malibu on the basis of two seriously flawed arguments. He attempts to avoid censure by relying on another attorney's opinion — an opinion that is worthless given that [**10] Mr. Aldana apparently failed to disclose the most relevant facts. Mr. Aldana frequently appears in this Court, a claim that he is a bankruptcy neophyte is not a defense. And in the face of this serious situation, he again failed to file a timely response. Here his conduct appears, at best, reckless, and this recklessness appears coupled with frivolous arguments and actions and disregard of this Court's scheduling requirements. Bad faith appears to exist.

The court further ordered Mr. Aldana to report the sanction to the California bar.5

5We take judicial notice that, even after the Sanctions Order, the Appellants continued to exempt the entire value of the Malibu. On March 13, 2018, the Trustee requested that Mr. Gomez surrender the vehicles for liquidation. Mr. Gomez instead filed a second amended Schedule C wherein he claimed an exemption in the Focus under CCP section 703.140(b)(2) (motor vehicle) and again exempted the entire value of the Malibu under section 703.140(b)(5) (wild card).
The Appellants filed a timely notice of appeal from the Sanctions Order. Mr. Aldana represents that he has paid the sanction.

**JURISDICTION**

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(2)(A) and (B). We have jurisdiction under 28 U.S.C. § 158.

**ISSUES**

(1) Whether the bankruptcy court abused its discretion in sanctioning Mr. Aldana for asserting a meritless claim of exemption in the Malibu.

(2) Whether the Trustee is entitled to his fees and costs for the Appellants' frivolous appeal.

**STANDARD OF REVIEW**

We review a sanctions order for abuse of discretion. See Miller v. Cardinale (In re DeVille), 361 F.3d 539, 547 (9th Cir. 2004) (citation omitted). Similarly, the bankruptcy court's choice of sanction is reviewed for abuse of discretion. See In re Nguyen, 447 B.R. 268, 276 (9th Cir. BAP 2011) (citations omitted). Accordingly, we reverse only where the bankruptcy court applied an incorrect legal rule or where its application of the law to the facts was illogical, implausible, or without support in inferences that may be drawn from the record. United States v. Hinkson, 585 F.3d 1247, 1262 (9th Cir. 2009) (en banc).

The Trustee filed an objection to the amended exemption. Mr. Gomez amended Schedule C yet again and omitted the Malibu. The bankruptcy court stated that Mr. Aldana's argument that he did not need to turn over the Malibu was "nonsensical." It sustained the Trustee's objection and awarded the Trustee $1,592.20 in fees and costs. The bankruptcy court also granted a Rule 9011 motion brought by the Trustee and ordered Mr. Aldana to pay the Trustee $3,408.33. The Trustee filed a motion for contempt against Mr. Gomez for failure to turn over the Malibu. The bankruptcy court granted the motion and ordered Mr. Gomez to pay the Trustee $2,000. He also commenced an adversary proceeding for revocation of discharge for failure to turn over of the Malibu. This case is still pending.

The Trustee finally sold the Malibu at auction in late August 2018 for $2,500.

**DISCUSSION**

A. The bankruptcy court did not abuse its discretion in sanctioning Mr. Aldana for bad faith.

The basic issue on appeal is whether the bankruptcy court erred in sanctioning Mr. Aldana for recklessly and frivolously pursuing the exemption in the Malibu, in addition to repeatedly failing to respond to the court's inquiries and the Trustee's filings. The bankruptcy court exercised its inherent power to sanction Mr. Aldana for "recklessness . . . coupled with frivolous arguments and actions and disregard of this Court's scheduling requirements."

A bankruptcy court "has the inherent authority to impose sanctions for bad faith, which includes a broad range of willful improper conduct." Fink v. Gomez, 239 F.3d 989, 992 (9th Cir. 2001); see Knupfer v. Lindblade (In re Dyer), 322 F.3d 1178, 1196 (9th Cir. 2003); Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.), 77 F.3d 278, 284 (9th Cir. 1996). Before the bankruptcy court imposes sanctions under its inherent authority, it must find either bad faith, conduct tantamount to bad faith, or recklessness with an "additional factor such as frivolousness, harassment, or an improper purpose." [*12] Fink, 239 F.3d at 994. The bankruptcy court "must make an explicit finding . . . ." Primus Auto. Fin. Servs., Inc. v. Batarse, 115 F.3d 644, 648 (9th Cir. 1997).

On appeal, the Appellants offer two pages of argument that merely repeat the [*705] same arguments presented to the bankruptcy court. They do not explain their superficial contentions or support them with any legal authority, other than their steadfast reliance on Law v. Siegel. This appeal is both frivolous and meritless. The bankruptcy court did not err.

1. The Appellants' arguments that ignore § 522(g)(1) are frivolous and reckless, not a mere "difference of opinion."

The Appellants insist that the law allows Mr. Gomez to exempt the Malibu at any time prior to the closing of the bankruptcy case. They say that the dispute in this case is really only a difference in interpretation of the law, which does not give rise to bad faith.

The Appellants are wrong, and the law on this point is not ambiguous or open to interpretation. As the Trustee explained repeatedly, [HN3] if he recovers certain property prior to the debtor claiming an exemption, that property cannot be exempted. Section 522(g) provides:

\[\text{Section 522(g) provides:}\]
case law clearly states that a debtor cannot knowingly conceal a prepetition transfer or an interest in property, and such property is returned to the estate as a result of the trustee’s actions directed toward either the debtor or the transferee, the debtor is not entitled to claim an exemption under § 522(g)(1).

Id. at 764-65 (emphasis added).

It matters not that the transfer in this case was the perfection of a lien rather than a transfer of ownership. In Wharton v. Schwartzter (In re Wharton), 563 B.R. 289 (9th Cir. BAP 2017), we considered a similar situation where the trustee avoided a creditor’s security interest in a vehicle and objected to a later attempt to exempt the vehicle. In that case, the debtors scheduled their 1965 Corvette, in which the debtor-husband’s brother held a nonpurchase money security interest to secure a debt in excess of the vehicle’s value. The trustee then sought turnover of the vehicle because the security interest was not perfected under Nevada law. The debtors amended their schedules to claim an exemption in the Corvette, but the trustee objected. The court agreed with the trustee and sustained the trustee’s objection under § 522(g)(1)(A). It determined that there was a transfer of a security interest and that the trustee had recovered the vehicle under §§ 544 and 550 for the benefit of the estate when the brother released the lien.

On appeal, we first considered whether there was a “voluntary transfer” under § 522(g)(1). We applied Nevada law and concluded that the debtors had transferred a security interest in the Corvette.

Second, we considered whether the trustee had avoided the security interest and recovered it for the estate. We noted that the brother did not perfect his interest in the Corvette under state law. The trustee’s motion and threat of avoidance powers constituted “some action” that caused the brother to release the lien.

In [*16] the present case, the bankruptcy court did not err in holding that the Trustee satisfied the two prongs of § 522(g)(1)(A).

First, there was a "transfer" of estate property. *HN5[†] The perfection of a security interest is a "transfer" within the meaning of § 101(54)(D), See Daigle v. Kennedy (In re Daigle), No. 08CV0256-LAB (AJB), 2008 U.S. Dist. LEXIS 128666, 2008 WL 11337933, at *5 (S.D. Cal. July 14, 2008) (citing § 101(54)(D) and stating that "[i]t is well established that, under bankruptcy law, perfection of an interest in property is considered a transfer separate and apart from the transfer of title" (citation omitted)); Hawkins v. Lister (In re Hawkins), No. 16-00154, 166 B.R. 841 (N.D. Ill. 1994) (quoting § 522(g)(1)(A) and stating that "[w]hile it is well established that a security interest may be perfected by means other than a voluntary transfer, in the case at bar the perfected security interest existed at the time the asset was transferred to the estate; the order of perfection was irrelevant.

(g) Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to [**13] the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if —

(1)(A) such transfer was not a voluntary transfer of such property by the debtor; and

(B) the debtor did not conceal such property; or

(2) the debtor could have avoided such transfer under subsection (f)(1)(B) of this section.

§ 522(g) (emphases added). In other words, § 522(g)(1) "allows the debtor to exempt property that the trustee recovers under [various sections of the Bankruptcy Code] as long as the transfer was involuntary and the property was not concealed by the debtor." 4 Collier on Bankruptcy ¶ 522.12[1] (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.) (emphases in original). Conversely, a debtor may not exempt property that the trustee recovers under one of the enumerated provisions if the debtor voluntarily transferred or concealed the property. See Guthrie v. Stadtmueller (In re Guthrie), BAP No. SC-15-1390-FYJu, 2017 Bankr. LEXIS 269, 2017 WL 431398, at *4 (9th Cir. BAP Jan. 31, 2017).

Our HN4[††] case law clearly states that a debtor cannot exempt property that the trustee recovers using his avoidance power. In Hitt v. Glass (In re Glass), 164 B.R. 759 (9th Cir. BAP 1994), aff’d, 60 F.3d 565 (9th Cir. 1995), we explained the contours of § 522(g):

Section 522(g), however, limits the ability of a debtor to claim an exemption where the trustee has recovered property for the [**14] benefit of the estate. Under § 522(g)(1), a debtor may claim an exemption where the trustee has recovered property pursuant to §§ 510(c)(2), 542, 543, 550, 551 or 553 only if the property was involuntarily transferred and the debtor did not conceal the transfer or an interest in the property. . . . Thus, under § 522(g)(1), a debtor may not exempt recovered property if the debtor voluntarily transferred such property or concealed the transfer or an interest in such property.

164 B.R. at 761-62 (emphasis added) (citations omitted).

After examining the language of the statute, we reiterated:

Accordingly, we hold that *HN5[††] where a debtor voluntarily transfers property in a manner that triggers the trustee’s [*706] avoidance powers or the debtor knowingly conceals a prepetition transfer or an interest in property, and such property is returned to the estate as a result of the trustee’s actions directed toward either the debtor or the transferee, the debtor is not entitled to claim an exemption under § 522(g)(1).

Id. at 764-65 (emphasis added).
The bankruptcy court never suggested that the exemption should be denied because it was untimely or for any extraneous reason. Instead, it relied on the relevant statute that specifically prohibited Mr. Gomez from claiming an exemption in the Malibu. Law is inapplicable.

2. The bankruptcy court did not err in considering the totality of factors concerning the surrender of the Malibu.

The Appellants argue that the bankruptcy court erroneously considered the facts in finding bad faith. They argue that the Trustee saw the Malibu at Mr. Gomez's house and chose not to retrieve the vehicle.

The bankruptcy court did not err. There is no evidence in the record that the Trustee saw the Malibu at Mr. Gomez's house. Rather, the Trustee's declaration did not mention the Malibu and only states that Mr. Gomez was not home.

The Appellants also assert that the Trustee never told Mr. Gomez where to surrender the Malibu. But the Trustee told the Appellants to surrender the Malibu to the Trustee's auctioneer. They cannot claim that they did not know how to surrender the vehicle.

3. The bankruptcy court did not err in considering Mr. Gorski's declaration.

The Appellants argue that the bankruptcy court abused its discretion by improperly discounting Mr. Gorski's declaration because he did not state that he was aware that the Trustee had avoided the lien.

The bankruptcy court did not err. It considered M. Gorski's declaration and only states that Mr. Gomez was not home. Rather, the Trustee's declaration did not mention the Malibu and only states that Mr. Gomez was not home.

The Appellants also assert that the Trustee never told Mr. Gomez where to surrender the Malibu. But the Trustee told the Appellants to surrender the Malibu to the Trustee's auctioneer. They cannot claim that they did not know how to surrender the vehicle.

4. The bankruptcy court applied the correct standard.

The Appellants argue that the bankruptcy court "called the actions reckless, but [§708] that is not sufficient to sanction one's belief in the law."

The Appellants are correct that the §77[§] award of sanctions requires more than recklessness alone. The Ninth Circuit has stated that “[s]anctions are available for a variety

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**Section 6300 of the California Vehicle Code** provides:

> no security interest in any vehicle registered under this code, irrespective of whether the registration was effected prior or subsequent to the creation of the security interest, is perfected until the secured party or his or her successor or assignee [§522(g)(1)] has deposited, . . . with the department, . . . a properly endorsed certificate of ownership to the vehicle subject to the security interest showing the secured party as legal owner . . .

**Cal. Veh. Code § 6300.** Similarly, section 6301 states: “When the secured party . . . has deposited . . . with the department a properly endorsed certificate of ownership showing the secured party as legal owner . . . the deposit constitutes perfection of the security interest . . .”

Although Mr. Gomez purchased the Malibu prepetition, the Trustee alleged that Anayas Auto only attempted to perfect its lien two months after Mr. Gomez filed his petition. As such, the perfection of the lien constituted a postpetition transfer.

7 Mr. Gomez valued the Malibu at $4,500. He sought to exempt 100 percent of that value, which necessarily included the $2,700 encumbered by Anayas Auto's lien. The lien, however, was only $2,700, leaving $1,800 in equity (assuming that Mr. Gomez's scheduled value was correct). Mr. Gomez never sought to limit his exemption to the equity in the Malibu and never mentioned this point on appeal. Therefore, we need not discuss whether the Trustee's avoidance of the $2,700 lien precluded Mr. Gomez from exempting the value (if any) of the Malibu in excess of the avoided lien under §522(g)(1).
of types of willful actions, including recklessness when combined with an additional factor such as frivolousness, harassment, or an improper purpose." *Fink*, 239 F.3d at 994.

The Appellants ignore the bankruptcy court's ruling. The court held multiple times that Mr. Aldana was reckless, but it also held that his positions were frivolous. It stated at the hearing, "And it rises above the level of recklessness, because your positions are frivolous and because you also did so in a manner that, in a small-dollar estate, has huge impact." (Emphasis added.) The Sanctions Order confirms: "Here his conduct appears, at best, reckless, and this recklessness appears coupled with frivolous arguments and actions and disregard of this Court's scheduling requirements." (Emphasis added.) The bankruptcy court did not err.

B. The Trustee is entitled to recover his fees [**20**] and double costs from Mr. Aldana for this frivolous appeal.

The Trustee requested by separate motion that we sanction the Appellants for filing a frivolous appeal, not following the appellate rules, and offering a "fluctuating and erratic presentation of the issues on appeal." In keeping with their usual pattern, the Appellants filed an untimely opposition. We GRANT the request for fees and double costs against Mr. Aldana only.

**HN8** Rule 8020, which conforms to the language of Federal Rule of Appellate Procedure ("FRAP") 38, provides that: "If the district court or BAP determines that an appeal is frivolous, it may, after a separately filed motion or notice from the court and reasonable opportunity to respond, award just damages and single or double costs to the appellee." Rule 8020(a). Under FRAP 38, "a frivolous appeal is one where the result is obvious or the appellant's arguments are wholly without merit." First Fed. Bank of Cal. v. Weinstein (In re Weinstein), 227 B.R. 284, 297 (9th Cir. BAP 1998) (citations omitted). We may impose sanctions to penalize an appellant or attorney who pursues a frivolous appeal and to compensate the appellee for the delay and expense of defending the appeal. 10 Collier on Bankruptcy ¶ 8020.03; see Burlington N.R. Co. v. Woods, 480 U.S. 1, 7, 107 S. Ct. 967, 94 L. Ed. 2d 1 (1987).

Even a cursory review of § 522(g)(1) and the relevant case law would have told the Appellants [**21**] that they could not claim an exemption in the Malibu after the Trustee had recovered it from Anayas Auto.⁸ The Trustee explained this to Mr. Aldana, and the bankruptcy court clearly stated the rationale behind its ruling. Furthermore, the Appellants did not bother to respond to the Motion to Compel or the court's threat of sanctions, yet they took the same incorrect position on appeal and submitted an opening brief with only two pages of argument that was largely devoid of legal authority or analysis. They did not address § 522(g)(1) or the relevant case law. Nor did they bother to oppose the motion for sanctions on appeal within the seven days provided by Rule 8013(a)(3)(A).

They argue that Mr. Aldana's "subjective good faith belief in his course [*709*] of conduct should insulate him from punishment." But **HN9** Rule 8020(a) is not susceptible to a "pure heart, empty head" defense. See United States v. Nelson (In re Bectraft), 885 F.2d 547, 549 (9th Cir. 1989) (stating that "a finding of bad faith is not necessary to impose sanctions under [FRAP] 38 . . . ."); Hermosilla v. Hermosilla, 447 B.R. 661, 668 (D. Mass. 2011) (stating that "the court may impose sanctions if the appellant raises issues that are contradicted by long-established precedent"); Maloni v. Fairway Wholesale Corp. (In re Maloni), 282 B.R. 727, 734 (1st Cir. BAP 2002) (stating that, on appeal, that panel "will consider whether appellant's argument addresses the issues on appeal properly; fails [**22**] to support the issues on appeal; fails to cite any authority; cites inapplicable authority; makes unsubstantiated factual assertions; makes bare legal conclusions; or, misrepresents the record").

Mr. Aldana laments that he has already paid over $9,500 in sanctions, which is far more than the value of the Malibu. Even if this is true, it is irrelevant. The sanctions represent attorneys' fees that the Trustee had to incur in order to overcome Mr. Aldana's baseless contentions. Mr. Aldana is solely responsible for his predicament.

As we discuss above, the Appellants' appeal from the Sanctions Order is frivolous and lacks any merit. We conclude that the Trustee is entitled to the imposition of sanctions against Mr. Aldana, who is responsible for advocating the frivolous legal arguments and positions on appeal. We exercise our discretion and award the Trustee his fees and double costs.

The Trustee is ORDERED to file a declaration attesting to his fees and costs incurred in this appeal, supported by appropriate documentation, on or before **Tuesday, December 4, 2018**. Mr. Aldana may respond no later than **Tuesday, December 11, 2018**. Upon our review of these filings, the amount of the award shall [**23**] be established by a separate order. *Taylor v. Sentry Life Ins. Co.*, 729 F.2d 652, 657 (9th

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⁸The Appellants appear to fault the Trustee for not telling Mr. Gomez to exempt the Malibu or explaining the relevant law to Mr. Aldana. But there is no basis for the proposition that a trustee must provide legal advice to debtors or their counsel.
CONCLUSION

The bankruptcy court did not err. We AFFIRM and GRANT the Trustee's motion for sanctions against Mr. Aldana.

End of Document
What Do the FDCPA and the CFPB's Debt Collection Rulemaking Have to Do with Bankruptcy?
What Do the FDCPA and the CFPB’s Debt Collection Rulemaking Have to do with Bankruptcy?

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What Do the FDCPA and the CFPB’s Debt Collection Rulemaking Have to do with Bankruptcy?
Overview of the FDCPA rulemaking
What the CFPB is Trying to Accomplish

• Move industry into the 21st Century.

• Create opportunities for technology.

• Create more infrastructure into existing operations.

• Standardize processes – what will be the differentiation?

• Old methods maybe the thing of the past.
Key Elements of the NPR

- Guidelines for the use of email & text.
  - These were never prohibited however such practices were viewed as a “do at your own risk” due to the lack of clarity in the rules.
- Definitive safe harbors in the area of call frequency, limited content messages & validation notice.
- Incorporation of UDAAP principals into FDCPA which may create issues for creditors.
- New definitions - “call attempts” and “validation end date”.
- “Known or should know” standard incorporated into some collection activities.
- Address some aspects of credit reporting.
§ 1006.6 Communications in connection with debt collection.
(a) Definition. For purposes of this section, the term consumer includes: …
   (5) A confirmed successor in interest, as defined in Regulation X, 12 CFR 1024.31, and Regulation Z, 12 CFR 1026.2(a)(27)(ii).

Bureau Analysis states:
A person to whom a borrower transfers an ownership interest either in a property securing a mortgage loan subject to subpart C of Regulation X, or in a dwelling securing a closed-end consumer credit transaction under Regulation Z, provided that the transfer is:
   (1) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
   (2) a transfer to a relative resulting from the death of a borrower;
   (3) a transfer where the spouse or children of the borrower become an owner of the property;
   (4) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property; or
   (5) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property. A confirmed successor in interest, in turn, means a successor in interest once a servicer has confirmed the successor in interest’s identity and ownership interest in the relevant property type.
Mortgage Issues Addressed in the NPR (con’t)

§ 1006.6 Communications with a consumer

(c) Communications with a consumer – after refusal to pay or cease communication notice: …

The prior 2016 Servicing Final Rule and the concurrently issued 2016 FDCPA Interpretive Rule interpreted the written early intervention notice required in Regulation X, 12 CFR 1024.39(d)(3), to fall within the exceptions to the cease communication provision in FDCPA section 1692c(2) & (3).

The Bureau has proposes an Official Comment to §1006.6(c)(2):

1. Written early intervention notice for mortgage servicers. The Bureau has interpreted the written early intervention notice required by 12 CFR 1024.39(d)(3) to fall within the exceptions to the cease communication provision in FDCPA section [1692c(2) & (3)]. See 12 CFR 1024.39(d)(3), its commentary, and the Bureau’s 2016 FDCPA Interpretive Rule (81 FR 71977 (Oct. 19, 2016)).
Mortgage Issues Addressed in the NPR (con’t)

§ 1006.34(c) Validation Information

(5) Special rule for certain residential mortgage debt. For residential mortgage debt subject to Regulation Z, 12 CFR 1026.41, a debt collector need not provide the validation information described in paragraphs (c)(2)(vii) through (ix) of this section if the debt collector:

   (i) Provides the consumer at the same time as the validation notice, a copy of the most recent periodic statement provided to the consumer under Regulation Z, 12 CFR 1026.41(b); and

   (ii) Refers to that periodic statement in the validation notice.

Bureau Analysis states:

Special rule that would replace proposed disclosure requirements when collecting residential mortgage debt;

Periodic statements are “functionally equivalent” to validation proposal which would require a breakdown of interest, costs and fees as of itemization date.
Timeline for NPR & Final Rule

- Comment period ends August 19, 2019.

- Trade associations will submit comprehensive comments but all stakeholders are encouraged to submit comments on some if not all aspects of the NPR.

- CFPB will take at least a year to review the comments and issue a final rule in 2020.

- 1 year implementation period thereafter.
The Intersection of the NPR and Bankruptcy
NPR and Bankruptcy

• NPR mentions bankruptcy discharge with respect to the transfer of debts and the prohibition to sell, transfer or place any debt for collection if there has been a discharge.

• No other guidance or proposals (beyond the instances of residential mortgages) when a debt collector is required to communicate with a consumer that has filed bankruptcy.

• Validation notice & proofs of claim require different information which could be confusing to the consumer.

• No mini-miranda exception for bankruptcy.

• Difficulties in communicating with bankruptcy counsel not addressed, especially for communication requirements for Reg Z.
The FDCPA and Bankruptcy Rule 3001

The Supreme Court opinion in Midland v. Johnson held that filing a proof of claim on a time-barred debt did not violate the FDCPA.

The Court did not address whether other conduct by a debt collector during a consumer’s bankruptcy could violate the FDCPA.

Rule 3001 has specific requirements for filing proofs of claim, and many debt collectors run the risk of violating the FDCPA by not complying with Rule 3001.
### Identify the Claim

1. **Who is the current creditor?**
   - **Williamson and Rowen LLC**
   - Name of the current creditor or entity to be paid for this claim:

2. **Has this claim been acquired from someone else?**
   - ☐ No
   - ☑ Yes. From whom?

3. **Where should notices and payments to the creditor be sent?**
   - Name: Williamson and Rowen LLC
   - Address: 4621 Clifton Parkway
   - Phone: 1 (603) 621-2557

<table>
<thead>
<tr>
<th>City</th>
<th>State</th>
<th>ZIP Code</th>
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<tr>
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</tbody>
</table>

4. **Did the claimant amend a claim previously filed?**
   - ☐ No
   - ☑ Yes. Claim number on previous claim: X

5. **Do you know if anyone else has filed a proof of claim for this claim?**
   - ☐ No
   - ☑ Yes. Who made the earlier filing?

---

**Official Form:** 410  **Proof of Claim:**  **Page:** 1
**Case 18-32857-KLP**  
**Claim 5**  
**Filed 07/19/18**  
**Desc Main Document**  
**Page 2 of 3**

**Part 2:** Provide Information About the Claim as of the Date the Case Was Filed

1. **Do you have any reason you were not able to identify the doctor?**
   - [ ] No
   - [x] Yes. Last 4 digits of the doctor’s account or any number you use to identify the doctor: 7240

2. **How much is the claim?**
   - 347.00
   - [ ] No
   - [ ] Yes. Attach statement showing interest, fees, expenses, or other charges required by Bankruptcy Rule 2001(c)(7)(A).

3. **What is the basis of the claim?**
   - **Examples:** Goods sold, money loaned, lease, services performed, personal injury, or wrongful death, or credit card.
   - Attach redacted copies of any documents supporting the claim required by Bankruptcy Rule 2001(c).
   - Limit disclosing information that is entitled to privacy, such as health care information.

   **Money Loaned**

4. **Is all or part of the claim secured?**
   - [ ] No
   - [x] Yes. The claim is secured by assets on property.
   - **Nature of property:**
     - [ ] Real estate: In the case of a security interest in real estate, file a Mortgage or Initial Claim  
       Statement (Official Form 301) with this Statement of Claim.
     - [ ] Motor vehicle
     - [ ] Other: Describe:

   **Attach:**
   - Redacted copies of documents, if any, that show evidence of perfection of a security interest (for example, a mortgage, lien, certificate of title, financing statement, or other document that shows the lien has been filed or recorded.)

   **Value of property:** $___________
ACCOUNT NUMBER: Redacted
DATE DUE: N/A
AMOUNT DUE: $347.00

This letter is in reference to a debt owed to the client listed below:

ALLIED CASH ADVANCE VIRGINIA LLC

WILLIAM ROZZELL HARRIS
6425 RUDD PL
HENRICO, VA 23231

SS#..................................: xxx-xx-Redacted
REFERENCE#: Redacted
CLIENT ACCOUNT#: xxxxxRedacted
AMOUNT OWED.........: $347.00
PRINCIPAL BALANCE.....: $347.00

Upon successful receipt and clearance of the payment, this office will submit a closing report to our client for credit reporting purposes when all arrangements are met in full. This account will be removed from all three major credit reports upon successful clearance of the funds. This payment is NULL and VOID if not paid accordingly. Your account will be returned to our client as uncollectable if you default on these arrangements.

We charge no interest, even if you opt for our monthly installment plan.
From the first page of the settlement agreement:

“WHEREAS, although Releasees admit that information in the Proof of Claim is not accurate, the issue of intent is a disputed and triable issue of fact, and Releasees deny that any inaccuracy was intentional, or not made in good faith.”
Although not a formal class settlement, the remedy went to all other debtors in the District.

“Withdrawal of Claims:” Arcese and Williamson and Brown each acknowledge that it has or, within fourteen (14) days of execution of this Agreement, will withdraw all claims it has filed as of the date of this Agreement in the Eastern District of Virginia, including cases of Similarly Situated Debtors or Other Debtor Objectors, including Plaintiff’s, that remain active in the Bankruptcy Courts for the Eastern District of Virginia and further covenant and agree not to re-file any such claims during the pendency of those bankruptcy cases. In the event, that such proof of claims are not withdrawn within 14 days, upon notice to Williamson and Brown, LLC, they shall promptly cause the withdrawal of such claim, or Williamson and Brown, LLC irrevocably consents to the withdrawal of such claim.”
“In addition to the monetary consideration described in Section 2 and the non-monetary consideration described throughout this Agreement, Arcese and Williamson and Brown agree to entry of an Order that, in any filing in the Eastern District of Virginia, they shall comply with Federal Rule of Bankruptcy Procedure 3001(c), and further agree that:

13.1 For a period of (2) years from the date of this Agreement, Williamson and Brown, LLC and Alexander Nial Arcese. individually and any entity either Defendant controls shall not file proof of claims in the Eastern District of Virginia against any individual based upon consumer debt; and that, thereafter, all filings of proof of claims against consumer debtors in the Eastern District of Virginia, shall comply with requirements of Rule 3001, and the Local Rules in effect at that time.”
**Proof of Claim**

Read the instructions before filing out this form. This form is for making a claim for payment in a bankruptcy case. Do not use this form to make a request for payment of an administrative expense. Make such a request according to 11 U.S.C. § 503.

Filers must leave out or redact information that is entitled to privacy on this form or on any attached documents. Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, judgments, mortgages, and security agreements. **Do not send original documents;** they may be destroyed after scanning. If the documents are not available, explain in an attachment.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Fill in all the information about the claim as of the date the case was filed. That date is on the notice of bankruptcy (Form 309) that you received.

**Part 1: Identify the Claim**

1. **Who is the current creditor?**

   Williamson and Brown LLC

   Name of the current creditor (the person or entity to be paid for this claim)

   Other names the creditor used with the debtor

2. **Has this claim been acquired from someone else?**

   - [ ] Yes. From whom?
   - [x] No

3. **Where should notices and payments to the creditor be sent?**

   Federal Rule of Bankruptcy Procedure (FRBP) 2002(g)

   **Where should notices to the creditor be sent?**

   Williamson and Brown LLC

   Name

   4691 Clifton Parkway

   Number

   Hamburg

   City

   NY

   State

   14075

   ZIP Code

   **Where should payments to the creditor be sent? (if different)**

   Name

   Number

   Street

   City

   State

   ZIP Code

   Contact phone 1 (800) 651 9637

   Contact phone

   Contact email a.arcese@williamsonandbrown.com

   Contact email

   Uniform claim identifier for electronic payments in chapter 13 (if you use one):

   __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __}
**Part 2: Give Information About the Claim as of the Date the Case Was Filed**

6. **Do you have any number you use to identify the debtor?**
   - No
   - Yes. Last 4 digits of the debtor’s account or any number you use to identify the debtor: 7 2 4 0

7. **How much is the claim?**
   
   $347.00

   **Does this amount include interest or other charges?**
   - No
   - Yes. Attach statement itemizing interest, fees, expenses, or other charges required by Bankruptcy Rule 3001(c)(2)(A).

8. **What is the basis of the claim?**
   Examples: Goods sold, money loaned, lease, services performed, personal injury or wrongful death, or credit card.

   Attach redacted copies of any documents supporting the claim required by Bankruptcy Rule 3001(c).

   Limit disclosing information that is entitled to privacy, such as health care information.

   ____________________________________________________________________________
   Money Loaned

9. **Is all or part of the claim secured?**
   - No
   - Yes. The claim is secured by a lien on property.

   **Nature of property:**
   - Real estate. If the claim is secured by the debtor’s principal residence, file a Mortgage Proof of Claim Attachment (Official Form 410-A) with this Proof of Claim.
   - Motor vehicle
   - Other. Describe: ____________________________________________________________________________

   **Basis for perfection:**
   ____________________________________________________________________________
   Attach redacted copies of documents, if any, that show evidence of perfection of a security interest (for example, a mortgage, lien, certificate of title, financing statement, or other document that shows the lien has been filed or recorded.)

   **Value of property:**
   ________________

   **Amount of the claim that is secured:**
   ________________

   **Amount of the claim that is unsecured:**
   ________________ (The sum of the secured and unsecured amounts should match the amount in line 7.)

   **Amount necessary to cure any default as of the date of the petition:**
   ________________

   **Annual Interest Rate** (when case was filed) _____ %
   - Fixed
   - Variable

10. **Is this claim based on a lease?**
    - No
    - Yes. Amount necessary to cure any default as of the date of the petition. ________________

11. **Is this claim subject to a right of setoff?**
    - No
    - Yes. Identify the property: ____________________________________________________________________________

   ____________________________________________________________________________
   ____________________________________________________________________________
Part 3: Sign Below

The person completing this proof of claim must sign and date it. FRBP 9011(b).

If you file this claim electronically, FRBP 5005(a)(2) authorizes courts to establish local rules specifying what a signature is.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Check the appropriate box:

- I am the creditor.
- I am the creditor’s attorney or authorized agent.
- I am the trustee, or the debtor, or their authorized agent. Bankruptcy Rule 3004.
- I am a guarantor, surety, endorser, or other codebtor. Bankruptcy Rule 3005.

I understand that an authorized signature on this Proof of Claim serves as an acknowledgment that when calculating the amount of the claim, the creditor gave the debtor credit for any payments received toward the debt.

I have examined the information in this Proof of Claim and have a reasonable belief that the information is true and correct.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on date 7/16/2018

Signature

Print the name of the person who is completing and signing this claim:

Name
Alexander Nial Arcese
First name Middle name Last name

Company
Williamson and Brown, LLC
Title
President

Address
4691 Clifton Parkway

Contact phone 1 (800) 651 9637
City Hamburg State NY ZIP Code 14075
Email a.arcese@williamsonandbrown.com

Amount entitled to priority

- Domestic support obligations (including alimony and child support) under 11 U.S.C. § 507(a)(1)(A) or (a)(1)(B).
  $__________________

- Up to $2,850* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use. 11 U.S.C. § 507(a)(7).
  $__________________

- Wages, salaries, or commissions (up to $12,850*) earned within 180 days before the bankruptcy petition is filed or the debtor’s business ends, whichever is earlier. 11 U.S.C. § 507(a)(4).
  $__________________

- Taxes or penalties owed to governmental units. 11 U.S.C. § 507(a)(8).
  $__________________

  $__________________

  $__________________

* Amounts are subject to adjustment on 4/01/19 and every 3 years after that for cases begun on or after the date of adjustment.
This letter is in reference to a debt owed to the client listed below:

**ALLIED CASH ADVANCE VIRGINIA LLC**

WILLIAM ROZZELL HARRIS  
6425 RUDD PL  
HENRICO, VA 23231  

SS#.............................................: xxx-xx-Redacted  
REFERENCE#.........................: Redacted  
CLIENT ACCOUNT#.............: xxxxxRedacted  
AMOUNT OWED...............: $347.00  
PRINCIPAL BALANCE........: $347.00

Upon successful receipt and clearance of the payment, this office will submit a closing report to our client for credit reporting purposes when all arrangements are met in full. This account will be removed from all three major credit reports upon successful clearance of the funds. This payment is NULL and VOID if not paid accordingly. Your account will be returned to our client as uncollectable if you default on these arrangements.

We charge no interest, even if you opt for our monthly installment plan.

This is an attempt to collect a debt. Any information obtained will be used for that purpose.

Thank You,

[Signature]
Alexander Arcese  
President

To contact us, call 1 (800) 651-9637

Important Notice:  
This letter is an attempt to collect a debt and any information obtained will be used for that purpose.

Here to Help:  
Turning your debt around is just a call or click away!

Visit us online at  
www.WilliamsonandBrown.com

After clicking "Pay Online" enter your customer reference number.

All major credit cards accepted.

ACCOUNT NUMBER  DATE DUE  AMOUNT DUE  
Redacted  N/A  $347.00

Please note my change of address on the reverse side.
Here at Williamson & Brown, LLC, we strive to always provide a new standard of service as well as dynamic and flexible payment plans to each one of our customers. Our team is here to work with you, to create repayment opportunities that fit your life and get you on the road to better credit and a bright financial future.

This is our promise to you.

Notice of Rights

CALIFORNIA NOTICE OF RIGHTS
“The state Rosenthal Fair Debt Collection Practices Act and the federal Fair Debt Collection Practices Act require that, except under unusual circumstances, collectors may not contact you before 8 a.m. or after 9 p.m. They may not harass you by using threats of violence or arrest or by using obscene language. Collectors may not use false or misleading statements or call you at work if they know or have reason to know that you may not receive personal calls at work. For the most part, collectors may not tell another person, other than your attorney or spouse, about your debt. Collectors may contact another person to confirm your location or enforce a judgment.”

COLORADO NOTICE OF RIGHTS
If a consumer notifies a debt collector or collection agency in writing that the consumer refuses to pay a debt or that the consumer wishes the debt collector or collection agency to cease further communication with the consumer, the debt collector or collection agency shall not communicate further with the consumer with respect to such debt, except to advise the consumer that the debt collector’s or collection agency’s further efforts are being terminated; notify the consumer that the collection agency or creditor may invoke specified remedies that are ordinarily invoked by such collection agency or creditor, or notify the consumer that the mail, notification shall be complete upon receipt. For information about the Colorado fair debt collection practices act, see: WWW.COLORADOATTONEYGENERAL.GOV/CA

MASSACHUSETTS NOTICE OF RIGHTS
You have the right to make a written or oral request that telephone calls regarding you debt not be made to you at your place of employment. Any such oral request will be valid for only ten days unless you provide written confirmation of the request postmarked or delivered within seven days of such request. You may terminate this request by writing to the debt collector.

This is an attempt to collect a debt and any information obtained will be used for that purpose.

HAVE QUESTIONS? WE’RE HERE
Our staff is standing by to help you better understand this notice, your overdue accounts, credit score impact and more. Call us anytime during regular business hours, Monday thru Friday at 1(800) 651-9637 for expert assistance.

WE MAKE PAYMENT EASY
There are three simple ways to pay: phone, mail or online. We accept all major credit cards, personal checks and money orders. Customers can save by paying their outstanding balance in one lump sum or spread the payments into smaller, monthly amounts.

Williamson & Brown, LLC. Copyright ©2014-15. All Rights Reserved. P.O. Box 64, Hamburg, NY 14075. 1(800) 651-9637. The information contained in this letter is strictly confidential and should not be shared with anyone.

TEAR OFF HERE AND RETURN BOTTOM PORTION IN RENEWAL ENVELOPE PROVIDED

Sign up for one of the following Auto Bill Pay options and sign
Processing takes up to 2 weeks, so please retain a copy this completed notice for your records. For a faster way to enroll, go to williamsonandbrown.com and click “Pay Online.”

☐ Credit/Debit Card Auto Bill Pay  Visa  MC  AmEx  Discover

Card # ________________ ________________ ________________ ________________

Exp ____________ CVV __________

Amount $25 $50 $100 Other $____________

Preferred Date of Month to Charge __________

Signature: ___________________________ Date: __________

Change my billing address to:
Only fill this section out if you have moved from the address printed on front side.

Street Address ____________________________________________________________

City _______________________________________________ State _______ Zip ______

Phone ( )

Want an e-mail bill instead?
Call 1(800) 651-9637 to make arrangements.
SETTLEMENT AGREEMENT AND RELEASE

This Settlement Agreement and Mutual Release ("Agreement"), dated April 9, 2019, is given by William Rozell Harris ("Plaintiff" or "Releasor"), and anyone who succeeds to his rights and responsibilities including, but not limited to, his agents, representatives, assigns, successors, heirs, executors, insurers, and administrators (hereinafter referred to as "Releasor"), and Alexander Nial Arcese ("Arcese") and Williamson and Brown, LLC ("Williamson and Brown") and their agents, employees, officers, directors, predecessors, successors, insurers, shareholders, and any other person, partnership, firm or entity (hereinafter referred to as "Releasees" and/or "Defendants"). When referring to all parties to this Agreement collectively, they shall be hereinafter known as "the Parties."

WHEREAS, Releasor filed for relief under Chapter 13 of Title 11 U.S. Code in the United States Bankruptcy Court for the Eastern District of Virginia, Case No. 18-32857-KLP.

WHEREAS, Arcese filed a Proof of Claim on behalf of Williamson and Brown in the Chapter 13 Bankruptcy in the amount of $347.00, which was designated by the Court as Claim 5-1 (the "Proof of Claim").

WHEREAS, Releasor filed the subject adversary proceeding as a Class Action Complaint, alleging, inter alia, violations by Releasees of Federal Rules of Bankruptcy Procedure 3001(c)(1) & (2) and the Fair Debt Collection Practices Act, 15 U.S.C. § 1692 (c) & (f) ("FDCPA") in connection with the filing of the Proof of Claim and the filing of other proofs of claim in the United States Bankruptcy Courts for the Eastern District of Virginia. The claims, allegations and causes of action in the complaint, including without limitation any allegations of violations of the FDCPA or Bankruptcy Rules collectively referred to as the "Claim".

WHEREAS, although Releasees admit that information in the Proof of Claim is not accurate, the issue of intent is a disputed and triable issue of fact, and Releasees deny that any inaccuracy was intentional, or not made in good faith. Releasees deny any and all liability under any federal or state law arising from debt collection activities by Releasees, including the filing of the Proof of Claim and other proofs of claim in the United States Bankruptcy Courts for the Eastern District of Virginia;

WHEREAS, Releasees are willing to settle this matter to avoid the costs of litigation and to avoid litigation with putative class members, identified, generally, by Releasor as individuals in the United States Bankruptcy Courts for the Eastern District of Virginia in whose bankruptcy cases Releasees filed proofs of claim that referenced any Allied Cash entity ("Similarly Situated Debtors") or in whose bankruptcy cases Releasees filed proofs of claims that were objected to by any of Plaintiff's respective counsel's ("Other Debtor Objectors") whether or not the claim was paid, dismissed, objected to, or withdrawn by Defendants, in exchange for dismissal with prejudice of the Lawsuit;

WHEREAS, Releasor states that he is presently of sound mind and body, willing and able to release all allegations and claims that have been alleged or could have been alleged as of the date of execution of the Agreement, and
WHEREAS, the Parties desire to make a full and final settlement of the Claim, as well as any and all other claims, without trial or arbitration and without any adjudication of any issue of law or fact; and

NOW THEREFORE, in consideration of the promises and the mutual covenants of the Parties and promises contained herein and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Parties agree as follows:

1. **Release and Covenant Not To Sue.**

1.1 **Plaintiff:**

1.1.1 Effective upon the final payments required under this Agreement, respectively, and subject to the provisions of this Agreement, and without need for further documentation, Plaintiff on behalf of himself as well as any and all of his heirs, legatees, beneficiaries, guardians, administrators, executors, executrixes, representatives, employees, employers, agents, attorneys, successors and assigns, hereby releases and forever discharges Defendants, individually and collectively, and all of their respective employees, agents, officers, directors, attorneys, divisions, departments, subdivisions, owners, trustees, creditors, joint venturers, co-venturers, vendors, nominees, representatives, managers, administrators, affiliates, subsidiaries, shareholders, predecessors, successors and/or assigns (as well as the officers, directors, members, shareholders, beneficiaries, and employees of the foregoing entities) (collectively, the "Released Defendant Parties"), of and from any and all allegations, any and all claims and rights, causes of action, suits, debts, dues, accounts, bonds, bills, covenants, agreements, controversies, promises, charges, complaints, counter-claims, cross-claims, demands for indemnity, damages, judgments, sums of money, interest, counsel fees, costs which they may have against the other, their assigns, predecessors, successors, affiliated entities, current or former insurers, brokers, producers, owners, partners, shareholders, officers, directors, managers, administrators, agents, servants, and employers, with reference to any and all claims that Plaintiff may have against any of the Defendants, whether known or unknown up to and including the date of execution of the Agreement by the Parties.

1.1.2 Plaintiff realizes that he may sustain unknown or unforeseen losses, costs, expenses, liabilities, claims, injuries, damages and consequences thereof which may be at this time unknown, unrecognized and not contemplated by him. By executing this Agreement, it is the full intent of the Parties that Plaintiff releases each of the Defendants of and from any and all liability for such unknown and/or unforeseen losses, costs, expenses, liabilities, claims, damages and consequences thereof, including those not known, recognized or contemplated. A portion of the consideration herein is for the release of such unknown or future claims or damages.

1.1.3 **Plaintiff's Counsel.** The foregoing provisions are agreed to by Plaintiff's counsel:

1.1.3.1 Plaintiffs' counsel warrants and agrees that the settlement hereunder, resolves all of their claims for attorney's fees related to the Claims, and that,
subject to the Ethical Rules in the Commonwealth of Virginia and Eastern District of Virginia, they each agree that they will not engage in solicitation of members of the putative class, or other persons against whom Williamson and Brown, LLC has filed proof of claims in the Eastern District of Virginia, provided however that nothing in this paragraph prevents Plaintiff’s counsel from representing any person, including members of the putative class of Similarly Situated Debtors and Other Debtor Objectors, with claims against the Defendants if requested to by such person. Plaintiff’s counsel affirmatively represent, other than clients who previously filed objections to proof of claims filed by Defendants, they are not aware of any other clients having claims against Defendants as of the date of execution of this Agreement. Plaintiff’s counsel agree that any protective order entered in this case shall remain in effect, and that all materials produced under such protective order shall be subject to such protections. Subject to the Court’s approval of this Agreement, Plaintiff’s counsel shall not engage in the representation of any members of the putative class for affirmative claims against Defendants premised upon a violation of Rule 3001 or the Fair Debt Collections Practices Act claims related to Defendants’ filing of a proof of claim by or on behalf of Williamson and Brown, LLC prior to the date of this agreement. Nothing herein precludes representation in connection with an objection to a proof of claim, provided that no recovery against Defendants is sought. For purposes of this paragraph, “affirmative claims” means claims seeking relief against Defendants, such as damages, punitive damages, or attorneys’ fees, but does not include challenging the validity of a proof of claim, without seeking damages, punitive damages, or attorneys’ fees.

1.1.3.2 Plaintiff’s counsel agrees that the settlement provided hereunder shall compensate Plaintiff’s counsel its reasonable attorney’s fees (as determined by the Court, unless the Parties mutually agree) for the filing of any objection to a proof of claim on or before February 25, 2019 for Similarly Situated Debtors or Other Debtor Objectors who were represented by one or more of Plaintiff’s counsels (“POC Objections” or singularly “POC Objection”). Plaintiff’s counsel agrees that, subject to the Defendant’s withdrawal of such proof of claim, no claim for attorney’s fees shall be made or advanced against their respective client, or against Defendants in connection with such POC Objection.

1.2 Defendants:

1.2.1 Effective upon the final payments required under paragraphs of this Agreement, respectively, and subject to the provisions of this Agreement, and without need for further documentation, Defendants covenant not to file any proof of claims against (i) Plaintiff; (ii) Similarly Situated Debtors; or (iii) Other Debtor Objectors. Plaintiff expressly recognizes that part of the claims in this lawsuit includes allegations that Defendants do not have the right to collect against them; therefore, nothing herein shall waive, release, or satisfy any right to collect against Plaintiff, Similarly Situated Debtors or Other Debtor Objectors, which is held by any third-party.

1.2.2 Defendants further warrant that it has not and will not sell to any third-party any information about (i) Plaintiff; (ii) Similarly Situated Debtors; or (iii) Other Debtor Objectors,
including but not limited to any information about the alleged debts for which Defendants filed proofs of claims against these people.

1.3 Bankruptcy Court Approval: This Agreement including the release provided hereunder is subject to the approval of the Court of the motion to approve settlement agreement, which shall be filed upon execution of this Agreement. Each Party agrees to join in and consent to the motion to approve the settlement, as provided under this Agreement. All of the parties' rights and obligations are contingent upon approval of this settlement, including approval and dismissal of all claims against Defendants with prejudice, with each Party to bear its own costs. Notwithstanding such dismissal, any Party shall be entitled to file a motion with the Court to enforce the terms of this Agreement.

1.4 Covenant Not to Sue: The Parties further covenant and agree not to commence, prosecute, cause, consent to, permit or advise to be commenced or prosecuted, any action or proceeding against any Party based on any the Claims, including any claims dealing in whole or in part from any act, omission to act, transaction, practice or conduct of any Party which arose, occurred, or failed to occur prior to the date of execution of this Agreement. Nothing herein shall preclude a Party from seeking to enforce this Agreement.

1.5 Withdrawal of Claims: Arcese and Williamson and Brown each acknowledge that it has or, within fourteen (14) days of execution of this Agreement, will withdraw all claims it has filed as of the date of this Agreement in the Eastern District of Virginia, including cases of Similarly Situated Debtors or Other Debtor Objectors, including Plaintiff's, that remain active in the Bankruptcy Courts for the Eastern District of Virginia and further covenant and agree not to re-file any such claims during the pendency of those bankruptcy cases. In the event, that such proof of claims are not withdrawn within 14 days, upon notice to Williamson and Brown, LLC, they shall promptly cause the withdrawal of such claim, or Williamson and Brown, LLC irrevocably consents to the withdrawal of such claim.

2. Payment.

2.1 Payments to be made by Defendants.

2.1.1 Defendants' Payment to Similarly Situated Debtors. On or before twenty-one (21) days after entry of an Order approving this agreement, Defendants shall place in the trust account of Beiranes Law Group, P.C., or such other person designated between the Parties to administer payments, an amount equal to Fourteen Thousand Dollars ($14,000.00), which shall be distributed pro-rata among all of the following persons: (i) Similarly Situated Debtors; and (ii) Other Debtor Objectors, for whom one or more proofs of claims were filed by Defendants in the Eastern District of Virginia. The number of Similarly Situated Debtors is expected to be 18, and the number of Other Debtor Objectors is expected to be 10. The anticipated payment to each Similarly Situated Debtor and/or Other Debtor Objectors is $500.00. For any check sent to a Similarly Situated Debtor and/or Other Debtor Objectors not cashed within 90 days of when such check is sent, the proceeds will be delivered as a donation to the Virginia Poverty Law Center, in Richmond, Virginia.
2.1.2 Defendants' Payment to Plaintiff. Defendants shall pay Three Thousand Dollars and No Cents ($3,000.00) to Plaintiff via check made payable to William Harris and delivered to his counsel on or before twenty-one (21) days after entry of an Order approving this agreement.

2.1.3 Attorneys' Fees. In satisfaction of Plaintiff’s claims against Williamson and Brown for costs and attorney's fees, Williamson and Brown agrees to pay Plaintiffs’ reasonable attorneys’ fees in an amount first to be negotiated between the parties, which if not successful will then be mediated before Judge Santoro, and if not agreed to, then to be decided by the Court. Plaintiff's release as to his claim for attorney's fees shall not be effective until the final payment toward such fees is made.

3. No Admission of Liability. It is understood and agreed that this Agreement was entered into voluntarily without any Party admitting liability to any claim, and for the purpose of avoiding the continuing time, resources and monies to prosecute and/or defend the pending litigation and post-judgment collection efforts of Releasee. This Agreement is not intended, and shall not constitute nor be construed as, an admission of liability by any Party or person.

4. Sole Owner of Released Claims. Except for the proofs of claims for the respective debtors, Releasor and Releasee's covenants, warrant and represent that each is the sole owner of the causes of action, claims, damages and rights which each is releasing, or which are purportedly released, pursuant to the provisions of this Settlement Agreement, and each has not assigned any of the causes of action, claims, damages or rights to any other person or entity and has not commenced any legal, governmental or administrative proceedings with respect to such causes of action, claims, damages, or rights.

5. Voluntary Agreement. Each Party acknowledges, warrants and agrees that they have fully and carefully read this Settlement Agreement, consulted with their legal counsel before entering into this Settlement Agreement, and executed this Agreement voluntarily and with full knowledge and understanding that they are releasing claims and rights against the other Parties and that this Agreement constitutes a binding, enforceable contract.

6. Severability of Provisions. If any provision of this Settlement Agreement is determined to be invalid or unenforceable, then the invalidity or unenforceability of that provision shall not affect the validity or enforceability of any other provision of this Settlement Agreement and all other provisions shall remain in full force and effect.

7. Entire Agreement. This Settlement Agreement constitutes the entire understanding of the Parties and supersedes any other oral or written understanding or agreement as to the matters contained herein. No person or Party is authorized to make any representations, warranties or promises except as set forth in writing in this Settlement Agreement and no statement, agreement, representation or promise by any person which is not contained in this Settlement Agreement shall be valid or binding. No modification of this Settlement Agreement shall be of any force or effect until in writing and executed by all the Parties. Except and only to the extent expressly set forth herein, there are no intended third-party beneficiaries of this agreement.
8. **Counterparts/Facsimile Copies.** To expedite the consummation of this Settlement Agreement, the Parties agree that this Settlement Agreement may be executed in two or more counterparts, each of which shall be deemed to be an original, all of which together shall constitute one and the same instrument. The Parties shall each furnish an original signed Settlement Agreement to the other. A facsimile copy of the signature page of this Settlement Agreement shall be acceptable to bind the Parties so long as the original signatures are promptly forwarded to legal counsel for the opposing Parties.

9. **Authority to Act.** Each signatory to this Agreement who executed it on behalf of a corporation or other legal entity warrants and represents that he or she has been directed by such corporation or entity to enter into this Agreement on its behalf and is fully authorized to enter into this Agreement on behalf of such corporation or entity and to otherwise bind such corporation or entity.

10. **Who is Bound.** All Parties are bound by this Release and Settlement Agreement as set forth in Section 1, above, anyone who succeeds to their rights and responsibilities, such as (but not limited to) respective parents, subsidiaries, divisions, affiliates and their respective officers, trustees, directors, insurers, agents, employees, attorneys, and successors. The release contained herein shall further inure to the benefit of each released party and their respective parents, subsidiaries, divisions, affiliates and their respective officers, trustees, directors, insurers, agents, employees, attorneys, and successors.

11. **Indemnification.** The Parties agree to indemnify and hold each other and/or each other’s respective present and former officers, directors, shareholders, employees, representatives, agents, executors, administrators, heirs, subsidiaries, assigns and successors in interest, harmless from and against any and all claims, including court costs and attorneys’ fees, from or in connection with any action or other proceeding brought, assisted, or prosecuted contrary to the provisions of this Settlement Agreement.

12. **Miscellaneous Provisions.**

12.1 It is the intention of the Parties in delivering and accepting the consideration provided for herein and in executing this Agreement that this instrument shall be effective as a full and final accord and satisfaction and release of each and every matter released herein.

12.2 Each Party has received independent legal advice from her/its attorneys with respect to this settlement and the advisability of executing this Agreement.

12.3 This Agreement shall be deemed to have been drafted jointly by the Parties. Any uncertainty or ambiguity shall not be construed for or against any Party based upon attribution of drafting to any Party.

12.4 This Agreement contains the entire agreement and understanding concerning the subject matter hereof and supersedes and replaces all prior negotiations, proposed agreements, and agreements, whether written or oral. The Parties acknowledge that no
one has made any promise, representation or warranty whatever, express or implied, not contained herein concerning the subject matter hereof to induce them to execute this Agreement. The Parties acknowledge and warrant that they are not executing this Agreement in reliance upon any promise, representation, or warranty not contained herein.

12.5 The failure of a Party to insist upon strict adherence to any term of this Agreement, or to object to any failure to comply with any provision of this Agreement, shall not be a waiver of that term or provision, shall not estop that Party from enforcing that term or provision, or shall not preclude that Party from enforcing that term or provision by estoppel or by laches. The receipt by a Party of any benefit from this Agreement shall not be deemed a waiver or estoppel of the right of that Party to enforce any section. None of the terms of this Agreement shall be deemed to be waived or modified, including all provisions of this section, except by an express agreement in writing signed by an authorized officer of the Party against whom enforcement of the waiver or modification is sought, supported by new consideration.

12.6 The Parties intend to enter into a valid, legal, and enforceable agreement, and each provision herein shall be interpreted in such a manner as to be valid, legal, and enforceable. A determination that any provision of this Agreement is for any reason invalid, illegal, or unenforceable shall not affect the validity of this Agreement and any other provisions herein, and this Agreement shall be interpreted and construed as if such invalid, illegal, or unenforceable provisions were not contained herein.

12.7 This Agreement shall be deemed to have been entered into in the Commonwealth of Virginia, and shall be interpreted and construed in accordance with the laws of the Commonwealth of Virginia without regard to conflict of laws principles or the conflict of laws principles of any other jurisdiction. Any dispute under this Agreement shall be decided in the local, federal or state courts located in the Commonwealth of Virginia and the Parties hereby consent to personal jurisdiction in said courts and service of process by mail and further hereby agree to waive any objection or defense arising out of the venue or forum selection. By executing this Agreement below, the signatories understand that they are entering into a binding and enforceable contract on the above date subject to the above terms and conditions.

12.8 In the event that any Party fails or refuses to comply with any of the provisions, terms or conditions of the agreement, or non-fulfillment of any representation or warranty in its sole discretion, all waivers and releases in this agreement are null and void.

13. Additional Promises Made by Defendants. In addition to the monetary consideration described in Section 2 and the non-monetary consideration described throughout this Agreement, Arosee and Williamson and Brown agree to entry of an Order that, in any filing in the Eastern District of Virginia, they shall comply with Federal Rule of Bankruptcy Procedure 3001(c), and further agree that:

13.1 For a period of (2) years from the date of this Agreement,
Williamson and Brown, LLC and Alexander Nial Arcese, individually and any entity either Defendant controls shall not file proof of claims in the Eastern District of Virginia against any individual based upon consumer debt; and that, thereafter, all filings of proof of claims against consumer debtors in the Eastern District of Virginia, shall comply with requirements of Rule 3001, and the Local Rules in effect at that time.

14. Signatures. IN WITNESS WHEREOF the Plaintiff and Defendants have duly affixed their signatures under hand and seal on this 9th day of April, 2019.

[Signature]
William Rozzell Harris

[Signature]
Alexander Nial Arcese

[Signature]
Williamson and Brown, LLC, by its authorized agent, Alexander Nial Arcese
UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF VIRGINIA
Richmond Division

In re: WILLIAM ROZZELL HARRIS, Debtor.

WILLIAM ROZZELL HARRIS, Plaintiff,
v. WILLIAMSON AND BROWN, LLC And ALEXANDER NIAL ARCESE, Defendants.

CLASS ACTION COMPLAINT

COMES NOW the Plaintiff, WILLIAM ROZZELL HARRIS, (“Plaintiff”), by counsel, and for the Complaint against the Defendants alleges as follows:

I. PRELIMINARY STATEMENT

1. This is an action for actual damages, statutory damages, costs, and attorney’s fees brought pursuant to the Fair Debt Collection Practices Act, 15 U.S.C. § 1692 (“FDCPA”), and for appropriate relief under Federal Rule of Bankruptcy Procedure 3001. Plaintiff brings this action individually and on behalf of all others similarly situated to recover damages and other appropriate relief by reason of the Defendants’ violations of the FDCPA and Federal Rule of Bankruptcy Procedure 3001.
Bankruptcy Procedure 3001. The violating actions addressed in this Complaint stem from Defendants’ attempts to collect debts by filing a proof of claim in Plaintiff’s Chapter 13 bankruptcy case that contained false statements, and its business practice of not providing the information required by Rule 3001.

II. JURISDICTION

2. This Court has jurisdiction pursuant to 28 U.S.C. §§ 151, 157(b), and 1334, 11 U.S.C. §§ 105 and 502, and Federal Rules of Bankruptcy Procedure 3001, 3007, and 7023 in that this action arises in and relates to the Chapter 13 bankruptcy case of Plaintiff.

3. This proceeding is a core proceeding under 28 U.S.C. §157(b)(2)(A), (B), (C), and (O). The claims in this case arise under 28 U.S.C. §§ 1331 and 1332, and 15 U.S.C. § 1692k(d). To the extent that the Court finds any of Plaintiff’s claims are non-core claims, Plaintiff consents to entry of final judgment on all claims presented in this matter by the Bankruptcy Court.

4. Venue is proper pursuant to 28 U.S.C. §§ 1391(b)(2) and 1409. A substantial portion of the events giving rise to Plaintiff’s claims occurred in this District, Plaintiff and other similarly situated debtors filed bankruptcy in this District, proofs of claims were filed by Defendants in this District, and Defendants transact business in this District.

III. PARTIES

5. Plaintiff is a natural person and an adult resident of this District. Plaintiff is a “consumer” as defined by 15 U.S.C. § 1692a(3).

6. Defendant Williamson and Brown, LLC (“Williamson”) is a foreign limited liability company that is filing claims in the United States Bankruptcy Court for the Eastern District of Virginia.
7. The principal purpose of Williamson’s business is collecting debts, including by filing claims in bankruptcy cases.

8. Williamson is a “debt collector” as defined by 15 U.S.C. § 1692a(6).

9. Defendant Alexander Nial Arcese (“Arcese”) is the President of Williamson, and his principal business is collecting debts, including by filing claims in bankruptcy cases.

10. Arcese is a “debt collector” as defined by 15 U.S.C. § 1692a(6).

IV. FACTUAL ALLEGATIONS

11. Plaintiff filed for relief under Chapter 13 of Title 11 U.S. Code in the Bankruptcy Court for the Eastern District of Virginia.

12. Plaintiff listed no debts to Williamson on his Schedules filed as part of the bankruptcy.

13. Somehow Williamson received notice of the Plaintiff’s bankruptcy filing.

14. Williamson, through Arcese, filed a Proof of Claim for $347.00 (“Claim 5-1”). (Proof of Claim 5-1, attached as Exhibit 1).


16. In Box 1 of the Proof of Claim, Williamson and Arcese described the current creditor as “Williamson and Brown LLC.”

17. In Box 2 of the Proof of Claim, Williamson and Arcese stated Williamson has not acquired the debt from anyone else.

18. In Box 7 of the Proof of Claim, Williamson and Arcese stated no interest or other charges were included in the $347.00.
19. In Box 8 of the Proof of Claim, Williamson and Arcese stated the basis of the claim as “Money Loaned.”

20. The Proof of Claim is electronically signed by Arcese and asserts under penalty of perjury that the information in the Proof of Claim has been examined and that he has a reasonable belief it is true.

21. Williamson never loaned any money to Plaintiff.

22. Williamson never loans money to any consumers in Virginia.

23. The Part 2 document is electronically signed by Arcese.

24. The Part 2 document was prepared by Arcese and Williamson and formatted to give the appearance of an account bill sent to Plaintiff in an attempt to collect a debt.

25. The Part 2 document was not previously sent to Plaintiff.

26. The Part 2 document states the debt is owed to “Allied Cash Advance Virginia LLC.”


28. The Part 2 document states that, if payment of $347.00 is made, then the client will be notified and the “account will be removed from all three major credit reports upon successful clearance of the funds.”

29. Both Allied Cash Advance Virginia LLC, who was a licensed payday lender, and Allied Title Lending LLC, who uses credit contracts that purport to be open-end credit, have done business in Virginia as “Allied Cash Advance”, and both used the same principal office at 7955 NW 12 Street, Suite 300, Doral, Florida, 33126.
30. Allied Cash Holdings LLC is a holding company that consists of many LLCs in several states, and includes companies that do business as “Allied Cash Advance” (“Allied”).

31. In the lawsuit Taylor v. Allied Title Lending LLC, Adv. Pro. No. 18-03003-KRH, counsel for Allied confirmed that Williamson is not Allied’s agent, and that Allied has not hired Williamson to file proofs of claim on its behalf or to collect these debts.

32. Furthermore, no debt to Allied is reported on Plaintiff’s credit.

33. Williamson did not have a reasonable belief that the information in the Proof of Claim was true.

34. Arcese did not have a reasonable belief that the information in the Proof of Claim was true.

35. No reasonable belief in the accuracy of the information could be true because the identity of the current creditor in Box 1 contradicts the identity of the creditor in the Part 2 document.

36. No reasonable belief in the accuracy of the information could be true because, contrary to the claim in Box 2, Williamson does not extend credit in Virginia and, thus, for any debt for money loaned in Virginia, Williamson would have had to acquire the debt from someone else.

37. No reasonable belief in the accuracy of the information could be true because, contrary to Box 7, if Allied had asked Williamson to collect on a debt for it, that debt would include interest, fees, expenses, or other charges.

38. Defendants knew when they filed the Proof of Claim that it contained false statements of material fact.
39. The Proof of Claim does not make clear whether the “Money Loaned” was allegedly for open-end credit or closed-end credit.

40. Whether based on open-end credit or closed-end credit, Claim 5-1 does not comply with Rule 3001(c).

41. For closed-end credit, Claim 5-1 fails to attach the writing on which the claim is based.

42. For open-end credit, Claim 5-1 does not include the required information about the date of last payment and the date the account was charged-off.

43. Williamson and Arcese were aware that the Proof of Claim failed to include the information required by Rule 3001(c) and intentionally filed it despite not complying with Rule 3001(c).

44. Whether for open-end credit or closed-end credit, Williamson and Arcese do not possess the information or documents to comply with Rule 3001(c).

45. Defendants knew or reasonably should have known when they filed the Proof of Claim that they did not possess sufficient information or documentation to comply with the requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure for filing a claim.

46. As part of that process and, whether open-end or closed-end credit, Williamson and Arcese knew Williamson needed ready access to a copy of the writing underlying the claim or knowledge of the circumstances of the loss or destruction of the writing.

47. As part of their normal process for filing claims throughout the Eastern District of Virginia, Defendants do not have ready access to a copy of—or knowledge of the circumstances of the loss or destruction of—the writing underlying the claim.
48. Plaintiff hereby formally requests that Defendants provide Plaintiff with a copy of the writing underlying the claim they have filed.

49. Plaintiff has been directly harmed by Defendants’ actions, has lost time, and has been inconvenienced by trying to determine what debt underlies the claim, whether it was open-end or closed-end, when it may have been obtained, and whether it is actually owed.

50. Until Defendants provide Plaintiff with a copy of the writing underlying the claim or information concerning the circumstances of the loss or destruction of the writing underlying the claim, Plaintiff cannot fully determine whether any part of the alleged claim is actually based on an unpaid debt for extension of credit that is not barred by the statute of limitations.

V. CLASS CERTIFICATION ALLEGATIONS

51. Pursuant to Rules 23(a), (b)(3), (b)(2) and (c)(4) of the Federal Rules of Civil Procedure, Plaintiff brings this class action on behalf of Plaintiff all others similarly situated. Specifically, Plaintiff seeks to represent the following persons (“the Class” or “Class Members”):

   All debtors in the Bankruptcy Court for the Eastern District of Virginia as to whom Williamson filed a proof of claim for a debt that was not scheduled as due Williamson, and where such proof of claim includes a reference to an “Allied Cash” entity as the creditor.

52. Members of the above-defined Class can be easily identified through Defendants’ records, and can also be identified through this Court’s records.

   A. Numerosity

53. The proposed Class is so numerous that individual joinder of all Members is impracticable.

54. The subject of this case involves hundreds of Class Members. While the identities of Class Members are unknown to Plaintiff at this time, such information can be readily
ascertained through appropriate investigation and discovery. The disposition of the claims of the Class Members in a single action will provide substantial benefit to all parties and to the Court.

B. Predominance of Common Questions of Law and Fact

55. Common questions of law and fact exist as to all Members of the Class and predominate over any questions affecting only individual Class Members. These common legal and factual questions include, but are not limited to, the following:

(a) Whether the proofs of claims are false;

(b) Whether the proofs of claims are fraudulent;

(c) Whether the proofs of claim violate Federal Rule of Bankruptcy Procedure 3001;

(d) Whether the Defendants violated the Fair Debt Collection Practices Act;

(e) Whether the Defendants engaged in unfair, deceptive, and unconscionable practices in connection with the proofs of claim;

(f) Whether, as a result of the Defendants’ illegal activities, Plaintiff and Class Members have suffered damages and, if so, the appropriate amount of such damages;

(g) Whether, when Defendants filed the Proof of claim, Defendants had ready access to the writing upon which the claim is based or knowledge concerning the circumstances of the loss or destruction of the writing;

(h) Whether, as a result of Defendants’ activities, Plaintiff and Class Members are entitled to declaratory and injunctive relief, or other relief, and, if so, the nature of such relief;

(i) Whether Defendants acted knowingly or willfully when they violated the law;

(j) What appropriate remedy should be issued by the Court.

56. Pursuant to Federal Rule of Civil Procedure 23(b)(2), as made applicable to this proceeding by Bankruptcy Rule of Civil Procedure 7023, the Defendants have acted or refused to
act on grounds generally applicable to the Class, thereby making final injunctive or corresponding declaratory relief appropriate with respect to the Class as a whole. In particular, the Defendants have sought to collect upon debts by systematically filing proofs of claim with false information within this District when they know their systemic process is not to comply with Rule 3001.

C. Typicality

57. Plaintiff’s claims are typical of the claims of the Members of the Class. Plaintiff shares the aforementioned facts and legal claims or questions with Class Members, and Plaintiff and all Class Members have been similarly affected by Defendants’ common course of conduct of filing false and fraudulent proofs of claim in this District.

D. Adequacy

58. Plaintiff will fairly and adequately represent and protect the interests of the Class. Plaintiff has retained counsel with substantial experience in handling bankruptcy matters as well as complex class action litigation, including complex questions that arise in this type of financial and consumer protection litigation.

59. Plaintiff and Plaintiff’s counsel are committed to the vigorous prosecution of this action. Plaintiff and Plaintiff’s counsel will fairly and adequately protect the interests of the members of the Class. Neither Plaintiff nor Plaintiff’s counsel have any interests which might cause them not to vigorously pursue this action.

E. Superiority

60. A class action is superior to other available methods for the fair and efficient adjudication of the present controversy for at least the following reasons:
(a) The claims presented in this case predominate over any questions of law or fact affecting individual Class Members;

(b) Individual joinder of all Class Members is impracticable;

(c) Absent a Class, Plaintiff and Class Members will continue to suffer harm as a result of Defendants’ unlawful conduct;

(d) Given the amount of individual Class Members’ claims, few, if any, Class Members could afford to, or would, seek legal redress for the wrongs Defendants committed against them, and absent Class Members have no substantial interest in individually controlling the prosecution of individual actions;

(e) Even if individual Class Members had the resources to pursue individual litigation, it would be unduly burdensome to the courts in which the individual litigation would proceed;

(f) Adjudications of individual Class Members’ claims against Defendants would, as a practical matter, be dispositive of the interests of other Class Members who are not parties to the adjudication and may substantially impair or impede the ability of other Class Members to protect their interests; and,

(g) This action presents no difficulty that would impede its management by the Court as a class action, which is the best available means by which Plaintiff and Class Members can seek redress for the harm caused by Defendant.

F. Injunctive and Declaratory Relief

61. Defendants knowingly filed proofs of claim that failed to comply with Bankruptcy Rule 3001, which resulted in uniform damage to Plaintiff and Class Members. As a result, Defendants have acted or refused to act on grounds generally applicable to each Class Member, thereby making appropriate final injunctive relief or corresponding declaratory relief
with respect to the Class as a whole. Plaintiff and Class Members will continue to be subject to Defendants’ conduct and have no adequate remedy at law to compel compliance with Bankruptcy Rule 3001 and to obtain the information to which they are entitled. Pursuant to 28 U.S.C. § 2201, there is an actual justiciable controversy which is not speculative, and injunctive relief and corresponding declaratory judgment in the nature of requiring compliance or disallowing the claims is the appropriate mechanism for resolving the dispute.

62. Because Plaintiff seeks injunctive and corresponding declaratory and equitable relief for the entire Class, the prosecution of separate actions by individual Class Members would create a risk of inconsistent or varying adjudications with respect to individual Class Members, which would establish incompatible standards of conduct for Defendant. Further, bringing individual claims would overburden the courts and would be an inefficient method of resolving the dispute at the center of this litigation.

VI. CLASS CLAIMS

COUNT I

63. Plaintiff realleges and incorporates all of the preceding paragraphs as if fully set out herein.

64. Defendants violated 15 U.S.C. § 1692e by using false, deceptive, and/or misleading representations or means in connection with collection of a debt, including but not limited to the false assertion about who was the creditor, that the claim was not acquired from someone else, that no interest or fees were included in the amount, and that Defendants had a reasonable belief in the accuracy of the information.

65. Defendants violated 15 U.S.C. § 1692f by using unfair and unconscionable means to collect a debt, including but not limited to a standard practice of filing Proofs of Claim without
complying with Federal Rule of Bankruptcy Procedure 3001(c)(2)(A), without intending to comply with Federal Rule of Bankruptcy Procedure 3001(c), by preparing an account bill that falsely makes it appear like it had been sent to a debtor, and not being ready to provide the writings underlying Proofs of Claim.

66. As a result of their violations of the FDCPA, Defendants are liable to Plaintiff and the putative Class Members for actual and statutory damages, plus costs and attorneys’ fees.

COUNT II
VIOLATIONS OF FEDERAL RULE OF BANKRUPTCY PROCEDURE 3001

67. Plaintiff realleges and incorporates all of the preceding paragraphs as if fully set out herein.

68. Defendants violated Federal Rule of Bankruptcy Procedure 3001(a) by failing to file a proof of claim that conformed substantially to the Official Form because it failed to accurately disclose the current creditor, how the claim was acquired, and the interest, fees, expenses, or charges were included in the claim amount.

69. Defendants violated Federal Rule of Bankruptcy Procedure 3001(c)(2) by failing to file with its proof of claim an itemized statement of the interest, fees, expenses, or charges that were included in the claim amount.

70. If the claim is for closed-end credit, Defendants violated Federal Rule of Bankruptcy Procedure 3001(c)(1), and if the claim is for open-end credit, Defendants violated Rule 3001(c)(3)(A) by not providing information required by subsections (i) through (v).

71. As a result of their violations of Federal Rule of Bankruptcy Procedure 3001, Defendants should to be subject to an appropriate remedy as determined by this Court including requiring them to pay Plaintiff’s and the putative Class Members’ costs and attorneys’ fees.
72. Regarding the attorneys’ fees, Plaintiff requests that fees be awarded under the lodestar method after submission to the Court of a written motion for such fees that includes declaration of counsel as to their hourly rates, and their time incurred in the case for the identification, investigation, and prosecution of the Rule 3001 claim, which will necessarily include the time which will be spent in the future responding to Defendants’ arguments and obtaining the appropriate remedy.

73. Without the information required by Rule 3001(c), Plaintiff and the Class Members suffer irreparable injury of not having the information to readily analyze the claims by Defendants; the remedies at law are inadequate because of the inequality of information. Based on the knowing violations of the Rules and considering the balance of hardships, an injunction remedy in favor of Plaintiff and the Class is required. Such an injunction will serve the public interest of putting all creditors on notice for how they must comply with Bankruptcy Rule 3001.

COUNT III
REQUEST FOR RELIEF
PURSUANT TO 11 U.S.C. § 105

74. Plaintiff realleges and incorporates all of the preceding paragraphs in this complaint.

75. Both Defendants knowingly filed or knowingly authorized the filing of a Proof of Claim that contains false statements, for an improper purpose, resulting in damage to Plaintiff and the Class. As a result, both Defendants have acted or refused to act on grounds which make final injunctive relief or corresponding declaratory relief appropriate. Pursuant to 28 U.S.C. § 2201, there is an actual justiciable controversy which is not speculative, and a declaratory judgment is the appropriate mechanism for resolving the dispute.
Pursuant to 11 U.S.C. § 105(a), “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

“[Section] 105 may be used to sanction the filing of a proof of claim violative of the Bankruptcy Code and abusive of the bankruptcy process, that is, as the federal criminal code aptly describes, a claim that is false or fraudulent.” In re Varona, 388 B.R. 705, 717 (Bankr. E.D.Va. 2008).

Pursuant to Federal Rule of Bankruptcy Procedure 3001(a)(2), “A proof of claim shall conform substantially to the appropriate Official Form.” That Official Form requires that claims be true and correct and filed under penalty of perjury.

By stating in the Proof of Claim that Williamson was the creditor and that the claim had not been obtained from anyone else, Defendants knowingly filed false statements.

By stating in the document attached to the Proof of Claim that Allied was Williamson’s client for whom it was collecting the debt, Defendants knowingly filed a Proof of Claim with false information.

If this claim is actually for an Allied debt, then by stating in the Proof of Claim that no interest or fees were included Defendants knowingly filed a Proof of Claim with false statements.

Defendants’ actions in filing the Proof of Claim were taken willfully in an effort to collect a debt it knew it did not have the documentation to support.

Defendants’ action is an abuse of the requirements of Rule 3001 and has the effect of hindering the efficient administration of Plaintiff’s bankruptcy estate.

Defendants’ actions are part of a systemic practice of filing claims in this Court that do not comply with Rule 3001 and that contain false information.
85. Defendants’ pattern of filing documents containing false claims throughout the Eastern District of Virginia is “violative of the Bankruptcy Code and abusive of the bankruptcy process” and is precisely the kind of misconduct against which Varona says the Court’s § 105 powers may properly be employed.

86. Therefore, Defendants should be sanctioned under 11 U.S.C. § 105(a).

VII. DEMAND FOR RELIEF

Plaintiff therefore requests on behalf of Plaintiff and the proposed Class, the following relief:

(i) An order certifying Class Members' FDCPA claims pursuant to Fed. R. Civ. P. 23(b)(3) and/or 23(b)(2), or certifying such issues as may be deemed appropriately treated on a class basis;

(ii) An order certifying Class Members' Federal Rule of Bankruptcy Procedure 3001 claims pursuant to Fed. R. Civ. P. 23(b)(2), or certifying such issues as may be deemed appropriately treated on a class basis;

(iii) An order certifying Class Members' 11 U.S.C. § 105(a) claims pursuant to Fed. R. Civ. P. 23(b)(2), or certifying such issues as may be deemed appropriately treated on a class basis;

(iv) An order appointing named Plaintiff as representative of the Class and appointing undersigned counsel as Class counsel;

(v) An award of actual and statutory damages, jointly and severally, as against Defendants under the FDCPA claims, in an amount to be proven at the time of trial;
(vi) A Declaration that, as to Plaintiff and all Class Members, Defendants violated
Federal Rule of Bankruptcy Procedure 3001(a) and 3001(c)(1), and an Order that
disallows each individual claim, or other appropriate relief as determined by the
Court for the violations of Federal Rule of Bankruptcy Procedure 3001;

(vii) An award of attorneys’ fees determined by the lodestar method;

(viii) An award of litigation costs; and

(ix) Such other declaratory or injunctive relief as the Court may deem fair and
equitable.

Respectfully submitted,

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By Counsel

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MEMORANDUM OPINION

The Court now faces round two of the dispositive motions to dismiss or dispose of this adversary proceeding. In round one, the defendants, Midland Funding, LLC and Midland Credit Management, Inc. (“Midland”), moved to dismiss the complaint under Rule 12(b)(6) for failure to
state an actionable claim. The Court denied the motion to dismiss Count I but granted the motion to
dismiss Count II with leave to amend the complaint. Now in round two, the plaintiffs, Karen
Thomas, Gary Brooks, and Mary Gillespie-Brooks, amended the complaint, and the defendants
move to dismiss the amended complaint under Rule 12(b)(6) or in the alternative compel
arbitration.

This case is about practices of filing proofs of claim in chapter 13 bankruptcy cases that
may violate the Fair Debt Collections Practices Act (“FDCPA”)¹ and may not comply with Federal
Rule of Bankruptcy Procedure 3001. The plaintiffs allege the defendants’ business practice
involves filing proofs of claim that the defendants reasonably know contain false statements and
do not comply with Rule 3001 such that the defendants are violating the FDCPA and should be
subject to Court ordered relief for noncompliance with Rule 3001.

JURISDICTION

Karen Thomas, Gary Brooks, and Mary Gillespie-Brooks are debtors in this Court. Midland is a
creditor in each of the bankruptcy cases. This Bankruptcy Court has jurisdiction over these
bankruptcy cases by virtue of 28 U.S.C. § 1334(a). The amended complaint, which is
subject to this motion to dismiss, concerns federal non-bankruptcy law (specifically, the FDCPA)
and Federal Rule of Bankruptcy Procedure 3001. The plaintiffs have consented to have this Court
issue a final ruling in this adversary proceeding. Am. Compl. ¶ 3. The defendants move to dismiss
the amended complaint for failure to state a claim upon which relief can be granted under Federal
Rule of Civil Procedure 12(b)(6), or in the alternative to compel arbitration and strike class
allegations; the defendants have neither challenged this Court’s jurisdiction nor moved to dismiss
the complaint for lack of jurisdiction under Federal Rule of Civil Procedure 12(b)(1) or (b)(2). See

Fed. R. Bankr. P. 7012(b) (incorporating Federal Rule of Civil Procedure 12(b)–(i) and providing that “[a] responsive pleading shall include a statement that the party does or does not consent to entry of final orders or judgment by the bankruptcy court.”). The Court will issue its ruling on the motions by consent.

**PROCEDURAL HISTORY**

The plaintiffs’ initial complaint described the proofs of claim that defendants filed in these chapter 13 cases and defendants’ actions before and after they filed their claims. The Court determined that the complaint sufficiently pleaded, in Count I, a cause of action under the FDCPA (specifically, 15 U.S.C. § 1692e and § 1692f). As to Count II, the Court found that the complaint sufficiently pleaded how the proofs of claim did not comply with Rule 3001 but concluded that the complaint was so unspecific as to the relief requested that it failed to state a cause of action. The Court granted leave to amend the complaint.

The plaintiffs amended the complaint. In the amended complaint, the plaintiffs recount how after they filed the initial complaint, the defendants amended the proofs of claim. Plaintiffs contend that the amended proofs of claim still fail to adequately comply with Rule 3001. Plaintiffs assert that defendants’ practice of first filing claims that violate Rule 3001 and contain false statements, coupled with a practice of not providing complete documentation in response to written requests made by a debtor, and only after service of an adversarial complaint related to the practice, filing amended, yet still deficient, proofs of claim demonstrates conduct which violates the FDCPA.

Defendants naturally disagree. Defendants reiterate that the plaintiffs have failed to state an actionable claim under the FDCPA and insist that the misstatements in the original proofs of claim are simply not material misstatements or material misrepresentations and do not create any
plausible risk of injury. Defendants point out that all the same they amended the proofs of claim. They purport that the amended proofs of claim attach appropriate documentation and argue that the amended proofs of claim comply with Rule 3001 and do not violate the FDCPA.

**ANALYSIS**

**A. Motion to dismiss**

A motion under Rule 12(b)(6) looks into the legal sufficiency of a complaint. *RTC Mortg. Tr. v. McMahon*, 225 B.R. 604, 607 (E.D. Va. 1997). The merits of the claims or the defenses are not relevant. The relevant question is whether the plaintiffs pleaded a claim that is more than conceivable and indeed plausible. *See Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007).

The parties agree that the amended complaint, like the original complaint, sufficiently meets two of the three necessary elements\(^2\) of a FDCPA action: that the plaintiffs are “consumers” as defined by 15 U.S.C. § 1692a(3) and that Midland is a “debt collector” as defined by 15 U.S.C. § 1692a(6). The third element requires a plaintiff to plead the act or omission by which a defendant has violated the FDCPA. As in the previous motion to dismiss, the third element remains in dispute. The defendants move to dismiss the amended complaint alleging that the facts described in the amended complaint fail to show an actual violation of the FDCPA, fail to show that any alleged violation was material, and fail to show a plausible risk of injury from any alleged violation. More to the point, defendants refer to the amended facts and allegations in Count I that describe their amended proofs of claim. Midland argues these new allegations in the complaint

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\(^2\) A plaintiff must plead three elements to state a claim that a defendant has violated the FDCPA. The first two elements address identity: (1) the plaintiff must be a “consumer,” and (2) the defendant collecting the debt must be a “debt collector” as defined by the FDCPA. *Creighton v. Emporia Credit Serv., Inc.*, 981 F. Supp. 411, 414 (E.D. Va. 1997). The third element requires the plaintiff to plead the act or omission by which the defendant has violated the FDCPA. *Id.* When the plaintiff has sufficiently pleaded facts to support these three elements, he or she has made a prima facie case for a violation of the FDCPA.
provide a basis for the Court to dismiss Count I of the amended complaint notwithstanding the
Court’s earlier ruling denying the motion to dismiss Count I.

1. *The amended complaint*

Just as in the original complaint, the plaintiffs are debtors in pending chapter 13 bankruptcy
cases, and Midland is one of their creditors. Midland filed proofs of claim in each of the
bankruptcy cases. Midland did not itemize interest, fees, or costs when it originally filed its proofs
of claim. Midland has since filed amended proofs of claim with some itemization. The entire
dispute centers around Midland’s business practice associated with filing proofs of claim in
bankruptcy cases.

The amended complaint alleges, in addition to what has already been described in this
Court’s previous ruling: (1) the plaintiffs made formal written requests to defendants for the
writings on which the proofs of claim were based; (2) plaintiffs served defendants with the original
complaint on July 10, 2017; (3) four days later, on July 14, 2017, defendants filed amended proofs
of claim in the two cases of the named plaintiffs; (4) defendants have not amended other proofs of
claim that fail to disclose or itemize interest, in other bankruptcy cases in this district; (5) the
amended proofs of claim combine fees and interest together as “finance charges”; (6) defendants
informed plaintiffs that future proofs of claim will combine fees and interest as finance charges
and will separate the amount characterized as finance charges from principal; and (7) the amended
proofs of claim attach documentation but not the contract between the debtor and Synchrony Bank.
Further, the amended complaint alleges (8) the documentation attached to the amended proofs of
claim is insufficient because it fails to provide the contract between the debtor and Synchrony
Bank and so deprives the debtor from information such as the contract rate of interest and
applicable choice of state law; (9) the documentation fails to include the Purchase Agreement
between Synchrony Bank and Midland and so deprives the debtor of information confirming the extent of Synchrony Bank’s ownership in the receivable sold to Midland; (10) the documentation attached to the amended proofs of claim includes a document purporting to be an account statement but it is not an account statement; and (11) “the debtor cannot determine from the documentation provided the amount of finance charges attributable to interest and the amount attributable to fees and other charges.” The amended complaint notes that the documentation attached to the proofs of claim includes information created by Midland that “shows some of the account information that Synchrony Bank regularly makes available to Defendants, including the exact breakdown of the fees and interest charged on the account in that calendar year,” but all the same does not set apart the interest separate from the fees on the claim breakdown statement attached to the proofs of claim. The amended complaint stresses that the proofs of claim fail to attach the agreement between the debtor and Synchrony Bank and alleges that the defendants’ practice is to withhold this contract in response to a written request.

The Court has already ruled that Count I of the original complaint meets the pleading standard for a cause of action under FDCPA to defeat a Rule 12(b)(6) motion. Critical to the Court’s ruling was that the facts alleged demonstrated a practice of consciously making false statements on the proofs of claim and ignoring the requirements of Rule 3001. For example, the original complaint alleged Midland filed proofs of claim in amounts greater than the plaintiffs admitted they owed, Midland deprived the plaintiffs of accurate information about whether the proofs of claim included interest and fees, Midland falsely answered on the proofs of claim that no interest or fees were included in the claim amount, Midland had a reasonable belief that the information about the amount of principal on the proofs of claim was incorrect, and Midland knew its practice of incorrectly reporting interest as principal violated the Federal Rules of Bankruptcy
Procedure. This Court noted in its previous ruling that Rule 3001 requires a proof of claim to disclose the amount of interest and fees and that this information could inform the plaintiffs along with other parties in interest whether a legal challenge is appropriate. The Court concluded that the allegations in the complaint described material misrepresentations in connection with the collection of a debt which may create a plausible risk of injury and may constitute an unfair or unconscionable means to collect a debt. Putting it all together, the Court determined the plaintiffs sufficiently pleaded a cause of action under the FDPCA regarding the original proofs of claim filed in these chapter 13 cases.

2. The amended proofs of claim

Now the amended complaint notes Midland amended its proofs of claim. The complaint states the amended proofs of claim attach a statement with a breakdown of the claim into principal amount and “finance charges.” The complaint describes how the amended proofs of claim include language on the face of the attached claim breakdown statement declaring in all capital letters: “THE FINANCE CHARGES REFLECTED ABOVE MAY INCLUDE INTEREST, FEES, OR OTHER CHARGES TO THE ACCOUNT PRIOR TO ACQUISITION BY MIDLAND.” The complaint acknowledges the amended proofs of claim also attach other documents, including a document that discloses interest separate from fees as of a date sometime in the months leading up to the bankruptcy. Because the document discloses Synchrony Bank’s prior breakdown of interest and fees, the plaintiffs allege that had Synchrony Bank filed the claim (instead of Midland who apparently bought the receivable from Synchrony), it could have itemized the interest and fees instead of combining them as “finance charges.” The plaintiffs allege that it is not clear on the amended proofs of claim how to distinguish the interest from the fees, and, without the contract
between Synchrony Bank and the debtor, how to know the appropriate state law to apply or interest rate to verify if the interest and fees are appropriate.

At this stage, the Court must consider whether the amended proofs of claim make a difference. The plaintiffs correctly note that the original proofs of claim did not comply with Rule 3001 and the allegations that Midland’s practice of routinely filing claims knowing the claims were defective, coupled with the refusal to provide appropriate information in response to a written request, stated a claim under FDCPA. The plaintiffs are correct that amending the claims after the complaint does not erase or moot the fact that the original complaint sufficiently pleaded a violation. But the plaintiffs are also alleging that the practice of filing these amended proofs of claim is part of the FDCPA violations, that the amended proofs of claim do not comply with Rule 3001, and that the amended proofs of claim coupled with the failure to provide the contract also violate the FDCPA. If the plaintiffs have not alleged facts that show plausible actions given the new facts, the complaint may not meet the standard to defeat a Rule 12(b)(6) motion.

Like the exercise in round one, this Court now must determine if: (1) the amended proofs of claim contain misrepresentations which are material and lead to a plausible risk of harm; (2) the practices alleged in the amended complaint show unfair or unconscionable means to collect a debt; (3) the amended proofs of claim fail to comply with Rule 3001; and (4) if the answers to these questions are “no,” whether the plaintiffs have nonetheless pleaded a plausible cause of action.

a. Do the amended proofs of claim contain misrepresentations?

Unlike the original proofs of claim, the amended proofs of claim correctly answer “yes” to the question “does this amount include interest or other charges?” Unlike the original proofs of claim, the amended proofs of claim attach an exhibit labeled “account summary” and describe a “claim breakdown” followed by an itemization that separates the claimed amount among
“principal,” “finance charges,” and “adjustment.” Directly beneath the itemization appears the following disclaimer in all capitalized letters: “THE FINANCE CHARGES REFLECTED ABOVE MAY INCLUDE INTEREST, FEES, OR OTHER CHARGES TO THE ACCOUNT PRIOR TO ACQUISITION BY MIDLAND.” The amended complaint includes all of these facts.

The amended complaint alleges the defendants use the label “finance charges” for amounts that combine interest with charges and that these combined amounts “are not considered ‘Finance Charges’ by the federal Truth in Lending Act (“TILA”).” The amended complaint alleges the amount on the exhibit attached to the proof of claim statement under the term “finance charges” combines interest and fees. Yet this same exhibit (the claim breakdown statement attached to the proof of claim) discloses, as the complaint admits, that the amount shown for finance charges is likely a lumping of interest, fees, and costs. Midland is telling the reader, in clear language, that the figure underneath the label “finance charges” combines interest and fees. It is hard to see how Midland’s statement confessing that it has combined interest, fees, and costs under a single label “finance charges” is a false statement or misrepresentation.3

b. Are the amended proofs of claim misleading?

The complaint implies that the label of finance charges is inappropriate per TILA and is misleading. The amended proofs of claim include a disclaimer informing the reader that the claim breakdown lumps interest and fees directly under the term “Finance Charges.” Clear and simple language informs the reader that the amounts listed under the term finance charges may include amounts of interest, fees, and costs combined. That the amounts under the term finance charges does include a combination of interest, fees, and costs is a true statement. For this reason, and in

3 Although the amended complaint alleged the label “finance charges” for a figure which combines interest with fees or costs is “not considered finance charges” under the TILA, the amended complaint did not show how this fact or observation renders an actionable violation of the FDCPA or Rule 3001 in this case.
particular because of the disclaimer, the term finance charges on the attachment to amended proofs of claim does not mislead. The facts as alleged do not illustrate that the statement (acknowledging lumping) is false, or a misrepresentation, or misleading. Furthermore the facts as alleged show that the proofs of claim as amended do not contain a false statement. Consequently, the amended complaint does not state an actionable claim under section 1692e as to the amended proofs of claim. The motion to dismiss is granted in part as to the section 1692e counts related to the amended proofs of claim but again denied as to the portions of the complaint addressing the practice of filing the original proofs of claim knowing they contain false statements and knowing that they violate Rule 3001.

c. Does the amended complaint show unfair or unconscionable means to collect a debt?

The amended complaint alleges “Defendants violated 15 U.S.C. § 1692f by using unfair and unconscionable means to collect a debt, including but not limited to a standard practice of filing Proofs of Claim without complying with Federal Rule of Bankruptcy Procedure 3001(c)(2)(A) and without having the ability to comply with Federal Rule of Bankruptcy Procedure 3001(c)(3)(B).” The plaintiffs largely tie the violation under section 1692f to a practice of routine and intentional violations of Bankruptcy Rule 3001. This means that if the plaintiffs have not pleaded facts showing a violation under Rule 3001, it is not clear that the complaint has stated a claim under section 1692f.

So, a critical question at the center of this motion to dismiss is what “an itemized statement of the interest, fees, expenses, or charges” means as that phrase is used in Rule 3001. One reason why this is critical is that the proof of claim form directs the claimant to first answer (yes or no) whether the amount claimed includes interest or other charges, and if the answer is yes, to “attach
a statement itemizing interest, fees, expenses, or other charges required by Bankruptcy Rule 3001(c)(2)(A).”

The defendants contend the amended proofs of claim adequately comply with the requirement contained in Rule 3001 to itemize the interest and fees but the plaintiffs contend they do not. Further the plaintiffs contend that even if the amended proofs of claim remedy the false statements contained in the original proofs of claim, regardless, the business practice described in the amended complaint sufficiently supports an actionable claim under the FDCPA. The defendants in turn counter that if the Court finds that the amended complaint sufficiently states an action under the FDCPA, the Court must submit the action to arbitration.

This Court found that in the original complaint, the plaintiffs pleaded facts describing a business practice of reporting on proofs of claim filed in chapter 13 bankruptcy cases principal amounts of credit card debt exceeding the debt amounts the plaintiffs admit, then withholding from the plaintiffs information to explain how the amounts in the claim were derived, despite rules requiring its disclosure. The plaintiffs pleaded a potential injury: how they were deprived information to evaluate whether to object to the claim which seeks to collect amounts greater than the plaintiffs admit they owe as of the date they filed bankruptcy.

The Court noted in its previous ruling that “Rule 3001 requires substantive information: the amount of interest and fees must be disclosed. The information may inform the debtor, trustee, or other creditors if a legal challenge is appropriate. . . . Because Rule 3001 requires a proof of claim to disclose details regarding interest and fees, and this information could inform the plaintiff along with other parties in interest whether a legal challenge is appropriate, the complaint has alleged actions which demonstrate a plausible risk of harm and as such may prove material and

In the amended complaint, however, the pleaded facts describe that the amended proofs of claim answer correctly that the amount claimed includes interest and other charges. In addition, the amended proofs of claim attach a statement containing an itemization with interest and fees combined as “finance charges” plus a statement created by defendants which mirrors a customer credit card statement along with a copy of an actual, somewhat outdated, credit card statement for the account. Both of the credit card statement documents disclose fees separate from interest charges. The risk of injury is that the plaintiffs cannot determine whether they have a valid legal objection to the claim because Midland has withheld information showing the contractual interest rate and applicable state law governing the contract. The complaint alleges Midland is required to provide this information in response to a written request pursuant to Rule 3001, and the complaint further alleges that Midland neither has provided nor intends to provide the documentation. The complaint states “failure to comply with Rule 3001” is an unfair or unconscionable means of collecting a debt.

Plaintiffs allege that the amended claims do not adequately break down interest and fees on the attached statement in noncompliance with Rule 3001. Plaintiffs allege that not providing the contract in response to a written request pursuant to Rule 3001(c)(3)(B) prevents the plaintiffs from determining whether the amounts claimed for interest or other charges are authorized by the contract or applicable law. In this way, the practice of filing claims in noncompliance with Rule 3001, even if the claims do not contain a false statement, violate the FDCPA section 1692f as an unfair or unconscionable means of collecting a debt. Plaintiffs’ cause of action, it seems, gets down to whether the defendants comply or do not comply with Rule 3001. Count I alleges a
business practice of deliberate noncompliance with Rule 3001 as a basis for an unfair means to collect a debt. After that, Count II alleges the violation of Rule 3001 and prays for relief under that rule.

On a motion to dismiss for failure to state a claim, the Court does not rule on the underlying merits but only on whether the amended complaint states a claim at all. The amended complaint alleges a business practice of filing proofs of claim that knowingly contain false statements regarding whether the amount claimed includes interest, fees, or other charges, then withholding from debtors the credit card agreement when a written request is made pursuant to Bankruptcy Rule 3001, then amending the proofs of claim only when an adversary proceeding is filed against the defendants, but amending the claims in a manner that is inappropriate and defies Rule 3001. Accepting these facts as true, the amended complaint shows that the debtors had to file a lawsuit in a bankruptcy court before the defendants would amend the proofs of claim and also shows that the debtors, trustee, and other parties in interest are deprived from reviewing the contract in order to evaluate whether the proofs of claim (filed in amounts greater than the debtor admits owing) are incorrect (and accordingly merit objection). In this way, the amended complaint illustrates a plausible risk of injury from the conduct. Without ruling on the merits, the Court determines the amended complaint pleads a cause of action under section 1692f.

d. Does Count II of the amended complaint state a cause of action for relief under Bankruptcy Rule 3001?

The amended complaint alleges Midland’s business practice causes Midland to file proofs of claim which fail to comply with Bankruptcy Rule 3001. In particular, the amended complaint describes that despite the language of Bankruptcy Rule 3001, Midland (1) files proofs of claim that falsely answer “no” to the question whether the amount claimed includes interest, fees, or other charges; (2) fails to provide the credit card contract in response to a written request for the
writing upon which the claim is based; and (3) files amended proofs of claim that answer "yes" to the question whether the claimed amount includes interest, fees, or other charges yet fail to attach a statement itemizing the interest, fees, and other charges. The amended complaint requests that the Court, among other relief, (1) order Midland to pay the attorney’s fees based on an hourly rate for the time spent in each of the cases for services related to the review and prosecution of the Rule 3001 action, (2) direct Midland to amend the proofs of claim in a manner that complies with Bankruptcy Rule 3001, and (3) require Midland to provide the written credit card agreement in response to a written request.

As a matter of fact, Bankruptcy Rule 3001(c)(2)(A) provides that “[i]f . . . a claim includes interest, fees, expenses, or other charges incurred before the petition was filed, an itemized statement of the interest, fees, expenses, or charges shall be filed with the proof of claim.” Fed. R. Bankr. P. 3001(c)(2)(A). Additionally, Rule 3001(c)(1) requires the claimant to file a copy of the writing with the proof of claim “[e]xcept for a claim governed by paragraph (3),” which governs the claims at issue in the complaint. Rule 3001(c)(3)(B) requires that “[o]n written request by a party in interest, the holder of a claim based on an open-end or revolving consumer credit agreement shall, within 30 days after the request is sent, provide the requesting party a copy of the writing specified in paragraph (1) of this subdivision.” Fed. R. Bankr. P. 3001(c)(3)(B). When reviewing the amended complaint, and taking the facts as true, the Court finds that the assertions in the amended complaint line up neatly with the language of the Rule. The amended complaint pretty clearly alleges a violation of Rule 3001.

If a creditor fails to comply with Rule 3001(c)(2), the Rule allows for sanctions for failure to comply. After notice and a hearing, the Rule permits the Court to take one or both of two explicit actions. First, the Court may “preclude the holder from presenting the omitted
information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless.”  *Id.* at 3001(c)(2)(D)(i). Second, the Court may “award other appropriate relief, including reasonable expenses and attorney’s fees caused by the failure.”  *Id.* at 3001(c)(2)(D)(ii). The committee notes to this Rule express that “[t]he court retains discretion to allow an amendment to a proof of claim under appropriate circumstances or to impose a sanction different from or in addition to the preclusion of the introduction of evidence.”  Fed. R. Bankr. P. 3001(c) advisory committee’s note to 2011 amendment.  Rule 3001(c)(2)(D) does not expressly limit who may request relief.

Unlike the original complaint that pleaded nonspecific “appropriate relief” for the consequences of violating Rule 3001, the amended complaint provides for specific relief. The specific relief requested in the amended complaint does not include damages for failure to comply but rather sanctions in the form of attorney’s fees related to the Rule 3001 action. Indeed the Rule explicitly authorizes the Court to “award other appropriate relief, including reasonable expenses and attorney’s fees caused by the failure.”  For the Court to hold that a debtor has no right to the relief specifically provided in Rule 3001 would require the Court to ignore the language in the Rule or insert terms not present. Regardless, at this stage, the issue before the Court is not the merits of the action and whether to award the relief requested but merely whether the amended complaint sufficiently pleads a claim under Rule 3001. For all of the foregoing reasons, the amended complaint sufficiently pleads a claim under Bankruptcy Rule 3001.

The Court denies the motion to dismiss Count I as to the violation of FDCPA section 1692f and denies the motion to dismiss Count II.

**B. Motion to compel arbitration**
Midland asks, if this Court does not dismiss the complaint pursuant to Rule 12(b)(6), to compel arbitration of the FDCPA and Rule 3001 claims. According to Midland, the credit card contract agreements between Synchrony Bank and these debtors contain mandatory arbitration provisions.

Midland contends that it bought accounts, including those of the debtor plaintiffs in this action, from Synchrony Bank as part of a portfolio of charged off debts. Midland filed with the Court a redacted copy of its purchase agreement with Synchrony Bank. What Midland filed is a “Receivables Purchase Agreement” to sell “delinquent credit card account receivables.” ECF Doc. No. 40. Within this purchase agreement, the parties define “Account” as a “credit account owned by Seller with respect to which there is a Receivable.” The purchase agreement defines “Receivable” as “any credit agreement receivable that is being sold to Buyer pursuant to the terms of this Agreement, as such receivable exists as of the Cut-Off Date, to the extent such receivable is set forth on the Notification File.” The particular credit agreement receivables are identified in the notification file and described in the exhibits to the Receivables Purchase Agreement. The exhibits to the Receivables Purchase Agreement clarify the specifications for the credit agreement receivables sold to Midland. As shown in Exhibit G to the Receivables Purchase Agreement, the credit agreement receivables sold are the ones that are for borrowers who have filed chapter 13 bankruptcy within a certain time period of the Receivables Purchase Agreement, for which no proof of claim has been filed and for which the bar date has not passed, plus other specifications about the credit account receivables set out in Exhibit G. The Receivables Purchase Agreement and exhibits contain certain restrictions on the buyer (see e.g., ECF Doc. No. 40 at 10–11, 39), but otherwise sells the credit agreement receivables to Midland. The bill of sale attached to the Receivables Purchase Agreement provides “in further consideration of the mutual covenants and
conditions set forth in the [REDACTED] Receivables Purchase Agreement . . . Seller hereby transfers, sells, conveys, grants and delivers to Buyers . . . to the extent of its ownership, the Receivables.” It is through this agreement and the bill of sale that Midland apparently came to own the credit agreement receivable for each of the plaintiffs.

Midland points to language in the credit card agreement between the debtors and Synchrony Bank that provides for arbitration of disputes, other than Synchrony Bank’s collection action. The language in the credit card agreement also provides for a waiver of class action participation. For these reasons, Midland moves this Court to strike the class allegations in the amended complaint, dismiss or stay further proceedings, and compel plaintiffs to assert their claims through arbitration. Midland also notes, as an alternative, that to the extent ultimate adjudication of Count II would have an impact on the plaintiffs’ bankruptcy estates or if arbitration of Count II might pose a potential conflict with the Bankruptcy Code, the Court could retain jurisdiction of the claims of Count II but still compel arbitration in order to allow the arbitrator to determine the other claims but return to the Bankruptcy Court to apply the bankruptcy law to the arbitrator’s factual findings.

This adversary proceeding would not exist had the plaintiffs not filed bankruptcy. Apparently because the plaintiffs filed chapter 13 bankruptcy cases when they did, their credit account receivables were sold to Midland. And then Midland filed the proofs of claim, which are now the subject of this controversy. Ultimately, the plaintiffs assert that Midland buys credit account receivables of chapter 13 debtors but then does not or cannot comply with Bankruptcy Rule 3001 when it files its proofs of claim in the bankruptcy cases. Even if these facts constitute an unfair or unconscionable means of collecting a debt, or a violation of bankruptcy rules for which
the bankruptcy rules provide a remedy, the central question is whether Midland has or has not complied with Bankruptcy Rule 3001. This is a bankruptcy matter.

It appears Midland is asking this Court to stay the proceedings and require the plaintiffs to individually pursue arbitration in order for the arbitrator to find whether Midland has or has not complied with Rule 3001. All other essential facts are uncontested. To the extent Midland requests an arbitrator hear and determine whether Midland complied with Rule 3001, the Court finds that it would be inappropriate to compel arbitration of this bankruptcy question. “If Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent ‘will be deducible from [the statute’s] text or legislative history,’ or from an inherent conflict between arbitration and the statute’s underlying purposes.” *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 227 (1987) (quoting *Mitsubishi Motors Corp. v Soler Chrysler–Plymouth, Inc.*, 473 U.S. 614, 628 (1985)). In 2005, applying the inherent conflict analysis, the Fourth Circuit agreed with the Second Circuit concluding that “[i]n the bankruptcy setting, congressional intent to permit a bankruptcy court to enjoin arbitration is sufficiently clear to override even international arbitration agreements.” *Phillips v. Congelton, LLC (In re White Mtn. Mining Co.)*, 403 F.3d 164, 168 (4th Cir. 2005) (quoting *In re U.S. Lines, Inc.*, 197 F.3d 631, 639 (2d Cir. 1999)).

Patently, Federal Rule of Bankruptcy Procedure 3001 is a rule of procedure employed by this Court. More specifically, Rule 3001 establishes the basic standards of filing a proof of claim. The Rule sets out the form and content of the proof of claim to be filed with the Bankruptcy Court, who may file the proof of claim with the Bankruptcy Court, what supporting information must be provided to the Bankruptcy Court and parties in interest with the proof of claim, and what evidentiary effect the Bankruptcy Court must give the proof of claim if in compliance with the Rule.
In 2011, Rule 3001 was amended to add Rule 3001(c)(2) “to require additional information to accompany proofs of claim filed in cases in which the debtor is an individual. When the holder of a claim seeks to recover—in addition to the principal amount of a debt—interest, fees, expenses, or other charges, the proof of claim must be accompanied by a statement itemizing these additional amounts with sufficient specificity to make clear the basis for the claimed amount.” Fed. R. Bankr. P. 3001(c) advisory committee’s note to 2011 amendment. Rule 3001(c)(2) is the subsection which the plaintiffs allege the defendants have violated.

Included in the 2011 amendment was Rule 3001(c)(2)(D), which “sets forth sanctions that the court may impose on a creditor in an individual debtor case that fails to provide information required by subdivision (c).” Id. (emphasis added). As noted above, after notice and a hearing, Rule 3001(c)(2)(D) permits the Court to take one or both of two explicit actions. First, the Court may “preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless.” Id. at 3001(c)(2)(D)(i). Second, the Court may “award other appropriate relief, including reasonable expenses and attorney’s fees caused by the failure.” Id. at 3001(c)(2)(D)(ii).

These sanctions, however, are permissive and not mandatory. *In re Goeller*, Case No. 12-17123-RGM, 2013 WL 3064594, at *2 (Bankr. E.D. Va. June 19, 2013). The Court therefore may exercise its discretion in determining whether to impose the sanctions provided for by the Rule. The discretionary nature of the imposition of such sanctions comports with the reality that the relief exists solely by force of a rule of procedure. The Federal Rules of Bankruptcy Procedure are designed and maintained to aid in the just and efficient resolution of matters pending before the Court. *Cf.* Fed. R. Civ. P. 1 (mandating that the Federal Rules of Civil Procedure “should be
construed, administered, and employed by the court and the parties to secure the just, speedy, and inexpensive determination of every action and proceeding”). Although the Rules of Procedure may permit sanctions or other penalties as a part of enforcement, the Rules of Procedure do not allow for a private cause of action for damages from violating a rule of procedure (in other words, as noted by Midland, there is no private cause of action to seek damages for a violation of Rule 3001). Instead Rule 3001 gives the Court authority to patrol the parties before it to achieve the efficient, speedy, and just resolution of adversarial and contested matters.

Consequently, it is nonsensical for the Court to order parties to submit to an arbitrator the task of applying and enforcing a procedural apparatus applicable only before this Court. The question of whether an alleged violation of Rule 3001 occurred, and if so whether any relief is appropriate, is not a question of fact or law for arbitration.

The Court will not compel the parties to submit procedural mechanisms to arbitration in this case. For these reasons, the Court denies the motion to compel arbitration as to the Rule 3001 relief under Count II. This leaves the question as to whether the Court should direct the parties to submit to arbitration the FDCPA claims under Count I. The FDCPA claims boil down to a determination of whether Midland has complied with the procedural rules governing bankruptcy proceedings. Again, but for the filing of this bankruptcy case, the Federal Rules of Bankruptcy Procedure would not be triggered and an action claimed thereunder would not exist. For the same reasons as to Count II, the Court finds it appropriate to retain jurisdiction and determine whether the defendants violated procedural rules before deciding whether it is appropriate to submit the FDCPA implications of such alleged violation to arbitration.
Accordingly, having found that there is an inherent conflict between arbitration and the Bankruptcy Code as to the matters pending in this adversary proceeding, the Court denies Midland’s motion to compel arbitration in its entirety.

The Court will contemporaneously issue an Order consistent with the findings and ruling of this Memorandum Decision.
Debtor David Anthony Darby (the “Debtor”) filed a class action complaint\(^1\) (the “Complaint”) on behalf of himself and a putative class of other debtors\(^2\) against Defendant Portfolio Recovery Associates, LLC (“PRA”). PRA has moved, pursuant to Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure,\(^3\) that the Complaint be dismissed with prejudice (the “Motion to Dismiss” or “Motion”). The Complaint consists of three counts. In Count I, the Debtor alleges violations of the Fair Debt Collection Practices Act, 15 U.S.C. § 1692 et seq. (1996) (the “FDCPA”).

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\(^1\) The Debtor seeks to represent all debtors in this District “as to whom PRA filed a proof of claim for a credit card debt purchased from Capital One that was not scheduled as due to PRA, and where such proof of claim stated that no interest or fees were in the claim amount.” Complaint, Dkt. 1, ¶ 54.

\(^2\) If necessary, the issue of class certification will be addressed at another time.

\(^3\) Made applicable to this proceeding pursuant to Rule 7012 of the Federal Rules of Bankruptcy Procedure, Fed. R. Bankr. P. 7012.
Act ("FDCPA"), specifically 15 U.S.C. §§ 1692e and 1692f. In Count II, the Debtor seeks disallowance of PRA’s claims, an award of attorney’s fees, and other relief for PRA’s alleged violations of Rule 3001 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”). In Count III, the Debtor requests that the Court impose sanctions under § 105 of the Bankruptcy Code for PRA’s alleged Rule 3001 violations.

PRA asserts that the Complaint’s allegations, if true, would result in only a procedural violation of Rule 3001 and that the remedies contained in Rule 3001 are the sole and exclusive remedies available for that alleged violation. Accordingly, PRA contends that Count I should be dismissed for failure to state a claim under the FDCPA upon which relief may be granted and for lack of subject matter jurisdiction, Count II should be dismissed because a violation of Rule 3001 does not create an independent cause of action, and Count III should be dismissed due to the “lack of plausible allegations of sanctionable conduct by PRA.”

Factual Allegations

When considering a motion to dismiss under Rule 12, the Court must assume that the facts alleged are true and take those facts in the light most favorable to the plaintiff. Francis v. Giacomelli, 588 F.3d 186, 192 (4th Cir.

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5 All subsequent references to the Bankruptcy Code are to 11 U.S.C. §§ 101-1532.
6 Motion to Dismiss, Dkt. 7, ¶ 15.
The following are the facts as alleged in the Complaint.

The Debtor filed for relief under chapter 13 of the Bankruptcy Code on August 31, 2017. On his schedules, the Debtor did not list any debts to PRA and listed a $679.00 debt to Capital One. PRA, a foreign limited liability company whose business is collecting debts, including filing claims in bankruptcy cases, filed a proof of claim in the Debtor’s case in the amount of $788.53 (“Claim 13-1”) based on a credit card debt it had purchased from Capital One Bank (USA), N.A. (“Capital One”).

In Box 7 of Claim 13-1, PRA stated that no interest or other charges were included in its $788.53 claim. An account summary attached as part of Claim 13-1 stated that the last payment date was July 5, 2017, and the charge off date was September 30, 2017. The Debtor’s credit card account with Capital One included interest on unpaid balances and fees for late payments.

“A motion filed under Rule 12(b)(6) challenges the legal sufficiency of a complaint, considered with the assumption that the facts alleged are true.” Francis v. Giacomelli, 588 F.3d 186, 192 (4th Cir. 2009) (citations omitted).

Because only the legal sufficiency of the complaint, and not the facts in support of it, are tested under a Rule 12(b)(6) motion, we assume the truth of all facts alleged in the complaint and the existence of any fact that can be proved, consistent with the complaint’s allegations. While we must take the facts in the light most favorable to the plaintiff, we need not accept the legal conclusions drawn from the facts. Similarly, we need not accept as true unwarranted inferences, unreasonable conclusions, or arguments.

PRA knows that credit card accounts normally include interest on unpaid balances and fees for late payments. Capital One’s standard monthly late fee exceeds $30 and, with almost sixty days between the disclosed date of the last payment and the date of Debtor’s bankruptcy filing, PRA should have known that at least one late payment would have been assessed to Debtor’s Capital One account prior to his bankruptcy filing. Because PRA knew or should have known that Claim 13-1’s balance of $788.53 included some amount of either interest or fees or both, PRA had no reasonable belief in the truthfulness of its statement in Claim 13-1 that no interest or fees were included in the claim amount.

PRA’s normal business practice in this District has been to file proofs of claim for defaulted open-end credit and assert that no interest or fees are included in the claim amount. This is based on PRA’s position that because it did not add any interest or fees to a claim after it purchased the claim, then no interest or fees comprise a portion of the claim. PRA has continued this practice despite a ruling in this Court in 2016 that such a practice may violate Rule 3001.

When PRA purchases defaulted credit card accounts, it regularly obtains, or is able to obtain, information about the amount of interest and fees included in the claim amount. As an open-end creditor, Capital One can itemize for PRA the amount of any interest included in Claim 13-1 and the separate amount of included fees. As a debt buyer purchasing credit card
accounts that it intends to recover in bankruptcy, PRA should acquire such information and documents as necessary to enable it to comply with Rule 3001.

On April 10, 2018, the Debtor filed an objection to Claim 13-1 that included a request for the documents supporting the claim. PRA did not provide the documents requested and never intended to provide them. These documents would show the amount of interest and fees included in the claim and whether Capital One assessed any interest or fees between the bankruptcy filing date and the charge-off date.

PRA engages in a business practice that prevents interested parties from obtaining documents necessary to determine the amount of interest and fees included in its claims. PRA knows that providing these documents would reveal that it regularly files proofs of claim falsely stating that no interest or fees are included in the claims, and PRA has no intention of providing such documents when requested to do so. This is an intentional effort by PRA to receive payments through the bankruptcy system without complying with the requirements of Rule 3001.

PRA’s filing proofs of claim knowing that it will not provide documents underlying the claims is an intentional effort to prevent parties from determining whether the claims include interest or fees added after the bankruptcy filing. PRA knew when it filed Claim 13-1 that it contained false statements of fact. The Debtor was damaged as a result of PRA’s filing a
proof of claim that failed to comply with Rule 3001, having suffered the “irreparable injury of not having the information to readily analyze” PRA’s claims.

In addition to the facts outlined above, the Debtor advances the legal conclusion that the Debtor is a “consumer” as defined by 15 U.S.C. § 1692a(3) of the FDCPA and that PRA is a “debt collector” as defined by 15 U.S.C. § 1692a(6). The validity of these assertions is not currently at issue, as PRA has not disputed them.

**Jurisdiction and Venue**

The Court has jurisdiction over the Debtor’s bankruptcy case and this adversary proceeding pursuant to 28 U.S.C. §§ 157 and 1334 and the General Order of Reference from the United States District Court for the Eastern District of Virginia dated August 15, 1984. This adversary proceeding involves non-core matters as well as core proceedings under 28 U.S.C. § 157(b)(2)(A), (B), (C) and (O). The Debtor has consented to the entry of final judgment by the Bankruptcy Court. PRA has not challenged the Court’s jurisdiction except with respect to Count I, which contains claims under the FDCPA as to which PRA has moved for dismissal under both Rule 12(b)(1) (lack of subject matter jurisdiction) and 12(b)(6) (failure to state a claim upon which relief can be granted). Venue is appropriate in this Court pursuant to 28 U.S.C. §§ 1408 and 1409.
Analysis

A motion under Rule 12(b)(6) challenges the legal sufficiency of a complaint and requires the plaintiff to allege a plausible claim for relief that is “more than an unadorned, the-defendant-unlawfully-harmed-me accusation.” *Ashcroft v Iqbal*, 556 U.S. 662, 678 (2009); see also *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). A complaint should be dismissed only when “no relief could be granted under any set of facts that could be proved consistent with the allegations.” *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984).

Count I-Violations of the FDCPA

The Debtor asserts in Count I that PRA violated § 1692e of the FDCPA “by using false, deceptive, and/or misleading representations or means in connection with collection of a debt, including but not limited to the false assertion that no interest or fees were included in the amount, and that [PRA] had a reasonable belief in the accuracy of the information.”9 The Debtor further asserts that PRA violated § 1692f of the FDCPA “by using unfair and unconscionable means to collect a debt, including but not limited to a standard practice of filing Proofs of Claim without intending to comply with Federal Rule of Bankruptcy Procedure 3001(c) and by not providing the writings underlying its Proofs of Claim.”10

9 Complaint, Dkt. 1, ¶ 67.
10 *Id.* at ¶ 68.
PRA counters that Count I’s allegations constitute, at best, only a procedural violation of Rule 3001, the exclusive remedies for which are those set forth in Rule 3001(c)(2)(D). It argues that the “intended audience” of Claim 13-1 would not find it false, deceptive or misleading and further contends that the facts, as alleged, do not amount to a “material” violation of the FDCPA. PRA also claims that the Debtor lacks constitutional standing to assert the FDCPA claims because the Complaint fails to allege any harm to the Debtor or his estate.

In examining an alleged violation of the FDCPA committed in connection with the filing of a proof of claim in a bankruptcy case, a reasonable starting point is the Supreme Court’s opinion in *Midland Funding, LLC v. Johnson*, 137 S. Ct. 1407 (2017). There, the Court held that the filing of an obviously time-barred proof of claim is not a false, deceptive, misleading, unfair, or unconscionable practice within the meaning of the FDCPA. This decision was based primarily on two separate but related rationales – the Court’s analysis of the broad definition of “claim” under the Bankruptcy Code and its recognition of the differences between the purposes and structural features of the Bankruptcy Code and the FDCPA.

In *Midland*, the Supreme Court found that the filing of a proof of claim that on its face indicated that the limitations period had expired met the Bankruptcy Code’s definition of the term “claim” and was not false, deceptive, or misleading. Recognizing that § 101(5)(A) of Bankruptcy Code defines
“claim” as a “right to payment,” the Court declared that even an unenforceable claim “is nonetheless a ‘right to payment,’ hence a ‘claim,’ as the Code uses those terms.” *Id.* at 1412.12

The debtor in *Midland* cited various provisions contained in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure in support of her position that “claim” means an “enforceable claim,” but the Supreme Court found that the cited provisions “do not discuss the scope of the term ‘claim.’ Rather, they restate the Bankruptcy Code’s system for determining whether a claim will be allowed.” *Id.* The Court pointed out that under §§ 502 and 558 of the Bankruptcy Code, the debtor was entitled to object to allowance of the claim based upon the expiration of the limitations period, noting that “[t]he law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense, and there is nothing misleading or deceptive in the filing of a proof of claim that, in effect, follows the Code’s similar system.” *Id.*

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12 The Court noted its prior statement in *Johnson v. Home State Bank*, 501 U.S. 78, 83 (1991) that “Congress intended … to adopt the broadest available definition of ‘claim.’”
13 In particular, the debtor cited Bankruptcy Code § 502(a)’s provision that a claim will be allowed absent objection and Bankruptcy Rule 3001(f)’s provision that a properly filed claim is prima facie evidence of the amount and validity of that claim.
Claim 13-1, similar to the claim at issue in *Midland*, is a “claim” under the bankruptcy system that, unless objected to, would be allowed.\(^{14}\) The Debtor has filed an objection to Claim 13-1,\(^ {15}\) and the Court may ultimately disallow it,\(^ {16}\) but, in keeping with the Supreme Court’s analysis in *Midland*, it is nevertheless a “right to payment” and, thus, a “claim.”\(^ {17}\) The filing of

\(^{14}\) 11 U.S.C. § 502(a) (“A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects.”). *See also* Fed. R. Bankr. P. 3001(f) (“A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.”). \(^ {15}\) *See* 17-34385-KLP, Dkt. 28; 18-03097-KLP, Dkt. 1, Ex. C. \(^ {16}\) In chapter 7 and chapter 13 bankruptcy cases, an individual is appointed to serve as the trustee. 11 U.S.C. § 1302(a). One of the responsibilities of the trustee is to examine proofs of claim and, when appropriate, file an objection. 11 U.S.C. §§ 704(a)(5), 1302(b)(1). The trustee, if not the debtor, is aware that a creditor’s right to payment may be subject to disallowance. *See* 11 U.S.C. § 502(b)(1)-(9) (A claim may be disallowed if, for example, it “is unenforceable against the debtor . . . under any agreement or applicable law . . . or “is for unmatured interest.” § 502(b)(1) and (3).) If an objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim . . . as of the date of the petition.” 11 U.S.C. § 502(b). \(^ {17}\) *See also* Travelers Cas. & Surety Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 445 (2007) (“[W]e generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed.”). While the Complaint alleges that PRA’s proof of claim stated that the claim includes no interest or other charges when it knew or should have known that the claim includes some amount of either interest or fees or both, it does not allege that Claim 13-1 would not be enforceable under state law.

Also, the Court notes that, as pointed out by PRA, some courts have found that at the time a debt is purchased, the entire amount due becomes principal to the purchaser. *See, e.g.*, Gissendaner v. Credit Corp Sols., Inc., No. 18- CV-06313-EAW, 2019 WL 609559 (W.D.N.Y. Feb. 13, 2019) (“At the time Plaintiff’s debt was charged off and acquired by Defendant, all past interest charged to his credit card account by [the previous owner] had become the principal balance to be paid to Defendant as his debt collector.”). This does not lead the Court to reconsider the ruling in *Maddux*, but it does support PRA’s argument that its claim would be enforceable under state law.

The Fourth Circuit’s recent decision in *SummitBridge Nat’l Invs. III, LLC v. Faison*, 915 F.3d 288 (4th Cir. 2019), strengthens the proposition that a “claim” includes post-petition costs, if bargained for in the pre-petition contract. The court held that unsecured claims for post-petition attorneys’ fees based on valid pre-petition contracts, if allowed under state law, fall within the scope of § 101(5)(A)’s
Claim 13-1 subjects it to the Bankruptcy Code’s system for determining whether it will be allowed, but its mere filing does not violate the provisions of the FDCPA.

The second rationale applied by the Supreme Court in *Midland* – that the different purposes and structural features of the Bankruptcy Code and the FDCPA would be maintained and properly served if an improper claim filed in a bankruptcy case, as well as the creditor’s related misconduct, were to be remedied solely under the Bankruptcy Code – also applies here. The alleged impropriety of which the Debtor complains is that in order to impede debtors from discovering the amount of interest and fees included in the claim, PRA willfully failed to comply with Bankruptcy Rule 3001 when it purposefully did not attach, or provide upon request, the writings underlying Claim 13-1. These alleged improprieties are confined to PRA’s failure to abide by the requirements of Rule 3001, which are unique to bankruptcy. The bankruptcy system, through the Bankruptcy Code and the Bankruptcy Rules, specifically establishes the consequences for these violations.

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18 The Debtor alleges in Count I of the Complaint that PRA engaged in “an intentional effort to receive payments through the bankruptcy system without ever intending to comply with the requirements of Rule 3001” by “filing Proofs of Claim containing false statements about the interest and fees embedded in the claim.” Dkt. 1, ¶¶ 49, 50. The substance of Count I is essentially that PRA intentionally failed to comply with the procedural requirements of Bankruptcy Rule 3001, Fed. R. Bankr. P. 3001.
Nonetheless, the Debtor seeks to have the alleged violation of Rule 3001 serve as the basis for liability under the FDCPA.

In *Midland*, when comparing the relative goals of the bankruptcy system and the FDCPA, the Supreme Court responded to the debtor’s contention that the “assertion of an obviously time-barred claim is ‘unfair’ or ‘unconscionable’” under the FDCPA by pointing out that “the context of a civil suit differs significantly from the present context, that of a Chapter 13 bankruptcy proceeding,” in which “[t]he consumer initiates [the] proceeding,” “is not likely to pay a stale claim,” “[a] knowledgeable trustee is available” and “[p]rocedural bankruptcy rules more directly guide the evaluation of claims.” *Id.* at 1413. Addressing the debtor’s contention that Midland’s buying stale claims cheaply and filing them in bankruptcy while hoping that careless trustees won’t object to them is “sanctionable,” the Court declined to find a violation of the FDCPA, stating that it was “not persuaded by these arguments,” and declaring that “the protections available in a Chapter 13 bankruptcy proceeding minimize the risk to the debtor.” *Id.* at 1414.

The logical conclusion is that the Supreme Court has determined that when a creditor’s alleged misconduct involves the filing of a proof of claim in a bankruptcy case for a debt that would be enforceable under state law, the Bankruptcy Code and Rules provide the exclusive means for addressing the allowance of the claim and the creditor’s misconduct. This comprehensive and structured system is uniquely designed to maintain the “delicate balance of a
debtor’s protections and obligations.” *Id.* at 1415 (quoting *Kokoszka v. Belford*, 417 U.S. 642, 651 (1974)).¹⁹ For that reason, the FDCPA’s protections are inapplicable.

The Supreme Court’s ruling in *Midland* resolved a split among the circuit courts over the applicability of the FDCPA to the claims process in bankruptcy, tacitly approving previous Ninth Circuit²⁰ and Second Circuit²¹

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¹⁹ The improper acts attributed to PRA by the Debtor sufficiently parallel the creditor’s actions in *Midland* and, thus, compel a similar analysis. [W]e do not find in either the Fair Debt Collection Practices Act or the Bankruptcy Code good reason to believe that Congress intended an ordinary civil court applying the Act to determine answers to these bankruptcy-related questions. The Act and the Code have different purposes and structural features. The Act seeks to help consumers, not necessarily by closing what Johnson and the United States characterize as a loophole in the Bankruptcy Code, but by preventing consumer bankruptcies in the first place. See, e.g., 15 U.S.C. § 1692(a) (recognizing the “abundant evidence of the use of abusive, deceptive, and unfair debt collection practices [which] contribute to the number of personal bankruptcies”); see also § 1692(b) (“Existing laws and procedures ... are inadequate to protect consumers”); § 1692(e) (statute seeks to “eliminate abusive debt collection practices”). The Bankruptcy Code, by way of contrast, creates and maintains what we have called the “delicate balance of a debtor’s protections and obligations.” To find the Fair Debt Collection Practices Act applicable here would upset that “delicate balance.” From a substantive perspective it would authorize a new significant bankruptcy-related remedy in the absence of language in the Code providing for it. *Midland Funding, LLC v. Johnson*, 137 S. Ct. 1407, 1414–15 (2017) (internal citation omitted). As the Court will discuss infra, the remedies for PRA’s alleged improprieties are embedded in the Bankruptcy Code and the Bankruptcy Rules. See infra, Part II.

²⁰ *Walls v. Wells Fargo Bank, N.A.*, 276 F.3d 502, 510 (9th Cir. 2002) (“While the FDCPA’s purpose is to avoid bankruptcy, if bankruptcy nevertheless occurs, the debtor’s protection and remedy remain under the Bankruptcy Code.”).

²¹ *Simmons v. Roundup Funding, LLC*, 622 F.3d 93 (2d Cir. 2010). The court further noted that “[s]ome courts have ruled more broadly that no FDCPA action can be based on an act that violates any provision of the Bankruptcy Code, because such violations are dealt with exclusively by the Bankruptcy Code. See, e.g., *Walls v. Wells Fargo Bank, N.A.*, 276 F.3d 502, 510 (9th Cir.2002); *Diamante v. Solomon & Solomon, P.C.*, 1:99–CV–1339, 2001 WL 1217226, at *6, 2001 U.S. Dist. LEXIS...
precedent that limited the reach of the FDCPA. In *Simmons v. Roundup Funding, LLC*, the Second Circuit had held that “[t]he FDCPA is designed to protect defenseless debtors and to give them remedies against abuse by creditors. There is no need to protect debtors who are already under the protection of the bankruptcy court, and there is no need to supplement the remedies afforded by bankruptcy itself.” *Simmons v. Roundup Funding, LLC*, 622 F.3d 93, 96 (2d Cir. 2010). In *Walls v. Wells Fargo Bank, N.A.*, 276 F.3d 502, 510 (9th Cir. 2002), the Ninth Circuit had held that “[w]hile the FDCPA's purpose is to avoid bankruptcy, if bankruptcy nevertheless occurs, the debtor's protection and remedy remain under the Bankruptcy Code.”

The same rationale applies here.

The Fourth Circuit in *Dubois v. Atlas Acquisitions LLC (In re Dubois)*, 834 F.3d 522 (4th Cir. 2016), while stopping short of holding that the

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14818, at *18 (N.D.N.Y. Sept. 18, 2001); *Kibler v. WFS Fin.*, CV–00–5217, 2000 WL 1470655, at *10, 2000 U.S. Dist. LEXIS 19131, at *33 (C.D. Cal. Sept. 12, 2000). This broader rule has not been universally accepted, see *Randolph v. IMBS, Inc.*, 368 F.3d 726, 732–33 (7th Cir.2004), and we are not compelled to consider it in this case.” Id. at 96 n.2

22 *See also Nelson v. Midland Credit Mgmt., Inc.*, 828 F.3d 749, 752 (8th Cir. 2016) (“This court rejects extending the FDCPA to time-barred proofs of claim.”); *Owens v. LVNV Funding, LLC*, 832 F.3d 726 (7th Cir. 2016). *See also In re Varona*, 388 B.R. 705, 720 (Bankr. E.D. Va. 2008) (“The FDCPA guards against collection practices waged directly against a potentially unknowledgeable consumer. In the bankruptcy process, frequently, as here, debtors are represented by knowing counsel with the system of court scrutiny available to review claims and protect the rights of parties, including the debtor. As such, and as a number of courts have concluded in finding the FDCPA inapplicable to bankruptcy claims, there is no compulsion to invoke the principles of the FDCPA in the instant matter.”); *B-Real, LLC v. Rogers*, 405 B.R. 428, 431 (M.D. La. 2009) (“It is difficult for this court to understand how a procedure outlined by the Bankruptcy Code could possibly form the basis of a violation under the FDCPA.”).
Bankruptcy Code precludes an action under the FDCPA, held that the FDCPA had not been violated by a creditor who had filed a proof of claim on a time-barred debt. The Fourth Circuit in *Dubois* relied upon the broad definition of “claim” in the Bankruptcy Code as well as the adequacy of the provisions and procedures employed in bankruptcy in order to reject the FDCPA claim. *Id.* at 528-32. Subsequently, the Supreme Court in *Midland* employed the same analysis. Thus, rejection of the FDCPA claim under the facts alleged here is consistent with both Supreme Court and Fourth Circuit precedent.

Neither the Supreme Court nor the Fourth Circuit Court of Appeals has held that FDCPA actions may never be brought in the context of a bankruptcy, and this Court does not so hold. However, the Supreme Court’s decision in *Midland* leads this Court to find that the Complaint, which involves issues related to the filing of a proof of claim in order to collect payment of a debt that may be enforceable under state law, fails to state a cause of action under the FDCPA. The Bankruptcy Code and Rules provide

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23 “We do not reach [the creditor’s] argument that the Bankruptcy Code precludes the FDCPA . . . .” *Dubois v. Atlas Acquisitions LLC (In re Dubois)*, 834 F.3d 522, 533 n.11 (4th Cir. 2016).
24 The Supreme Court in Midland cited *Dubois* as one of the “majority” of circuit courts that had determined that the FDCPA had not been violated. 137 S. Ct. at 1411.
25 The court in *Dubois* held that filing a proof of claim is debt collection activity regulated by the FDCPA. 834 F.3d at 528. The Supreme Court did not expressly so hold in *Midland*.
26 In light of the Court’s decision to dismiss Count I, it need not determine the validity of PRA’s argument that the false misrepresentations alleged in the Complaint do not amount to a “material” violation of the FDCPA. Although
the appropriate and exclusive means to determine whether Claim 13-1
should be allowed and to address PRA’s alleged intentional violations of Rule
3001(c). Therefore, the Court will grant PRA’s Motion to Dismiss Count I of
the Complaint.27

Count II-Violations of Bankruptcy Rule 3001

Count II of the Complaint incorporates the same facts underlying
Count I but specifically seeks relief for PRA’s violations of the requirements
of Bankruptcy Rule 3001.28 First, the Debtor alleges that Claim 13-1 violates

mischaracterizing interest as principal may, in some circumstances, not be material
in the context of litigation between a debt collector and a consumer who is not in
bankruptcy (see e.g., Hahn v. Triumph P’ships LLC, 557 F.3d 755 (7th Cir. 2009)),
such mischaracterization in a bankruptcy case could have other more serious
ramifications. See Thomas v. Midland Funding, LLC (In re Thomas), 578 B.R. 355,
360-62 (Bankr. W.D. Va. 2017) (denying motion to dismiss FDCPA claim). This
Court shares the concerns expressed in Thomas but differs as to whether the
available remedies extend beyond those provided under the Bankruptcy Code and
Rules when the misrepresentations are limited to Rule 3001 violations such as those
alleged in this case.

27 Because the Court has determined that Count I should be dismissed pursuant to
Rule 12(b)(6) for failure to state a claim under the FDCPA, it need not address
PRA’s Rule 12(b)(1) contention that Count I should be dismissed because the Debtor
lacks constitutional standing to assert the FDCPA claims.

28 Bankruptcy Rule 3001 provides, in pertinent part:

(a) Form and Content. A proof of claim is a written statement setting forth
a creditor's claim. A proof of claim shall conform substantially to the
appropriate Official Form.

(c) Supporting Information.

(1) Claim based on a writing
Except for a claim governed by paragraph (3) of this subdivision, when a
claim, or an interest in property of the debtor securing the claim, is based
on a writing, a copy of the writing shall be filed with the proof of claim. If
the writing has been lost or destroyed, a statement of the circumstances
of the loss or destruction shall be filed with the claim.

(2) Additional requirements in an individual debtor case: sanctions for
failure to comply. In a case in which the debtor is an individual:
(A) If, in addition to its principal amount, a claim includes interest, fees, expenses, or other charges incurred before the petition was filed, an itemized statement of the interest, fees, expenses, or charges shall be filed with the proof of claim.

(D) If the holder of a claim fails to provide any information required by this subdivision (c), the court may, after notice and hearing, take either or both of the following actions:

(i) preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or

(ii) award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure.

(3) Claim based on an open-end or revolving consumer credit agreement

(A) When a claim is based on an open-end or revolving consumer credit agreement--except one for which a security interest is claimed in the debtor's real property--a statement shall be filed with the proof of claim, including all of the following information that applies to the account:

(i) the name of the entity from whom the creditor purchased the account;

(ii) the name of the entity to whom the debt was owed at the time of an account holder's last transaction on the account;

(iii) the date of an account holder's last transaction;

(iv) the date of the last payment on the account; and

(v) the date on which the account was charged to profit and loss.

(B) On written request by a party in interest, the holder of a claim based on an open-end or revolving consumer credit agreement shall, within 30 days after the request is sent, provide the requesting party a copy of the writing specified in paragraph (1) of this subdivision.

(d) Evidence of Perfection of Security Interest. If a security interest in property of the debtor is claimed, the proof of claim shall be accompanied by evidence that the security interest has been perfected.

(e) Transferred Claim.

(1) Transfer of Claim Other Than for Security Before Proof Filed. If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.

(2) Transfer of Claim Other Than for Security After Proof Filed. If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has
Rule 3001(a) because it does not conform substantially to the Official Form. 29 Next, the Debtor alleges a violation of Rule 3001(c)(2) resulting from PRA’s failure to include an itemization of the interest, fees, expenses or charges. Finally, the Debtor alleges that PRA’s intent to not provide upon request, along with its failure to provide, the writing underlying its proof of claim violates Rule 3001(c)(3)(B). For these violations, the Debtor seeks “an appropriate remedy as determined by the Court,” including attorneys’ fees.

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been filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 21 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.

. . .

(5) Service of Objection or Motion; Notice of Hearing. A copy of an objection filed pursuant to paragraph (2) or (4) or a motion filed pursuant to paragraph (3) or (4) of this subdivision together with a notice of a hearing shall be mailed or otherwise delivered to the transferor or transferee, whichever is appropriate, at least 30 days prior to the hearing.

(f) Evidentiary effect. A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.


29 It is apparent from Claim 13-1, which is attached to the Complaint as Exhibit A, that the Debtor is referring to Official Form 10, Proof of Claim, of the Official and Director’s Bankruptcy Forms as the form to which PRA’s claim must conform. This form has been revised and renumbered as Official Form B410. See Maddux v. Midland Credit Mgmt., Inc., 567 B.R. 489, 501 n.10 (Bankr. E.D. Va. 2016). The Debtor contends that Claim 13-1 does not so conform because it does not disclose the interest, fees, and expenses included in the claim.
In Count II, the Debtor also states that an “injunction remedy . . . is required.”

This Court has recently reviewed the requirements of Rule 3001(c)(2)(A) and the implications of a creditor’s failure to follow them. In *Maddux v. Midland Credit Management, Inc.*, 567 B.R. 489 (Bankr. E.D. Va. 2016), Midland had purchased a pool of charged-off credit card accounts from Synchrony Bank. Midland, as assignee of Synchrony, filed proofs of claim for the outstanding balances but did not check the box on Official Form 10 to indicate that interest and other charges were included in the claim. Itemized statements attached to the claims indicated $0.00 for interest, fees and costs. No supporting documentation was attached to the claims. After the debtors filed objections, Midland amended the claims by attaching supporting documentation but continued to assert that the amounts claimed did not include interest, fees or other costs.

In response to the amended claims, the debtors argued that the supporting documentation showed that the claims included an interest component and that Midland’s own internal documents belied its representation that the claims included no interest or fees. Therefore, the Debtors argued that the claims violated Rule 3001(c)(2)(A). Midland

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30 The Complaint’s Demand for Relief includes a request for “[s]uch other declaratory or injunctive relief as the Court may deem fair and equitable.” Dkt. 1, p. 16. Although Count II states that “[s]uch an injunction will serve the public interest of putting all creditors on notice as to how they must comply with Bankruptcy Rule 3001” (Dkt. 1, ¶ 76), it is unclear what acts of PRA the Debtor would have the Court enjoin.
maintained that because the interest and fees had been capitalized as new principal, it was not obligated to check the box stating that interest and fees were included. Judge Huennekens rejected Midland’s argument, finding that the plain language of Rule 3001(c)(2)(A) requires an itemized statement of interest and fees if the claim includes such charges, there being no exception for interest that may have been capitalized by the claimholder.31 Midland’s assertion that the claims included no interest was incorrect; thus, the amended claims violated Rule 3001(c)(2)(A).

After conducting a trial, the Court held that Midland had proven the validity and amount of its claims32 but then considered whether Midland’s claims should be disallowed for failing to comply with Rule 3001(c)(2)(A). The debtors argued that Midland had willfully filed false claims and that the Court should disallow the claims under 11 U.S.C. § 105. The Court disagreed, finding that Midland did not willfully file false claims and was forthcoming with information in response to the debtor’s objections. The Court thus confined its choice of remedies to those set forth in Rule 3001(c)(2)(D).

31 PRA has pointed out that some bankruptcy courts allow accrued interest to be included as principal for purposes of Rule 3001(c)(2)(A), although it brings this up in support of its motion to dismiss Count I and not for the purpose of asking the Court to reconsider Maddux. See, e.g., In re Osborne, No. 03-25176, 2005 WL 6425053, at *5 (Bankr. D. Kan. April 25, 2005). To avoid any doubt, the Court wholly ratifies the Maddux decision.

32 The court held that Midland’s failure to comply with Rule 3001(c)(2)(A) caused it to forfeit the presumption of validity normally afforded to a proof of claim. 567 B.R. at 495, citing In re Varona, 388 B.R. 705 (Bankr. E.D. Va. 2008).
Having determined that Midland’s failure to itemize interest and fees was not “substantially justified or . . . harmless,” the Court awarded reasonable expenses and attorneys’ fees to the debtor. The court elected not to impose the additional sanction of precluding the omitted evidence pursuant Rule 3001(c)(2)(D)(i) after finding that Midland had acted in good faith, determining that additional sanctions were not necessary to deter future noncompliance. *Id.* at 500.

*Maddux* provides a roadmap for dealing with many of the issues addressed in Count II of the Complaint. It establishes that filing a proof of claim and falsely reporting that no interest or fees are included in the balance violates Rule 3001(c)(2)(A) and may deprive the claimholder the benefit of *prima facie* validity of its claim. It confirms that the failure to itemize interest and fees under Rule 3001(c)(2)(A) is not, in most instances, “substantially justified or . . . harmless.” Finally, it instructs that in the absence of bad faith or the willful filing of a false claim, the Court should, in most cases, confine itself to imposing the remedies specifically set forth in Rule 3001(c)(2)(D).

In this adversary proceeding, the Debtor is seeking disallowance of Claim 13-1 and has alleged violations of Rule 3001(c) no less egregious than

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33 The Debtor’s Objection to Claim (Dkt. 1, Ex. C), which is attached as an exhibit to the Complaint, is currently pending in the Debtor’s main case as a contested matter. Case No. 17-34385, Dkt. 28. In addition to other relief, the Complaint seeks disallowance of “each individual claim” (Dkt. 1, p. 16), which necessarily incorporates a request to disallow Claim 13-1. Rule 3001(c)(2)(D)(i) provides that
those for which this Court granted relief in Maddux. For these reasons, the Court will deny PRA’s motion to dismiss Count II of the Complaint, subject to the following exception.

The Complaint seeks unspecified injunctive and declaratory relief in addition to relief specified under Rule 3001(c)(2). The Complaint is deficient insofar as it fails to adequately plead sufficient facts to authorize the injunctive and declaratory relief requested and fails to specify the nature and extent of the injunctive and declaratory relief being sought. Notwithstanding the ability of the Court to award “other appropriate relief” pursuant to Rule 3001(c)(2)(D)(ii), PRA is entitled to notice of the grounds underlying the Debtor’s request for an injunction, the specific injunctive relief requested, and the grounds for and specific declaratory relief the Debtor is seeking. Similar

the creditor may be precluded from presenting the omitted information in “any contested matter or adversary proceeding in the case.” This language clearly contemplates the applicability of Rule 3001 to adversary proceedings that may be initiated by a debtor. In this adversary proceeding, Count II alleges facts that, if true, would afford relief to the Debtor including, potentially, the disallowance of Claim 13-1. Pursuant to Bankruptcy Rule 9014(c), Bankruptcy Rule 7042 applies to contested matters. Rule 7042 permits the consolidation of actions before the court involving a common question of law or fact. Inasmuch as the Objection to Claim 13-1 and this adversary proceeding involve common questions of law and fact, the Court will order consolidation of these matters.

Recently, Chief Judge Connelly of the U.S. Bankruptcy Court for the Western District of Virginia denied a motion to dismiss an adversary proceeding seeking relief under Rule 3001 on facts nearly identical to this case. In Thomas v. Midland Funding, LLC (In re Thomas), 592 B.R. 99, 109 (Bankr. W.D. Va. 2018), Chief Judge Connelly stated that Rule 3001 “explicitly authorizes the Court to ‘award other appropriate relief, including reasonable expenses and attorney’s fees caused by the failure.’ For the Court to hold that a debtor has no right to the relief specifically provided in Rule 3001 would require the Court to ignore the language in the Rule or insert terms not present. Regardless, at this stage, the issue before the Court is not the merits of the action and whether to award the relief requested but merely whether the amended complaint sufficiently pleads a claim under Rule 3001.”
deficiencies were addressed in *Thomas v. Midland Funding, LLC (In re Thomas)*, 578 B.R. 355, 365-66 (Bankr. W.D. Va. 2017), in which the court dismissed the underlying count in the complaint with leave to amend. For the same reasons, the Court will dismiss, with leave to amend, the portion of Count II requesting injunctive and declaratory relief.

**Count III-Request for Relief Pursuant to 11 U.S.C.§ 105**

Having advanced his grounds for declaratory and injunctive relief, that PRA intentionally filed a proof of claim containing false statements for an improper purpose, the Debtor seeks to have the Court sanction PRA pursuant to 11 U.S.C. § 105. Count III alleges that PRA is engaged in the “systemic practice before this Court of violating Rule 3001 and filing claims that contain false information.”

The Supreme Court has recognized a bankruptcy court’s broad authority under 11 U.S.C. § 105(a) to take necessary or appropriate action “to prevent an abuse of process.” *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007) (quoting 11 U.S.C. § 105(a)). This Court has previously acknowledged that “§ 105 may be used to sanction the filing of a proof of claim violative of the Bankruptcy Code and abusive of the bankruptcy

35 Dkt. 1, ¶86.
36 11 U.S.C. § 105(a) provides: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.”
process, that is, as the federal criminal code aptly describes, a claim that is false or fraudulent.” *In re Varona*, 388 B.R. 705, 717 (Bankr. E.D. Va. 2008)

Section 105 does not create a private right of action; it may, however, be invoked “if the equitable remedy utilized is demonstrably necessary to preserve a right elsewhere provided in the Code,’ so long as the court acts consistent with the Code and does not alter the Code’s distribution of other substantive rights.” *Bessette v. Avco Fin. Servs., Inc.*, 230 F.3d 439, 444-45 (1st Cir. 2000), quoting *Noonan v. Sec’y of Health & Human Servs. (In re Ludlow Hosp. Soc’y, Inc.)*, 124 F.3d 22, 27 (1st Cir. 1997). In *Maddux*, Judge Huennekens considered imposing remedies under § 105 but chose not to do so after hearing the evidence at trial and determining that Midland did not willfully file false claims. 567 B.R. at 499.

Bankruptcy Rule 3001(c)(2)(D)(ii) authorizes the Court, in appropriate circumstances, to “award other appropriate relief.” If the allegations of the Complaint are true, and at this stage the Court must assume that they are, “other appropriate relief” may warrant the invocation of § 105. The Court will not relinquish its authority to act under its provisions at this stage of the proceedings. For that reason, the Motion will be denied as to Count III of the Complaint.
Conclusion

For the foregoing reasons, the Motion is granted as to Count I. With respect to Count II, the Motion is granted in part as to the requests for declaratory and injunctive relief, with leave to the Debtor to amend, and denied in part, as to the remaining relief requested. The Motion is denied as to Count III.

Separate orders shall accompany this Memorandum.

Signed: March 28, 2019 /

/s/ Keith L. Phillips
United States Bankruptcy Judge

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A. As a consumer protection statute, the FDCPA prohibits both misleading or deceptive tactics, and also unfair or unconscionable tactics.

“The FDCPA protects consumers from abusive and deceptive practices by debt collectors, and protects non-abusive debt collectors from competitive disadvantage.” Yarney v. Ocwen Loan Serv., LLC, 929 F. Supp. 2d 569, 575 (W.D. Va. 2013) (Moon, J.) (citing United States v. Nat’l Fin. Servs., Inc., 98 F.3d 131, 135 (4th Cir. 1996)). The FDCPA prohibits “debt collectors” from using “any false, deceptive, or misleading representation or means in connection with the collection of any debt,” and from using “unfair or unconscionable means to collect or attempt to collect any debt.” 15 U.S.C. §§ 1692e-1692f. To state a claim for a violation of the FDCPA, a plaintiff must allege: (1) the plaintiff is a “consumer” within the meaning of the statute, (2) the defendant collecting the debt is a “debt collector” within the meaning of the statute, and (3) the defendant has violated a provision of the FDCPA by act or omission. Creighton v. Emporia Credit Serv. Inc., 981 F. Supp. 411, 414 (E.D. Va. 1997). For an FDCPA claim, no plaintiff is required to satisfy the more rigorous pleading standard for fraud as Rule 9(b) otherwise requires. See, e.g., Robinson v. Managed Accounts Receivables Corp., 654 F. Supp. 2d 1051, 1058 (C.D. Cal. 2009) (explaining that “[t]he FDCPA is not such a lengthy or complex statute as to render Defendants unable ‘to prepare an adequate defense’” without more specific pleading detail”).

The FDCPA’s principal definition of a “debt collector” states that: “The term “debt collector” means any person . . . who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another. 15 U.S.C. § 1692a(6). Defendants do not dispute that they are debt collectors under the statute that were seeking to collect a debt. The civil liability section of the FDCPA then provides for the private relief that
Plaintiffs now seek, stating that “any debt collector who fails to comply with any provision of this subchapter with respect to any person is liable to such person”. 15 U.S.C. § 1692k(a). Violations of the FDCPA subject the defendant to an award of actual damages, statutory damages, and attorney’s fees and costs. 15 U.S.C. § 1692k(a).

Section 1692e of the FDCPA prohibits any false, deceptive, or misleading representation in an attempt to collect a debt. The question is not whether the misrepresentation or falsehood misleads a particular plaintiff or consumer, but instead whether it has the capacity to mislead. See e.g. Neild v. Wolpoff & Abramson, L.L.P., 453 F. Supp. 2d 918, 923-24 (E.D. Va. 2006); Vitullo v. Mancini, 684 F. Supp. 2d 747, 757-58 (E.D. Va. 2010); Goodrow v. Friedman & MacFadyen, P.A., 788 F. Supp. 2d 464, 472 (E.D. Va. 2011).

Additionally, the FDCPA prohibits unfair and unconscionable business practices. Section 1692f of the FDCPA states a “debt collector may not use unfair or unconscionable means to collect or attempt to collect any debt.” It provides a non-exhaustive list of examples and the “statute does not say” what is unfair or unconscionable. See Beler v. Blatt, Hasenmiller, Leibske & Moore, LLC, 480 F.3d 470, 473 (7th Cir. 2007). Where a complaint alleges conduct that does not fit under other claims that have been successfully plead, a claim under 1692f is proper. See Vanhuss v. Kohn Law Firm, 127 F. Supp.3d 980, 990 (W.D. Wis. 2015).

B. Filing false proofs of claims in bankruptcy can be a violation of both Sec. 1692e and Sec. 1692f.

The United States Supreme Court in Midland Funding, LLC v. Johnson explained why Proofs of Claim are so important. “The audience in Chapter 13 bankruptcy cases includes a trustee, 11 U. S. C. §1302(a), who must examine proofs of claim and, where appropriate, pose an objection, §§704(a)(5), 1302(b)(1) (including any timeliness objection, §§502(b)(1), 558).” 581 U.S. ----, 137 S. Ct. 1407, 1413 (2017). Given that a trustee “bears the burden of investigating
claims” and determining when to object, see id. at 1414, trustees necessarily rely on the information in the sworn Proof of Claim to determine how to exercise those duties, and that information must necessarily be accurate. For instance, a very large fee or interest itemization might be cause to investigate the legal basis for such fees or interest. Thus, the information in a Proof of Claim filed by a debt collector is by definition material to any debt collection effort.

Because Proofs of Claim are filed under oath, FDCPA cases regarding how debt collectors who file false oaths violate the FDCPA provide the authority for applying the FDCPA. For instance, in Vassalle v. Midland Funding LLC, “the district court issued a self-described ‘landmark ruling,’ holding that “robo-signing” affidavits in debt-collection actions violates the FDCPA. The court found the affidavit to be false and misleading under the FDCPA due to the false attestation of personal knowledge. As it turns out, Midland employees had been signing between 200 and 400 computer-generated affidavits per day for use in debt-collection actions, without personal knowledge of the accounts.” 708 F.3d 747, 752 (6th Cir. 2013)(see also Midland Funding LLC v. Brent, 644 F. Supp.2d 961, 967-69 (N.D. Ohio 2009) explaining in detail the process by which Midland systematically created hundreds of false attestations of personal knowledge per day to be submitted in debt collection actions). The Sixth Circuit described the false attestation of personal knowledge as a “predatory practice” and stated that the “unnamed class members’ greatest interest is their ability to contest these allegedly fraudulent judgments.” 708 F.3d at 756 and 759.

As a predatory practice, filing false oaths can be both a misrepresentation and an unconscionable practice. Therefore, unless a FDCPA claim is precluded from being based on conduct within the bankruptcy process, a FDCPA claim could be stated on such conduct.

C. Midland v. Johnson decided a narrow limitations issues based on a proof of claim that complied with Rule 3001.
In *Midland v. Johnson*, the Supreme Court held that “Midland’s filing of a proof of claim that on its face indicates that the [statute of] limitations period has run” is not “false, deceptive, or misleading representation” under 15 U.S.C. 1692e, and that by doing so Midland was not using “unfair or unconscionable means” to collect, or attempt to collect, a debt under 15 U.S.C. 1692f. 137 S.Ct. at 1411. The Court began its analysis by giving “claim” under 11 U.S.C. §101(5) “the broadest available definition,” based on its own precedent, *Johnson v. Home State Bank*, 501 U.S. 78, 83, 111 S.Ct. 2150 (1991). This broad view of claim, the Court explained, encompasses even unenforceable claims such as those Midland filed. *Midland*, 137 S.Ct. at 1412.

Because of the Bankruptcy Code’s system of inviting creditors to file a claim, “whether or not such right is ... fixed, contingent, ... [or] disputed,” 11 U.S.C. 101(5), subject to the right of any party in interest to object and have unenforceable claims disallowed, the filing of a time-barred debt was not “false” under the FDCPA. *Id.* Likewise, the Court saw nothing “misleading or deceptive” in a properly-filed proof of claim. This was so because the “audience” for the proof of claim includes a sophisticated Chapter 13 trustee, whose duties include “examin[ing] proofs of claim and, where appropriate, pos[ing] an objection.” *Id.* at 1413, citing 11 U.S.C. 1302(b)(1). The important fact to this conclusion was the Court’s finding that the claim in issue had been properly filed and provided the information necessary for the proper functioning of the bankruptcy process.

Although the Court understood that Midland’s practice of purchasing stale debts for the purpose of filing claims in bankruptcy more closely appeared “unfair” or “unconscionable,” it also found no violation of 15 U.S.C. § 1692f. *Midland v. Johnson*, 137 S.Ct. at 1413. Even though the Court noted numerous decisions holding that 15 U.S.C. § 1692f is violated by a civil suit to collect stale debts, the Court explained, “the context of a civil suit differs significantly
from the present context, that of a Chapter 13 bankruptcy proceeding.”  *Id.*  Specifically, the Court viewed Chapter 13 as providing more structural protections for debtors, reducing the risk that they will be duped into paying a stale debt:

> These considerations have significantly diminished force in the context of a Chapter 13 bankruptcy. The consumer initiates such a proceeding and consequently the consumer is not likely to pay a stale claim just to avoid going to court. A knowledgeable trustee is available. Procedural bankruptcy rules more directly guide the evaluation of claims. And, as the Eighth Circuit Bankruptcy Appellate Panel put it, the claims resolution process is “generally a more streamlined and less unnerving prospect for a debtor than facing a collection lawsuit.” These features of a Chapter 13 bankruptcy proceeding make it considerably more likely that an effort to collect upon a stale claim in bankruptcy will be met with resistance, objection, and disallowance.

*Id.* at 1413-1414 (citations omitted).

As part of its decision, the Court discussed the different purposes of the FDCPA, one perhaps even helping consumers avoid bankruptcy, and the Bankruptcy Code, with its “delicate balance of a debtor’s protections and obligations.”  *Id.* at 1414-15. In reversing the Eleventh Circuit Court of Appeals’ decision, the Supreme Court’s majority opinion did not address the lower court’s holding that “[t]he Bankruptcy Code does not preclude an FDCPA claim in the context of a Chapter 13 bankruptcy when a debt collector files a proof of claim it knows to be time-barred.”  *Johnson v. Midland Funding, LLC*, 823 F.3d 1334, 1338 (11th Cir. 2016). Instead, the Court confined its ruling to one specific issue – whether “filing (in a Chapter 13 bankruptcy proceeding) a proof of claim that is obviously time barred is . . . a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act.” 137 S.Ct. at 1415-1416.

**D. Midland v. Johnson did not resolve the Circuit split regarding whether FDCPA claims can be stated against debt collectors who violate the Federal Bankruptcy Rules.**

On the issue of whether an FDCPA claim be stated for conduct within a bankruptcy proceeding, the dissenting opinion in *Midland v. Johnson* commented “the Court does not hold
that the Bankruptcy Code altogether displaces the FDCPA, leaving it with no role to play in bankruptcy proceedings. Such a conclusion would be wrong.” *Id.* at 1419 (Justice Sotomayor, joined by Justice Ginsburg and Justice Kagan).

Because the Supreme Court did not overrule the Eleventh Circuit’s opinion that a FDCPA claim could be based on actions by a creditor in the bankruptcy process, in the Eleventh Circuit this issue is decided. Prior to *Midland v. Johnson*, in the Seventh Circuit, *Randolph v. IMBS, Inc.*, 368 F.3d 726 (7th Cir. 2004) found no implied repeal or conflict between the FDCPA and the Bankruptcy Code, and the Third Circuit found similarly in *Simon v. FIA Card Services*, 732 F.3d 259, 280 (3d Cir. 2016). On the other hand, the Ninth Circuit’s opinion in *Walls v. Wells Fargo Bank*, 276 F.3d 502 (9th Cir. 2002) and the Second Circuit’s opinion in *Simmons v. Roundup Funding*, 622 F.3d 93 (2d Cir. 2010) each held that the bankruptcy procedures were the sole source for remedies for creditor misconduct.

The Fourth Circuit Court of Appeals’ decision in *Dubois v. Atlas Acquisition, LLC*, which properly predicted the *Midland* decision, held that the filing of a claim for a stale debt, where the date of last payment and date of charge-off is properly shown on the claim form, does not violate 15 U.S.C. §§1692e or 1692f. *See* 834 F.3d 522, 525, 533 (4th Cir. 2016). Its rationale for its holding closely tracks the *Midland* decision regarding how the information in a proof of claim is to be used:

Various other considerations also differentiate filing a proof of claim on a time-barred debt from filing a lawsuit to collect such debt. First, the Bankruptcy Rules require claims like the ones filed by Atlas to accurately state the last transaction and charge-off date on the account, making untimely claims easier to detect and relieving debtors from the burden of producing evidence to show that the claim is time-barred. Second, a bankruptcy debtor is protected by a trustee and often by counsel who are responsible for objecting to improper claims even if, as Appellants argue, they currently do not always do so.
834 F.3d at 533. The Fourth Circuit made clear that the debt collector’s act of filing its proof of claim is an act to collect a debt that initially is under the ambit the FDCPA. Id. at 528. “Although a proof of claim is filed with the bankruptcy court, it is done with the purpose of obtaining payment from the debtor’s estate. That the claim is paid by the debtor’s estate rather than the debtor personally is irrelevant for purposes of the FDCPA.” Id. It also noted the following: “There is no allegation that Atlas filed inaccurate proofs of claim. A debt collector who supplies false dates to obscure a claim’s staleness may well violate the FDCPA. However, we have no occasion to consider that issue today.” Id. at 532, FN10.

Given the unresolved Circuit Court split, to properly apply Midland v. Johnson to non-statute-of-limitations issues, the narrow scope of its holding and its factual basis should be respected, while using its analysis to guide application to other circumstances. One analysis is that because Midland adhered to Federal Rules of Bankruptcy Procedure 3001(c)(3)(iv), which requires creditors to file a statement with claims based on open-end credit such as Midland’s indicating “the date of the last payment on the account”, the core idea is that compliance with Rule 3001 does not create a FDCPA violation. From this perspective, by complying with the procedural requirements, Midland provided the accurate information which the “streamlined” claims process in Chapter 13 requires to work properly, and to insert FDCPA liability for a compliant proof of claim would upset the “delicate balance” within bankruptcy procedure. Id. at 1413. A competing analysis is that the Supreme Court was giving priority to the Bankruptcy Code and the Bankruptcy Rules and implicitly siding with the Ninth and Second Circuits.

Several Bankruptcy Courts to consider this issue post Midland v. Johnson have declined to dismiss FDCPA claims based on false information submitted in Proofs of Claim. See e.g. May v. Midland Funding, 4:18-ap-01057 (E.D.Br. Ark., Nov. 1, 2018); Ellswick v. Quantum3 Group,
2018 WL 1408536 (N.D. Al., March 21, 2018)(discussing the FDCPA standard in Midland v. Johnson). In Virginia, the attached two opinions show a split of opinion about whether violations of Rule 3001 for an otherwise valid debt support an FDCPA claim.
Clash of Codes – Tax Issues in Consumer Bankruptcy
Introduction

Few issues ignite the emotions of the parties to a bankruptcy like taxes. For debtors’ attorneys, it is a complicated area of two competing areas of federal law that leads to unnerving CLE programs and articles warning of “traps for the unwary” when dealing with clients with tax debts. For debtors, the rules can be counterintuitive, any legal advice seems filled with uncertainty and hedging, and unwanted surprises pop up all too often even after the case is long over.

Rarely, in the practice of bankruptcy, is a surprise a good thing. Particularly when it comes to taxes, clients want their cases to unfold according to plan. Understanding the impact of bankruptcy on tax liabilities and expressing the same clearly to the client will reduces stress and increase the client’s overall sense of relief from the process. Knowing the right questions to ask and when to ask them of the IRS is critical to evaluating a client’s case. To that end, the overwhelming share of the work needed for a successful bankruptcy involving tax liabilities is done before the case is filed. Completing land record searches, reviewing tax account transcripts, and applying the rules of discharge, priority and tolling will permit an attorney to minimize surprise and accurately set the expectations of the client. Understanding the tax discharge rules, however, must begin with a review of the applicable Bankruptcy Code sections.

Statutory Framework

The rules and tests for the discharge of income taxes in bankruptcy derive from a combination of Bankruptcy Code sections, including 11 U.S.C. § 523 and § 507, as well as each chapter’s particular discharge sections.1

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1 See 11 U.S.C. §§ 727, 1141, 1328. While this article focuses on the discharge of federal income taxes, the analysis and the “rules” described herein are the same for state income taxes.
Bankruptcy Code § 507(a)(8) assigns 8th priority to income taxes filed or assessed within specified timeframes. As example, priority taxes would include: (1) income or excise taxes for which the return was last due within three years of the petition date, (2) taxes collected and held in trust by the debtor for the taxing authority, and (3) taxes assessed within 240 days before the date of the filing of the petition.

Bankruptcy Code Section 523(a)(1)(A) excepts from discharge under 11 U.S.C. § 727, as well as the hardship discharge provisions of 11 U.S.C. § 1328(b), priority tax claims under 11 U.S.C. § 507(a)(8). In contrast, under the broad Chapter 13 discharge provisions of 11 U.S.C. § 1328(a), these same priority claims are dischargeable. As priority claims, though, they must be paid in full in order to receive the more expansive Chapter 13 discharge under 11 U.S.C. § 1328(a).

The remaining subsections of 11 U.S.C. § 523(a)(1) are not related to whether the claim is priority but describe other circumstances where the taxes would be excepted from discharge, regardless of whether the debtor is in a Chapter 7 or 13. Bankruptcy Code Section 523(a)(1)(B) makes nondischargeable a tax for which the return was either not filed or was filed late and less than two years prior to the petition date. Section 523(a)(1)(C) makes a tax nondischargeable if the taxpayer made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

The Key Dischargeability Questions

Based on these controlling Bankruptcy Code sections, any tax discharge analysis should start with these three key timing questions for income taxes:

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The Three-Year Rule. Was the due date for filing the return required for a particular tax claim more than three years prior to the date of the bankruptcy filing?

The 240-Day Rule. Was the tax claim assessed more than 240 days before the bankruptcy filing?

The Two-Year Rule. Was the tax return filed more than two years before the filing of the bankruptcy?

If the answers to all of these questions are “yes” for a particular tax year’s liability and if the debtor neither fraudulently filed that year’s tax return nor has willfully evaded the tax (for purposes of this article, the “fraud/evasion test”), then the tax liability would be dischargeable in either Chapter 7 or 13 as a general unsecured claim. While the answers to the tests themselves are simple enough – yes or no decisions – the application of the tests can be more challenging.

**Determining Tax Return Due Date**

For the 3-Year Rule, the pivotal question is determining the due date for the tax return. The 3-year period does not start to run until the conclusion of any extension dates the taxpayer may have requested even if the actual tax return is filed before that final due date. Also, April 15th or October 15th may not be the actual due date for the return because holidays and weekends often delay the deadline to file.

**Determining Assessments**

The 240-day deadline is based on when the taxing authority actually assesses a tax. The assessment is the recording of the amount the taxpayer owes the government. An assessment generally marks the start of the IRS’s ability to collect a tax administratively. This assessment can be made either based on the information reported in a taxpayer’s tax return or after the audit process.

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3 E.g., 26 U.S.C. § 6203.
Although a taxpayer will have only one tax return due date for each tax year, multiple tax assessments are possible. As will be described in more detail later in this article, the assessment dates are noted on a taxpayer’s tax account transcript. Subsequent assessments trigger new 240-day tests for priority claim status. For example, if the IRS has made a second assessment, then two separate 240-day periods must be calculated to determine whether the tax resulting from each assessment will be a priority claim under 11 U.S.C. § 507(a)(8).

Reporting Federal Adjustments to the State

Taxes remain subject to audit and further assessment for three years from the day after the date on which the return was filed or is deemed filed.4 Returns that are filed early are deemed to be filed on the last day when the return is due without penalty.5 If an audit by the IRS results in an assessment, many state laws also require such assessments to be reported to the state.

Since 11 U.S.C. § 523(a)(1)(B) would make nondischargeable any tax arising from a required return that is not filed, or that is filed late and less than two years prior to the bankruptcy, the taxpayer that fails to report the results of an IRS audit to the state may find that state arguing that the resulting additional state assessment to be nondischargeable in a bankruptcy.6 Arguably, BAPCPA strengthened the position of the state by the addition of language expanding the requirement of a return (that would start the two-year dischargeability clock) to include any required “equivalent report or notice” in determining nondischargeability under 11 U.S.C. § 523(a)(1)(B).

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6 In re Ciotti, 638 F.3d 276, 279 (4th Cir. 2011) (Concluding that post-BAPCPA § 523(a)(1)(B) was sufficiently expansive to except from discharge not only tax debts for which no return is filed, but also tax obligations for which the debtor fails to file an amended return, report, or notice when one is required under the pertinent tax laws.).
Section 523(a)(1)(B): Defining a Return for Discharge Purposes

Bankruptcy Code Section 523(a)(1)(B) denies a discharge if a “return, or equivalent report or notice” was not filed or “was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension” and two years before the filing of the petition.

A split among the circuits, however, has developed as to whether a late filed return may be considered a tax return for purposes of dischargeability. The First, Fifth and Tenth circuits have found that the tax determined from untimely returns is never dischargeable in bankruptcy.7 The rulings are based on the hanging paragraph to 11 U.S.C. § 523(a) added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) and interpret the language to define “return” to exclude any taxpayer filing that does not strictly comply with all return filing requirements, including timeliness.

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 law.

11 U.S.C. § 523(a) (hanging paragraph).

The most well-known opinion in this developing area arises from the Fifth Circuit’s case, In re McCoy.8 The McCoy opinion actually involved the determination of the dischargeability of

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7 In re Fahey, 779 F.3d 1 (1st Cir. 2015); In re McCoy, 666 F.3d 924 (5th Cir. 2012); In re Mallo, 774 F.3d 1313 (10th Cir. 2014).
8 666 F.3d 924 (5th Cir., 2012).
state taxes owed to the Mississippi State Tax Commission. The Chapter 7 debtor brought an adversary proceeding to request a declaration that the taxes shown on her late filed state income tax returns, filed over two years prior to the commencement of her bankruptcy, were discharged under 11 U.S.C. 727.9 The McCoy court determined that the late-filed returns of the debtor did not qualify as tax returns for dischargeability purposes because the hanging paragraph of 11 U.S.C. § 523(a) defines a return as “a return that satisfies the requirements of applicable nonbankruptcy laws….” Having concluded that a late-filed return could not be a return for dischargeability purposes, the debtor could not show that such a return was filed in order to meet the dischargeability requirements of 11 U.S.C. § 523(a)(1)(B).10 Courts and commentators often describe the ruling from McCoy and the cases that follow it as the “one-day-late” rule because it prohibits discharge of a tax debt with respect to which a return was filed even one day late.11

The Ninth Circuit BAP rejected this one-day-late rule in finding that a late filed return may still otherwise qualify as a tax return for dischargeability purposes in the case of In re Martin.12 The Eleventh Circuit agreed in dicta in In re Justice,13 and both courts instead followed the Beard test14 to determine if a filed Form 1040 qualified as a return. Under the Beard test, a document must meet the following conditions to qualify as a tax return. The filing: (1) must purport to be a return; (2) must be executed under penalty of perjury; (3) must contain

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9 Id. at 925.
10 The McCoy court did leave open the possibility of a return qualifying under the safe harbor provisions of 26 U.S.C. § 6020(a). See the language of the hanging paragraph of 11 U.S.C. § 523(a). Returns under 26 U.S.C. § 6020(a) are prepared by the IRS for the taxpayer’s signature. The IRS, however, indicates that these § 6020(a) returns are only prepared in a “minute number of cases.” See, IRS NOTICE CC-2020-016, September 2, 2010, Office of Chief Counsel, “Litigating Position Regarding the Dischargeability in Bankruptcy of Tax Liabilities Reported on Late-Filed Returns and Returns Filed After Assessment.”
11 In re Justice, 817 F3d 738, 743 (11th Cir. 2016).
12 In re Martin, 542 B.R. 479 (B.A.P. 9th Cir. 2015).
13 Justice at 743 (“[W]e can assume arguendo, although we do not expressly decide, that the one-day-late rule is incorrect.”).
14 The Beard test for what constitutes a return originates from the opinion, Beard v. Commissioner, 82 T.C. 766 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986).
sufficient data to allow calculation of tax liability; and (4) must represent an honest and reasonable attempt to satisfy the requirements of the tax law.\textsuperscript{15}

Interestingly, the IRS does not appear to be following \textit{McCoy}.\textsuperscript{16} The IRS Office of Chief Counsel reported in its “Litigating Position Regarding the Dischargeability in Bankruptcy of Tax Liabilities Reported on Late-Filed Returns and Returns Filed After Assessment,” that tax debts related to late-filed returns may be discharged. Explaining its rejection of the one-day-late rule, the IRS Notice states:

Read as a whole, section 523(a) does not provide that every tax for which a return was filed late is nondischargeable. If the parenthetical “(including applicable filing requirements)” in the unnumbered paragraph created the rule that no late-filed return could qualify as a return, the provision in the same paragraph that returns made pursuant to section 6020(b) are not returns for discharge purposes would be entirely superfluous because a section 6020(b) return is always prepared after the due date. It is a cardinal principle of statutory construction that a statute should be construed so that no clause, sentence or word is rendered superfluous. \textit{Kawaauhau v. Geiger}, 523 U.S. 57, 62 (1998) (refusing to read one provision of the Bankruptcy Code to render another superfluous).\textsuperscript{17}

Thereafter, in the \textit{In re Martin} decision, the Ninth Circuit BAP acknowledged the position of the IRS against the one-day-rule.\textsuperscript{18} The BAP noted, “neither side here advocates in favor of the literal construction of the "return" definition that Congress added to the nondischargeability statute as part of the 2005 Bankruptcy Code amendments. Indeed, in this

\textsuperscript{15} Id.
\textsuperscript{16} See, IRS NOTICE CC-2020-016, September 2, 2010, Office of Chief Counsel, “Litigating Position Regarding the Dischargeability in Bankruptcy of Tax Liabilities Reported on Late-filed Returns and Returns Filed After Assessment.”
\textsuperscript{17} Id.
\textsuperscript{18} \textit{Martin} at 483.
case and in other cases, the IRS expressly has rejected the literal construction and has stated that the literal construction leads to "overly harsh" results."\textsuperscript{19} Instead the IRS advocated in the \textit{Martin} case for “its less draconian approach” turning on whether the taxpayer filing occurred before or after an assessment of tax from the preparation of a Substitute for Return (discussed in more detail below) by the IRS.\textsuperscript{20}

\textbf{Assessments when the Taxpayer has not Filed a Return}

The IRS may assess an income tax liability even if the taxpayer has not filed a return.\textsuperscript{21} This is often called the Substitute for Return process or SFR. From the taxpayer’s perspective, the tax imposed by the SFR is typically worse than if the taxpayer prepared the return because the IRS does not have the taxpayer’s information about exemptions, deductions, dependents, or other figures that may reduce an income tax liability if properly claimed by the taxpayer. More importantly, though, an assessment where the IRS has not received a return does not qualify as a return for bankruptcy discharge purposes. Further, even if the taxpayer files a return after the IRS assesses without the benefit of the return, most cases hold that such a filing of the Form 1040 does not qualify as a “return” for purposes of discharge. The majority of circuits courts that have considered the issue have found that a belated return does not serve a legitimate tax purpose.\textsuperscript{22} Accordingly, the subsequent return is not a return for discharge purposes and the taxes assessed may never be discharged.\textsuperscript{23}

Just because the Form 1040 does not qualify as a return for discharge purposes, that does not mean all hope is lost in obtaining relief for a client. IRS may accept a subsequently filed

\begin{itemize}
\item \textsuperscript{19} Id.
\item \textsuperscript{20} Id.
\item \textsuperscript{21} 26 U.S.C. § 6020(b).
\item \textsuperscript{22} \textit{Justice v. United States (In re Justice)}, 817 F.3d 738 (11th Cir.2016); \textit{In re Payne}, 431 F.3d 1055 (7th Cir.2005); \textit{In re Moroney}, 352 F.3d 902 (4th Cir. 2003).
\item \textsuperscript{23} Id.
\end{itemize}
Form 1040 and recalculate the debtor’s tax liability. This may grant practical relief by reducing the amount due to the IRS even if it may not be granted a discharge. In addition, if the debtor reports additional tax liabilities, those additional tax would be subject to discharge if all other tests of dischargeability are met.24

**Tolling**

The time periods described in the dischargeability tests for tax debts may be tolled or extended in various circumstances. The hanging paragraph of 11 U.S.C. § 507(a)(8) operates to toll the 240-day and 3-year time periods related to the tests of priority.

An otherwise applicable time period specified in this paragraph shall be suspended for 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 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.


Requests for Collection Due Process hearings and IRS administrative appeals toll the 240-day and 3-year tests by the duration of the time the government is prohibited under nonbankruptcy law from collecting a tax as a result of the requested hearing and appeal plus 90 days.25 Similarly, the 240-day and 3-year tests are also extended by the time the taxpayer’s prior

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24 See, IRS MEMORANDUM sbse-05-0911-078, August 1, 2012, Director, Collection Policy, “Determining Dischargeability of Late Filed Returns in Which a Substitute for Return was Prepared under 26 U.S.C. § 6020(b).”

bankruptcy was pending with collection prohibited due to the existence of the automatic stay or confirmed plan of the debtor, plus 90 days.\textsuperscript{26}

Under 11 U.S.C. § 507(a)(8)(ii), the 240-day test is tolled by a taxpayer’s Offer in Compromise for the length that the OIC was pending or in effect, plus 30 days. Interestingly, the 3-year period is not extended by an OIC.

Technically, the 2-year test of dischargeability under 11 U.S.C. § 523(a)(1)(B) does not have a similar statutory tolling provision like those under 11 U.S.C. § 507. However, the IRS takes the position that a bankruptcy filing or collection due process hearing will toll the 2-year rule also.\textsuperscript{27} Practitioners should also be aware that tax litigation typically postpones a tax assessment and under such circumstances would delay the start of the 240-day clock. The most useful nonbankruptcy tool for “buying time” by practitioners may be the initiation of an Installment Plan with the IRS as such action does not toll any of the time periods but typically does cease ongoing IRS collection efforts while the plan is in place.\textsuperscript{28}

\textbf{Fraud and Willful Evasion}

Bankruptcy Code § 523(a)(1)(C) excepts from Chapter 7 and 13 discharges any debt for a tax “with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.” These cases are fact specific and subjective, often making them difficult to analyze prior to a bankruptcy filing.\textsuperscript{29}

\begin{footnotesize}
\begin{enumerate}
\item Id.
\item \textit{Putnam v. Internal Revenue Serv.}, 503 B.R. 656, 659 (Bankr.E.D.N.C., 2014) (Finding that the two year look-back period in § 523(a)(1)(B)(ii) is subject to equitable tolling under either Bankruptcy Code Sections 105(a) or 108(c)).
\item The form for requesting an Installment Agreement may be found at www.irs.gov, Form 9465.
\item In determining whether the debtor filed a fraudulent return, courts consider badges of fraud, including (1) large understatements of income made consistently over time; (2) failure to keep adequate records; (3) failure to file tax returns; (4) implausible or inconsistent behavior by the taxpayer; (5) concealing assets; and (6) failure to cooperate with taxing authorities. See, e.g., \textit{Berkery v. Commissioner}, 192 B.R. 835, 841 (E.D.Pa.1996).
\end{enumerate}
\end{footnotesize}
Recently the U. S. Bankruptcy Court for the Eastern District of Virginia addressed the standards for willful evasion in a Chapter 7 case involving debtors with significant accumulated tax liability.\(^{30}\) Judge Phillips surveyed the standards for nondischargeability and determined that willful evasion under the Code includes both: (1) a conduct requirement that the debtor sought to evade or defeat the tax liability and (2) a mental state requirement that the debtor did so willfully.\(^{31}\) In evaluating the conduct portion of the test for evasion, Judge Phillips examined a series of badges of fraud, including the failure to pay taxes combined with other factors, such as the failure to file timely returns, the concealment of assets, inadequate recordkeeping, intra-family or fraudulent transfers, a lavish or extravagant lifestyle during the tax years in which the debtor failed to pay or during later years while the tax obligation remained due. With respect to the mental state requirement, Judge Phillips agreed with those courts that have required the government to prove that the debtor: “(1) had a duty to file income tax returns and pay taxes; (2) knew that he had such a duty; and (3) voluntarily and intentionally violated that duty.”\(^{32}\)

**Damages for Violations of Discharge Injunction and Automatic Stay**

Bankruptcy Code Section 523(a)(1)(C) operates automatically which means it is not necessary to obtain a dischargeability determination from the bankruptcy court. That said, subsection (e) to 26 U.S.C. § 7433 permits a taxpayer to recover damages against the United States for violations of both the automatic stay and the discharge injunction, including damages caused

\(^{30}\) *Conard v. IRS (In re Conard)*, 2017 Bankr. LEXIS 4258 (Bankr. E.D.Va., December 14, 2017). Interestingly, a companion case also exists, *Conard v. IRS (In re Conard)*, 2018 Bankr. LEXIS 2040 (Bankr. E.D.Va. 2018), and the appeal of that case was ultimately dismissed. *Conard v. IRS*, 2019 U.S. App. LEXIS 13108 (4th Cir., Apr. 30, 2019). In the companion case, the Court concluded that the IRS did not meet its burden to show that the joint debtor, Mrs. Conard, willfully attempted to evade her federal income tax liabilities within the meaning of 11 U.S.C.S. § 523(a)(1)(C) and found her liability for the tax obligations to the IRS for tax years 2004 through 2009 discharged. Based on Mrs. Conard’s testimony, the Court determined that her husband told her he was paying the taxes, she believed him, she did not know that the taxes were not being paid, and she had no control over her husband’s expenditures. *Conard*, 2018 Bankr. LEXIS at 11.

\(^{31}\) *Conard*, 2017 Bankr. LEXIS 4258 at 13.

\(^{32}\) *Id.*, at 11, quoting *United States v. Fretz (In re Fretz)*, 244 F.3d 1223, 1330 (11th Cir. 2001).
by the IRS. For this reason, the IRS may seek a determination before collection of a tax debt even if it believes the tax debt was not discharged.

The U.S. Court of Appeals for the First Circuit chastised the IRS for violating the discharge injunction holding “that an employee of the IRS ‘willfully violates’ a discharge order when the employee knows of the discharge order and takes an intentional action that violates the order.”

The court in Murphy rejected the IRS’s argument that there was a good faith exception to the violation of the discharge injunction. Murphy was decided prior to and without the benefit of the Supreme Court’s ruling in Taggert v. Lorenzen. After Taggert, the IRS may need some “objectively reasonable basis for concluding” that the debt was excepted from discharge before seeking to collect in order to avoid damages for violation of the discharge injunction of 11 U.S.C. § 524.

Employment Taxes and the Trust Fund Recovery Penalty

Sections 3102(a) and 3402(a) of the Internal Revenue Code require an employer to deduct and withhold certain employment taxes from the wages paid to employees. IRS Form 941 (or its equivalents) must then be filed by such an employer to report these employment taxes, along with making the required “federal tax deposits.”

Federal employment taxes have two parts: a trust-fund part and a non-trust-fund part. These two parts are so-named because Congress requires employers to withhold Social Security, Medicare, and income taxes from their employees’ paychecks. These withheld funds are then

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33 Section 7433 of the Internal Revenue Code is the exclusive remedy for damages against the IRS, and such damages are limited to “actual economic damages” under 26 U.S.C. § 7433(e).
34 IRS v. Murphy, 892 F.3d 29, 32 (1st Cir. 2018).
35 139 S. Ct. 1795 (2019).
36 Id. at 1799.
37 The introductory comments to this section are borrowed from a brief by co-panelist, Ari D. Kunofsky, filed 10/31/14 in the case of In re Net Pay Solutions, Inc., Case no.1:13-cv-2677-CCC, in the U.S. District Court for the Middle District of Pennsylvania.
38 See 26 U.S.C. §§ 3101, 3102(a), 3402(a)(1), 3403.
held in “special trust” for the United States. By contrast, employment excise taxes—Social Security and Medicare matching contributions—constitute the “non-trust fund” portion of federal employment taxes because the employer pays them directly. The Service’s longstanding policy is to apply a “payment first toward the employer’s nontrust fund liabilities . . . .”

Under 26 U.S.C. § 6672, the IRS may assess a Trust Fund Recovery Penalty against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. Note that the IRS does not assess liability for the TFRP against the owner of a sole proprietorship because the individual owner is already personally liable for employment taxes under 26 U.S.C. §§ 3101, 3402, and 3403. However, event in the case of a sole proprietorship, the TFRP may be needed to assert liability against an employee or other non-owner who exercises control over the finances or otherwise meets the definition of a responsible person under 26 U.S.C. § 6672.

A person should not be held liable for the TFRP unless he or she has the responsibility to account for, collect, and pay over the trust fund taxes to the government. In determining liability for the TFRP, the Internal Revenue Manual directs Revenue Officers to consider all relevant facts and circumstances, including: (1) the identification of the person as an officer, director, or principal shareholder of the corporation, a partner in the partnership, or member of

40 See 26 U.S.C. §§ 3111, 7501; see also Diamond Plating Co. v. United States, 390 F.3d 1035, 1038 (7th Cir. 2004).
41 E.g., Westerman v. United States, 718 F.3d 743, 749 (8th Cir. 2013); In re Ribs-R-Us, Inc., 828 F.2d 199, 201 (3d Cir. 1997); see IRS Policy Statement 5-14, ¶ 10, reprinted at, Internal Rev. Manual 1.2.14.1.3.
43 In investigating a taxpayer's potential liability for the TFRP, Revenue Officers utilize IRS Forms 4180 (Report of Interview With Individual Relative to Trust Fund Recovery Penalty), and IRS Form 4181 (Questionnaire Relating to Federal Trust Fund Tax Matters of Employer). Practitioners assisting clients facing these potential issues may want to consider reviewing with the clients the list of questions from those IRS forms. See, DISCHARGING TAXES In Consumer Bankruptcy Cases, Morgan D. King, King Law Publishing © KingLawPublishing.com / Morgan D. King 2016 (Release 2016 # 2 SKU #102-A 05/27/16).
the LLC; (2) the duties of the officer as set forth in the by-laws; (3) the authority to sign checks; 
(4) the identification of the person as the one in control of the financial affairs of the business; 
(5) the identification of the person as the one who had authority to determine which creditors would be paid and those who exercised that authority; (6) the identification of the person as the one who controlled payroll disbursements; (7) the identification of the person as the one who had control of the voting stock of the corporation; and (8) the identification of the person as the one who signed the employment tax returns.  

The TFRP is never discharged by a bankruptcy and is always classified as a priority claim. It is excepted from discharge under 11 U.S.C. § 1328(a)(2) as a 11 U.S.C. § 507(a)(8)(C) claim, regardless of the date of the assessment in relation to the filing of the bankruptcy. As a priority debt under 11 U.S.C. § 507(a)(8)(C), the TFRP is not dischargeable even when the IRS files an untimely claim or does not file a claim at all.  

An Effective Bankruptcy Doesn’t Necessarily Require All Tests to be Passed

Even if a debtor may not be able to discharge all tax liability in a Chapter 7, a bankruptcy may nonetheless be helpful to reduce the overall debt load and permit the debtor to focus on the remaining tax liabilities after the case concludes through the use of an Offer in Compromise or Installment Agreement. Other debtors may find that their tax liabilities only fail a Chapter 7 discharge because the debts are priority claims failing the 3-year or 240-day tests. In those

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44 Internal Rev. Manual 5.17.7.1.2 (08-01-2010) Responsibility. Although the Internal Revenue Manual describes the internal procedures of the IRS, it does not carry the force of law.
46 See the section of this article below addressing the interest that accrues on nondischargeable tax claims.
situations, if a debtor needs to move forward with a bankruptcy without delay and has nonexempt assets he is willing to sacrifice, the debtor at least has the assurance that those assets will be used to reduce his otherwise nondischargeable tax burden and not be effectively wasted on simple credit card or other fully dischargeable debts. Finally, overwhelming tax debt may have the added benefit of helping a high-income debtor avoid possible dismissal under the income-triggering dismissal provisions of 11 U.S.C. § 707(b)(2) reserved for debtors with primarily consumer debts. Most courts find tax claims to be nonconsumer debts, and if a high-income debtor has a majority of nonconsumer debts his likelihood of success in reaching a Chapter 7 discharge would increase significantly as he would not need to complete a means test and would not face a 11 U.S.C. § 707(b)(2) motion for dismissal based on abuse.

Under Chapter 13, even if a tax claim fails the 240-day or 3-year tests and is priority, it may still be discharged in Chapter 13 as long as it is otherwise dischargeable. Specifically, the tax claim would need to: (a) result from a tax return either filed timely or more than two years prepetition and (b) not involve fraud or willful evasion. This is because the Chapter 13 discharge provisions of 11 U.S.C. § 1328(a) do not except from discharge the priority taxes referenced in 11 U.S.C. § 523(a)(1)(A) but do except from discharge those taxes falling under 11 U.S.C. § 523(a)(1)(B) or (C) (the untimely return/2-year rule and fraud/evasion cases). Of course, if the tax claim is, in fact, priority and an allowed claim is filed, the claim must be paid in full for the debtor to receive a discharge under 11 U.S.C. § 1328(a).

48 See, STATEMENT OF THE U.S. TRUSTEE PROGRAM’S POSITION ON LEGAL ISSUES ARISING UNDER THE CHAPTER 7 MEANS TEST, April 23, 2010 (“Most tax debts are not typically consumer debt.”)
49 11 U.S.C. § 1328(a) will also not discharge taxes under 11 U.S.C. § 507(a)(8)(C), that is, “a tax required to be collected or withheld and for which the debtor is liable in whatever capacity....” In other words, trust fund taxes like withholding taxes. These tax liabilities will be priority and nondischargeable in 7 or 13.
Interest always follows the tax for discharge purposes. If the underlying tax is dischargeable, so is the interest.\(^50\) If a priority tax claim in a Chapter 13 does not involve the fraud or willful evasion of 11 U.S.C. § 523(a)(1)(C) and the applicable return was filed timely, then the interest on that claim would also be discharged upon the successful completion and discharge of the case under 11 U.S.C. § 1328(a). However, post-petition interest can accrue and not be discharged for priority tax claims that fall under § 523(a)(1)(B), even if the principal amount of the allowed priority claim is paid in full during the case.\(^51\)

Bankruptcy Code Section 523 (a)(1)(B) excepts from discharge any tax “with respect to which a return, or equivalent report or notice, if required – (i) was not filed or given; or (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition….” In other words, if the debtor failed to file a required return, or filed it late and within two years of the petition date, the underlying debt is not discharged. Following the rule above that interest follows the tax for discharge purposes, the failure of the tax to be dischargeable results in the interest not being discharged notwithstanding the payment of the tax claim as filed in the Chapter 13.\(^52\) Although BAPCPA added 11 U.S.C. § 1322(b)(10) to permit a Chapter 13 debtor to provide for the payment of post-petition interest on nondischargeable claims in a plan, such

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\(^{50}\) 26 U.S.C. § 6601(e)(1); See, IRS MEMORANDUM 202005029, October 21, 2009, Office of Chief Counsel, “Dischargeable Taxes, Penalties, and Interest under post-BAPCPA Chapter 13 Provisions.”


\(^{52}\) See, IRS NOTICE CC-2020-016, September 2, 2010, Office of Chief Counsel, “Litigating Position Regarding the Dischargeability in Bankruptcy of Tax Liabilities Reported on Late-Filed Returns and Returns Filed After Assessment.” According to this IRS memorandum, because “BAPCPA created a number of tax debts that are now non-dischargeable, debtors will owe post-petition interest on the non-dischargeable tax obligations.”
interest may be paid only to the extent that the debtor has disposable income available after making provision for full payment of all allowed claims.

**Which “Tax Bucket” Applies to Your Debtor?**

Processing all of the rules regarding the dischargeability of tax claims can be mind-numbing. Ultimately, though, all income tax claims should fall into one of the following categories or “buckets” which control the options the client has in bankruptcy.

**Bucket 1: Nonpriority and Dischargeable Tax.** Filing the petition when the timing tests indicate a tax is nonpriority and dischargeable will result in the discharge of the tax claim, regardless of whether filing a Chapter 7 or 13.53

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<thead>
<tr>
<th>CATEGORY</th>
<th>DESCRIPTION</th>
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<tbody>
<tr>
<td>Nonpriority AND Dischargeable</td>
<td>All three tests of dischargeability have been met and the tax does not involve fraud or willful evasion.</td>
<td>Fully dischargeable in a 7 or 13. From a tax perspective, now is a good time to file the bankruptcy.</td>
</tr>
</tbody>
</table>

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53 This analysis assumes the fraud/evasion test is also passed.
Bucket 2: Nonpriority and Nondischargeable Tax. If the tests of discharge result in a nonpriority and nondischargeable tax, careful explanation to the client about the impact of moving forward with a bankruptcy filing is necessary. It may be more beneficial to remain outside of bankruptcy and to pay the nondischargeable debts before filing the petition or to consider nonbankruptcy alternatives. In addition, delaying a petition may drop a claim from bucket 2 to bucket 1 if the discharge is based on a late-filed return in a jurisdiction that has rejected McCoy.54

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<tbody>
<tr>
<td>Nonpriority AND Nondischargeable</td>
<td>The tax satisfies the 3-year and 240-day tests but it is not dischargeable under § 523(a)(1)(B) or (C).</td>
<td>Give some thought to this case. Confer with the client. Document the file.</td>
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<tr>
<td></td>
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<td>In a Chapter 7 or 13, the tax claim and the post-petition interest are not discharged.</td>
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<tr>
<td></td>
<td></td>
<td>Can you fix the problem? Maybe if the problem arises from an unfiled return. If so, consider filing the return and wait out time if possible.</td>
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</table>

54 Of course, delaying the bankruptcy will not help if the basis of the nondischargeability is the fraud/evasion test of 11 U.S.C. § 523(a)(1)(C).
Bucket 3: Priority and Nondischargeable Tax. Taxes in Bucket 3 are not subject to discharge and receive priority status for payment. To limit surprises to the client, this is also an important area for memorializing warnings and advice in writing. Bucket 3 has two subgroups: (1) claims that are excepted from discharge only because the taxes are priority claims and (2) claims that are excepted from discharge under multiple tests. The two subgroups can result in potentially different results for post-petition interest.

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<tr>
<td>Priority AND Nondischargeable Under § 523(a)(1)(A) ONLY (because Priority)</td>
<td>An example might be a tax that has not met the 3-year rule but the return was filed timely. These taxes are not dischargeable in a Chapter 7 pursuant § 523(a)(1)(A) — BUT would be dischargeable in a Chapter 13 since § 523(a)(1)(A) is not an exception to the Chapter 13 discharge of § 1328(a).</td>
<td>Since dischargeable in a Chapter 13, the interest that would otherwise accrue during the plan is discharged upon plan completion. File Chapter 13 (and pay the priority tax) in the plan. Or consider delaying filing in order to turn this into a nonpriority and dischargeable tax. Then consider filing a Chapter 7 if possible (or perhaps a lower paying Chapter 13).</td>
</tr>
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</table>

55 The tax in this example would also not be dischargeable under a hardship discharge of 11 U.S.C. § 1328(b), but the claim may have received some distributions as a priority claim during the pendency of the case.
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<tr>
<td>Priority AND Nondischargeable Under § 523(a)(1)(B) or (C)</td>
<td>These taxes are priority because the bankruptcy is filed before the satisfaction of the 3-year or 240-day tests under § 507(a)(8). These taxes are also nondischargeable because return filed late and within the last 2 years or fraud/evasion issues.</td>
<td>These taxes are not discharged in a 7. Although the allowed priority tax claim will be paid under the plan in the 13, the post-petition will accumulate and not be discharged. File Chapter 13 (and pay the priority tax) with clear warnings to the client of the post-petition interest. Or, if there are no fraud/evasion issues, consider delaying filing in order to get to a nonpriority and dischargeable tax and file a Chapter 7 or low paying Chapter 13.</td>
</tr>
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**Nonbankruptcy IRS Collection Statute of Limitations.**

Even if bankruptcy does not prove to be a viable option, the statute of limitations may provide some hope for clients with older tax liabilities. The statute of limitations for the collection of income taxes by the IRS, defined by the Collection Statute Expiration Date (“CSED”), is independent of the Bankruptcy Code and runs 10 years from the date a tax was assessed.\(^{56}\) However, several tolling events are applicable to the IRS statute of limitation, and those tolling periods for purposes of collection under the Internal Revenue Code’s statute of limitations are not the same as the tolling periods in the Bankruptcy Code related to discharge issues. A thorough discussion falls outside of the scope of this paper because the CSED tolling periods are more complicated, but note that the CSED tolling periods also include numerous circumstances that would not trigger tolling in bankruptcy, such as when the taxpayer is outside

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\(^{56}\) 26 U.S.C. § 6502.
of the country continuously for 6 months or more or when the taxpayer formally requests an Installment Agreement.\textsuperscript{57}

**Tax Liens**

A tax lien may limit the benefits of a discharge in bankruptcy. Discharged debts may not be collected from debtors personally but recorded tax liens not otherwise avoided are enforceable even after the bankruptcy against property owned by the debtor prior to the bankruptcy.\textsuperscript{58} In the case of nondischargeable tax claims secured by a federal tax lien, such liens remain enforceable to collect those nondischargeable taxes after the bankruptcy filing even from after acquired property.

Outside of bankruptcy, the federal tax lien attaches to all of a debtor’s property and rights to property upon assessment.\textsuperscript{59} The lien then obtains priority over secured creditors, purchasers, and judgment lien holders upon filing of a notice of federal tax lien. If a notice of federal tax lien has been filed, then the tax lien will reach the bankruptcy debtor’s property, even if it is claimed as exempt. To be valid against real property in bankruptcy, the federal tax lien must be recorded in the county in which the real property is located.\textsuperscript{60} For the IRS to have a secured claim in bankruptcy against the debtor’s personal property, the lien must be recorded where the debtor resides, and once filed, the lien follows the taxpayer and his personal property even if he moves.\textsuperscript{61}

The enforceable duration of the lien is the same as the statute of limitations for collections of the underlying IRS tax, that is, 10 years from date of the original assessment of the

\textsuperscript{57} Internal Rev. Manual 8.21.5.4.1 – 14.
\textsuperscript{58} 11 U.S.C. § 524.
\textsuperscript{59} 26 U.S.C. § 6321.
tax, plus any time added by applicable tolling provisions.\textsuperscript{62} However, if the IRS reduces its assessments to a judgment, the IRS may continue collection of the judgment lien for an additional 20 years, which may be renewed for a second 20-year term.

A tax lien is a statutory lien and therefore cannot be avoided under 11 U.S.C. §§ 522(f) or 547. However, cramming down the lien permitted in Chapter 13. The limitation on cramming down a lien under BPACPA applies only to PMSI claims, and a tax lien is not a PMSI.\textsuperscript{63}

**Setoff of Tax Refunds**

Although 11 U.S.C. § 362(b)(26) provides that the automatic stay does not apply to an effort by a taxing authority to setoff a tax refund for prepetition tax refunds against liabilities arising from prepetition tax years, the authority of the IRS to deny a debtor his or her refund when the same has been exempted has resulted in varied opinions among the courts.

The legal issues surrounding whether a debtor is entitled to his or her tax refund involve the interaction of competing Bankruptcy Code and Internal Revenue Code sections. Taxing authorities asserting the right of offset point to 11 U.S.C. § 553(a), which generally preserves a creditor’s right “to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . . against a claim of such creditor against the debtor that arose before the commencement of the case . . . ,” and 11 U.S.C. § 362(b)(26), which provides that “[t]he filing of a petition . . . does not operate as a stay . . . 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 date of the order for relief against an income tax liability for a taxable period that also ended before the date of the order for relief . . . .” However, debtors seeking to retain their refunds may attempt to do so under 11 U.S.C. § 522(c), which arguably

\textsuperscript{62} 26 U.S.C. §§ 6322 and 6502.

\textsuperscript{63} 11 U.S.C. § 1325(a)(9)
conflicts with the above provisions and provides that “property exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case . . . .”

Recently, the Bankruptcy Court for the Eastern District of Virginia considered the impact of §§ 553 and 522(c) and held that the debtors’ valid exemption of their prepetition tax refund takes precedence over the IRS’s right of offset.64 Other courts have taken a contrary view and permitted the offset of the debtor’s tax refund when the debtor has unpaid prepetition tax liability. For example, the Fifth Circuit concluded that under such circumstances, the debtor was not entitled to a refund and the tax refund did not even become property of the estate for the debtor exempt.65

**Obtaining Tax Account Transcripts**66

To obtain tax account transcripts, the client should complete and sign an IRS Form 8821, Tax Information Authorization, or the IRS Form 2848, Power of Attorney. “Fillable” forms are located at: http://www.irs.gov. When completing this form, a practitioner must include the specific years and types of tax that the client is authorizing the IRS to discuss or share with you. Note that the Service does not accept general grants of authority such as “all tax years on record.”

Once the taxpayer has signed the authorization form, you may either call the IRS or utilize the “self-help” options through e-Services. If you want information the same day, call the

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64 *Copley v. United States (In re Copley)*, 547 B.R. 176 (Bankr. E.D. Va. 2016) (Phillips, J.), Note: This case was affirmed by the District Court for the Eastern District of Virginia in *United States v. Copley*, 591 B.R. 263 (E.D. Va. Sept. 10, 2018) and is currently on appeal in the Fourth Circuit Court of Appeals, Docket #: 18-2347.
65 *In re Luongo*, 259 F.3d 323, 335 (5th Cir. 2001); accord, *In re Gould*, 603 F.3d 1100 (9th Cir. 2010), aff’d 401 B.R. 415 (BAP 9th Cir. 2009) (“[A]bsent an interest in the estate to the refund, it could not properly be exempted by the debtor under § 522.”).
66 The critical document for tax discharge analysis is the Tax Account Transcript, not to be confused with a Tax Return Transcript.
Practitioner Priority phone line at 1-866-860-4259 and be prepared to fax over the signed authorization. This method can be frustrating, however, due to wait times and disconnections. A less time-consuming approach is available online. If you take the time to register for the IRS e-Services at https://www.irs.gov/tax-professionals/e-services-online-tools-for-tax-professionals, the e-Services program allows tax professionals to complete transactions, such as downloading tax transcripts, online with the IRS. However, this approach is not without drawbacks either, which include: (1) delay (access to a particular account is typically not available until several days after the IRS authorization form is faxed in for the taxpayer), and (2) re-authentication (the IRS regularly requires re-registration of the tax professional and such authentication procedures can be frustrating).

Through these services, the IRS will ultimately provide Tax Account Transcripts by fax for each tax year requested. The IRS will also provide Tax Return Transcripts, which include the data reported by the taxpayer on a corresponding return. In addition, a practitioner may obtain transcripts showing third-party data helpful to the preparation of a return, such as a Form W-2 or 1099, reported for a taxpayer for a particular tax year. These documents are critical in analyzing the impact of a bankruptcy on a client with tax liabilities.

**Interpreting the Tax Account Transcripts**

The Tax Account Transcript includes important data for analyzing the dischargeability of tax debt. This system is based on a series of three-digit codes along with their effective date. An exhaustive list of the potential IRS codes is beyond the scope of this article; however, some of the most significant codes are described below.
Code 150 shows the date of effective assessment and the tax liability and amount of tax assessed is shown inside of parenthesis. A common indication of the preparation of a Substitute for Return is when the figure in the parenthesis is shown as $0.00.

Codes 290 and 300 indicate that additional tax has been assessed, so attorneys should be mindful of the start of a new 240-day time period.

The receipt of an Offer in Compromise is shown by Code 480, and Code 780 reflects the acceptance of the OIC by the IRS. Code 481 signifies the rejection or withdrawal of that OIC.

Bankruptcy filings, litigation, and requests for due process hearings are indicated by Code 520. Code 521 is used to show the conclusion of the 520 event.

Although the location of the filing is not shown, Code 582 identifies that a tax lien has been recorded. Additional information may be found in the IRS “Transaction Codes Pocket Guide” at www.irs.gov/pub/irs-utl/transaction_codes_pocket_guide.pdf.

Conclusion

With practice and study, the rules of tax-debt dischargeability become easier to apply to individual client circumstances. Getting comfortable with the interplay between tax and bankruptcy law will not only grow the scope of an attorney’s practice, but will improve the advice and options that are provided to clients. Armed with the knowledge of the tax discharge rules in bankruptcy, an attorney may dramatically improve the client’s situation by determining the best time to file a case and to how to offer the most protection for a client that may be delaying such a filing. Most importantly, though, the attorney will be able to set better and more accurate expectations for a client facing the stress of overwhelming tax debt.
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A Fresh Start with Flexibility
Consumers Can Modify the Treatment of a Secured Claim in a Confirmed Plan to Surrender Collateral Under § 1329

Five years is a long time. For many consumer bankruptcy debtors, committing to a five-year reorganization plan is a challenge. “What if I move, get married or lose my job?,” are frequent questions clients may ask prior to executing a petition, schedule, statement and plan. The decision to retain a secured vehicle or home, while at the same time committing to making up to 60 months of plan payments, can be daunting.

Congress acknowledged this difficulty that honest-but-unfortunate debtors face as they attempt to plan for the next five years of their life on a fixed budget. Section 1329 of the Bankruptcy Code serves as the all-important “peace-of-mind” factor, providing the ground rules for a debtor, trustee or holder of an allowed unsecured claim to seek modification of a plan after confirmation.

Although this section does not spell out a specific formula for changing the treatment of a secured claim to an unsecured claim by surrendering collateral, the language of § 1329 has been interpreted to permit this very act. A thorough analysis of this Code section demonstrates that the value of a secured creditor’s claim is more than adequately provided for based on other statutory requirements at the time of confirmation. The flexibility accorded to § 1329 by courts across the nation has no doubt contributed to the success of many plans that would have otherwise ended in dismissal. It follows that the equitable principle of allowing consumer debtors to have a “post-confirmation change of heart” is rightfully upheld by a majority of bankruptcy courts, giving debtors the freedom to alter the treatment and classification of secured claims at any time prior to the completion of their plan payments.

In the chapter 13 context, the most commonly filed post-confirmation modification involves the surrender of a car or house and the resulting treatment of that creditor’s claim. The authority of § 1329(a) establishes the threshold requirement for applications to modify a confirmed plan. Any proposed modified plan must (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 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. Critics argue that this language does little to alleviate the debtor from making full payments on a secured obligation. How, then, does this language actually translate to the surrender of collateral and the reclassification of a claim mid-plan?

The majority of courts that have dealt with this issue have looked beyond the plain meaning of the statute. At first blush, this language appears to be silent as to a modification that wholly changes the qualification of a creditor. On its face, § 1329 only provides for modifications that increase or reduce the amount of payments on a claim, or enlarge or reduce the time for making payments to a particular class of claims. However, the phrase “particular claims,” as used in § 1329(a)(1), is synonymous with the phrase “allowed secured claims” by virtue of secured creditors being a class of claims unto themselves.1 Thus, where each secured claim is considered to be its own “unique” class in a chapter 13 plan, the proposed increase or reduction in payments on that claim will constitute a permissible modification.

Practically speaking, § 1329(a)(1) might be read to allow for a proposed reduction in payments on a secured car loan. For example, a plan modification under § 1329(a)(1) might propose for the secured

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1 In re Fayson, 573 B.R. 531, 535.
creditor to go from receiving full equal monthly installments to receiving no payments whatsoever. Under § 1329(a)(1), any modification to alter payments made to a creditor in a particular class is a valid modification of the treatment of that class. Changing the classification of a secured auto lender to an unsecured creditor might therefore be accomplished, notwithstanding the additional requirements under § 1329(b) and (c).

Likewise, § 1329(a)(3) provides that distributions to a creditor treated under a plan might be modified to account for payments made outside the plan. Courts that allow for debtors to change the treatment of a secured creditor have ruled that the act of “surrendering collateral” constitutes a form of payment other than under the plan. Section 1329(a)(3) provides a mechanism to alter a secured claim and its treatment in light of any non-plan payment made on the claim (i.e., the surrender of collateral in full satisfaction of the claim in lieu of continued equal monthly installment payments). However, what about the so-called “binding effect” of the order confirming a plan? How is it possible, critics in the minority might ask, that this omnipotent contract between the debtor and his/her creditors can so easily be undone?

The answer is simple: A post-confirmation modification will amend the order confirming a plan as long as the modification itself conforms with the standards set forth under title 11 as of the time of confirmation. These significant requirements can be found in the remaining two subsections of § 1329, which encompass the prerequisites for confirmation. Subsection (c) prohibits a proposed modification from either extending the plan terms beyond 60 months or altering the debtor’s original plan-commitment period. Under the loftier subsection, § 1329(b)(1), any proposed plan modification must comport with the requirements of §§ 1322(a) and (b), 1323(c) and 1325(a).

While secured creditors tend to argue that under this provision debtors do not possess a universal right to make changes to the classification of their claims, it must be noted that secured creditors themselves are never permitted to seek modification of a debtor’s plan. All secured creditors must be treated in accordance with the provisions of §§ 1322 and 1325 as of the time of confirmation. In other words, by the time an allowed party-interest seeks modification of the plan, the debtor has already elected one of three treatments with respect to his/her secured creditors: He/she may (1) retain the collateral under § 1325(a)(5)(B), (2) surrender the collateral under § 1325(a)(5)(C), or (3) propose a modification of the secured claim so long as it falls within the confines of § 1325(a). Therefore, it makes sense that one of the three basic requirements for a plan to be modified necessitates that the modification comply with the standards for confirmation.

Under this analysis, any plan modification that is proposed in good faith pursuant to § 1325(a)(3), as incorporated by § 1329(b)(1), will automatically satisfy the statutory requirements for an allowed modification. Likewise, if a debtor has the option of retaining or surrendering secured collateral to satisfy a claim at the outset of his/her case, logic follows that this option must be available during the course of the confirmed plan. After all, § 1329 is regarded by most courts as being a nonprohibitive Bankruptcy Code section; it does not prevent the debtor or an allowed party from taking any action. Instead, it is generally recognized as permitting certain types of modifications.

Understanding this analysis is important for debtors because of the great possibility of a change in their circumstances following confirmation. A negative unforeseeable change in circumstances will likely affect the debtor’s ability to make payments on secured collateral and ultimately receive a chapter 13 discharge. The filing of a plan modification to surrender a vehicle might be the factor that allows a debtor to remain in chapter 13. While courts have disagreed on what constitutes the level of “change” necessary to substantiate a viable reclassification modification in order to surrender collateral, only the minority view continues to uphold what the Sixth Circuit characterized in Chrysler Financial Corp. v. Nolan (In re Nolan) as “injustice” flowing to the secured creditor due to the proposed modification sought by a debtor.

Nolan is one of the two pivotal minority opinions on this issue (both Sixth Circuit cases were issued prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)). The Nolan court refused to allow a chapter 13 debtor to modify her plan to surrender a crammed down vehicle with a bifurcated claim, which would have reclassified the deficiency balance as wholly unsecured. In doing so, the Sixth Circuit ruled that Congress did not intend “to allow debtors to reap a windfall by employing a subterfuge that unfairly shifts away depreciation, deficiency, and risk voluntarily assumed by the debtor.” Indeed, the debtor in Nolan stated in her pleadings that the vehicle in question no longer provided dependable transportation, and in connection with the intended reclassification of the unsecured portion of Chrysler’s claim, sought permission to incur credit in order to finance another vehicle. Notwithstanding the fact that the practice of bifurcating an auto loan into separate secured and unsecured claims was eliminated after BAPCPA, the Sixth Circuit’s ruling in this case is still upheld as the minority view.

This position offers a drastically different interpretation of the statute, finding that the debtor’s proposed modification stood at odds with the plain language of § 1329(a). The Nolan court found that the terms “claim” and “payment” have two separate meanings, which (in the minority view) operate to prevent a debtor from reclassifying a secured claim. The court articulated that § 1329(a) “clearly indicates that modifications after plan confirmation cannot alter a claim but can extend or compress payments and reduce or increase the amount of the delivery of value planned as an eventual satisfaction for the creditor’s claim.”

Despite this ruling by the Sixth Circuit, a majority of bankruptcy courts have correctly found that the surrender of a vehicle in this situation satisfies what the court described as “delivery of value planned as eventual satisfaction.” The current breadth of cases in the majority have criticized the Sixth

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2 Id. at 535.
3 See In re Evans, 349 B.R. 498, 501 (when debtor surrenders collateral pursuant to §1325(a)(5)(C), creditor is not entitled to deficiency claim; rather, surrender of vehicle fully satisfies debt).
4 In re Scarver, 555 B.R. 822, 834.
5 232 F.3d 528 (6th Cir. 2000).
6 Id. at 533.
7 Id. at 534.
8 Id. at 535.
It is undeniable that the current majority has it right: Secured creditors are not defenseless victims in the chapter 13 process, who deserve the heavy-handed protection afforded by the Sixth Circuit’s outdated opinion in Nolan. Secured creditors who attempt to challenge a debtor’s modification in this light should be forewarned: Absent a serious lack of good faith on the part of the movant, § 1329 operates to allow any permissible modification of a secured claim. These creditors can — and should — file objections to confirmation in order to ensure that they protect themselves from any depreciation of their collateral.13 Secured creditors can also take solace in knowing that the good-faith requirement pursuant to § 1325(a)(3) as incorporated by § 1329(b)(1) will serve as a gatekeeper to protect any reclassification modification that attempts to violate this pre-confirmation standard. A chapter 13 debtor’s right to surrender collateral and reclassify any resulting deficiency balance from a secured claim to an unsecured claim, if done in good faith, must be preserved.

Not only has this been the prevailing view of bankruptcy courts for more than 10 years,14 but it is logical and acceptable from the perspective of both a debtor and secured creditor. Where the debtor can no longer afford to maintain payments on a vehicle, the vehicle is returned to the lender — and the claim is satisfied by the value of the asset being reclaimed. Car lenders can agree that following BAPCPA, their position as secured creditors was strengthened15 with the elimination of the cramdown option on “910 claims.” This change has ensured that creditors receive a greater deal of value for their claims, if collateral with arguably less depreciation is eventually surrendered.

Courts are encouraged to uphold the majority’s broad view of § 1329, as its application provides both protection to secured creditors and flexibility to consumer debtors. To deprive a debtor of this right would be inequitable, render many plans unfeasible and ultimately prevent a great number of debtors from receiving a chapter 13 discharge. Furthermore, circumstances often change for chapter 13 debtors, causing their best intentions with regard to secured collateral and the treatment of the underlying debt to become impracticable or even impossible.

Under § 1329, debtors could seek to modify the terms of their plan when life deals them a bad hand in the form of a car accident, loss of income or other changes affecting their ability to make payments. Courts should continue to provide debtors with this vital flexibility, which often becomes a necessary vehicle (no pun intended) for making changes to their reorganization plans. 

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The Code Does Not Permit a Debtor
to Modify an Allowed Secured Claim

There are a multitude of life events that a debtor can experience during the duration of a chapter 13 bankruptcy proceeding. Marriage, a new job, relocation or an unexpected change in circumstances are just a few of the scenarios that chapter 13 practitioners have likely encountered throughout the course of their practices. However, perhaps none of these events lead to as much confusion for a diligent practitioner as when a debtor desires to surrender property back to a creditor when the debtor’s confirmed plan provides for payment of the secured claim through the plan.

However, this confusion is no fault of the practitioner, as both bankruptcy and appellate courts have also struggled with this issue. The courts have come to starkly contrasting conclusions as to whether a debtor has any right to surrender property to a creditor after proposing to pay on the same through a confirmed plan.1 This split of authority and resulting confusion is largely “created by an absence of clear statutory guidance.”2

As one bankruptcy court’s decision on this issue has noted, “Unfortunately, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) does not address this issue, which cries out for legislative remediation and clarification.” Despite the seeming lack of consensus on this issue, a reading of the applicable provisions of the Bankruptcy Code necessitates a determination that debtors cannot alter the treatment of an allowed secured claim only arises after the debtor’s confirmed plan has been confirmed.3

The Effect of Confirmation of a Debtor’s Chapter 13 Plan

The issue as to whether a debtor can surrender collateral to a secured creditor in full satisfaction of its allowed secured claim only arises after the debtor’s chapter 13 plan has been confirmed.2 Once a chapter 13 plan has been confirmed, it “binds the debtor and all creditors — whether provided for in the plan or not — to its terms.”3 However, modifications to a confirmed plan are permitted under 11 U.S.C. § 1329, so it is the “governing authority” with regard to the present issue.4

The Debtor Has Only a Limited Ability to Modify a Confirmed Chapter 13 Plan Under § 1329

Of relevance to the issue at hand, 11 U.S.C. § 1329(a)(1)-(3) reads as follows:

(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

1 In re Adkins, 425 F.3d 296 (6th Cir. 2008); In re Ramos, 540 B.R. 580 (Bankr. N.D. Tex. 2015); In re Arguin, 345 B.R. 876 (Bankr. N.D. Ill. 2006); In re Coleman, 231 B.R. 397 (Bankr. S.D. Ga. 1999); In re Kurtz, 502 B.R. 238 (Bankr. D. Colo. 2013) (finding that debtors could not modify confirmed plan to reclassify allowed claim of secured creditor); but see Bank One NA v. Leuellen, 322 B.R. 648 (S.D. Ind. 2005); In re Scarver, 555 B.R. 822 (Bankr. M.D. Ala. 2016) (finding that debtors could modify confirmed plan to reclassify allowed claim of secured creditor).
2 In re Arguin, 345 B.R. 876, 879 (Bankr. N.D. Ill. 2006).
3 In re Ramos, 540 B.R. 580, 583 (Bankr. N.D. Tex. 2015) (“While ... any debtor has the option of surrendering collateral to a secured lender on account of its secured claim at the time of confirming his or her original plan ... there is ... a significant split of authority on whether a debtor may modify a chapter 13 plan, post-confirmation and before completion of payments under the plan, to surrender collateral to a secured creditor.”).
5 In re Ramos, 540 B.R. 580, 584 (Bankr. N.D. Tex. 2015).
of any payment of such claim other than under the plan. 6

As noted in In re Ramos, 7 “These specific provisions do not mention surrender (of secured collateral) as a possibility (to modify a confirmed plan).” 8 Therefore, courts have found that pursuant to a plain reading of the language of the Bankruptcy Code, modifications to a debtor’s confirmed plan are only permissible in the “limited circumstances” that are expressly set forth in § 1329(a). 9 These “limited circumstances” give a debtor a right to “request an alteration of the amount or timing of specific payments,” but not to “alter, reduce, or reclassify a previously allowed claim.” 10

In the present scenario, by proposing to surrender collateral of a secured creditor after a plan has been confirmed in satisfaction of the secured claim, a debtor is seeking to not only change the amount or timing of payments to a creditor (as permitted under § 1329), but to unilaterally alter the rights of a secured creditor’s allowed claim by presumably reclassifying the claim as unsecured and reducing the dollar amount to be paid to said creditor after surrender of the collateral (which is not expressly authorized by § 1329). Given the undisputed negative impact that such an interpretation has on secured creditors, one can reasonably assume that had Congress intended § 1329 to have this effect, it would have made it abundantly clear. As a reading of § 1329 makes clear, such language is not present and was not contemplated.

Judicial attention to the express language (or absence thereof) in § 1329 as to the rights of a debtor to modify a secured creditor’s claim cannot be overstated when it comes to analyzing this issue. Simply put, the author agrees with the line of decisions that posit that it is dangerous to “ignore the fact that the word ‘surrender’ does not appear in § 1329 of the Bankruptcy Code.” 11 As noted in Ramos:

We are to presume that Congress means to use the words that it uses. Congress knew when to use the word “surrender”: when it wanted to. Congress used the word “surrender” in the set of options for treatment of secured claims in connection with confirmation under section 1325(a)(5).... “Confirmation” is one thing. It refers to confirmation of the original plan. “Modification” — which is sometimes proposed years subsequent to confirmation — is quite another. It refers to the specific types of changes listed in § 1329(a) of the Bankruptcy Code. 12

The position that § 1329 does not permit a debtor to reclassify a previously allowed secured claim is also supported by respected bankruptcy treatises. 13 For example, with regard to this exact issue, the In re Coleman 14 court noted that Norton Bankruptcy Law and Practice provides as follows:

[A] straightforward interpretation of the rule in Code § 1327(a) that the “provisions of a confirmed plan bind the debtor and each creditor...” is that it is binding on debtor and creditor, subject to a fair and justifiable modification of the amount or time of payments on the creditor’s claim as the language of Code § 1329(a) provides — not a change in part of the claim from secured to unsecured with a resultant change in the total amount to be paid. The latter attributes to Congress an unlikely intention to give the debtors the option to shift to holders of allowed secured claims any loss in the value of collateral. 15

In addition, allowing a debtor to reclassify a secured claim to an unsecured one, after confirmation of the debtor’s plan, “effectively reads (adequate protection provisions) out of the Code,” as “[o]nce allowed, a secured claim is fixed in amount and must be paid in full,” and the claim “cannot be altered.” 16 As noted in Coleman, “altering the amount or timing of payments on a secured claim cannot change the fact that, in the end, the full amount of the secured claim established, as of the effective date of the plan, must be paid.” 17

Therefore, giving such an expansive reading to 11 U.S.C. § 1329 appears not only to read terms into the Bankruptcy Code that are not present, but would subject secured creditors to “the unilateral whims of a debtor throughout the life of a plan.” 18 Therefore, it is easy to see why courts are concerned with this concept, and this reasoning relates back to the fact that Congress did not insert any language permitting the surrender of collateral into § 1329. Had Congress intended that secured creditors’ rights could be modified at the unilateral request of the debtor, it is reasonable to think that such language surely would have made its way into § 1329. It did not, thus giving such a broad reading to § 1329 is problematic.

Broad Interpretations of § 1329 Run Afoul of Other Code Sections

The cases that take the position that a debtor has the right to surrender collateral to a secured creditor in satisfaction of its unpaid secured claim, despite a confirmed plan providing otherwise, generally rely on 11 U.S.C. § 1322(b)(8) as the authority contemplating surrender of collateral as a form of payment. 19 Emphasis is made on

\[\text{6} \text{11 U.S.C. § 1329}(b)(1), (2) and (3).\]
\[\text{7} \text{540 B.R. 580 (Bankr. N.D. Tex. 2015).}\]
\[\text{8} \text{Id. at 584.}\]
\[\text{9} \text{In re Arguin, 345 B.R. 875, 879 (citing In re Wilkoskey, 16 F.3d 739, 745 (7th Cir. 1994)).}\]
\[\text{10} \text{Id. at 890 (citing In re Nolan, 232 F.3d 529, 532 (6th Cir. 2000)).}\]
\[\text{11} \text{In re Ramos, 540 B.R. 580, 593 (Bankr. N.D. Tex. 2015); see also generally In re Hubble, 371 B.R. 730 (Bankr. E.D. Pa. 2007); In re Kurtz, 502 B.R. 238 (Bankr. D. Colo. 2013); In re Arguin, 345 B.R. 876 (Bankr. N.D. Ill. 2006); In re Adkins, 425 F.3d 296 (6th Cir. 2005); Chrysler Fin. Corp. v. Nolan (In re Nolan), 232 F.3d 529 (6th Cir. 2000).}\]
\[\text{12} \text{In re Ramos, 540 B.R. 580, 593-594 (Bankr. N.D. Tex. 2015).}\]
\[\text{15} \text{Id. (citing Norton Bankruptcy Law and Practice 2d, § 124:3 n.79, pp. 124-27 (1993)).}\]
\[\text{17} \text{Id. at 399-400.}\]
\[\text{18} \text{Id. at 400.}\]
§ 1329(b)(1), which provides that § 1322(b) applies to modifications of confirmed plans, and on § 1322(b)(8), which provides that the plan “may provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor.”

Thus, the argument follows that § 1322(b)(8) therefore “contemplates surrender of collateral as a form of payment,” and that said section “applies without qualification” to plan modifications under § 1329(b)(1).”

This view also posits that 11 U.S.C. § 1325(a)(5), which governs when the court shall confirm a plan with regard to secured claims, is incorporated into § 1329(a) due to the language present in § 1329(b). Therefore, in order for a plan to be modified under § 1329, it must also meet at least one of the subprovisions contained in § 1325(a)(5) governing confirmation of a chapter 13 plan, one of which states that a plan can be confirmed if, with respect to an allowed secured claim, “the debtor surrenders the property securing such claim to such holder.” Thus, these cases take the position that through Congress’s “explicit incorporation” of § 1322(b) and 1325(a) into § 1329(a), “Chapter 13 debtors retain the option to seek court permission to modify a confirmed plan by surrendering collateral to pay a secured claim.”

However, this analysis overlooks the express provisions of 11 U.S.C. § 1327, entitled “Effect of Confirmation.” In relevant part, § 1327 provides that both a debtor and creditor are bound by the provisions of a confirmed plan. As astutely noted in In re Kurtz, the line of cases that propose a broad interpretation of § 1329 “render[s] § 1327 meaningless.” Pursuant to Kurtz, “If a debtor can modify the claims of his secured creditors whenever the value of the creditor’s collateral depreciates, then that debtor has not been bound by his confirmed plan.”

In addition, not only does a broad interpretation of § 1329 appear to run afield of § 1327, it also overlooks and runs contrary to other key provisions of § 1325 that govern plan confirmation. Specifically, § 1325(a) “ties the value of property to be distributed on account of the allowed secured claim to the effective date of the plan.” As noted by Kurtz, this means that a debtor simply cannot “recalculate the amount of the ‘allowed secured claim’ based upon the depreciated value of the collateral after surrender and sale of the collateral, and discharge the new deficiency amount.”

Some proponents of a broad reading of § 1329 also advocate for the position that 11 U.S.C. § 502(j) (which provides, inter alia, that a claim that “has been allowed or disallowed may be reconsidered for cause” provides a basis for a court to revisit the issue of secured claim valuation and payout. However, this position appears to conflict with the express language of § 502(j) (as only the “allowance” or “disallowance” of claims are contemplated by this provision, not a “recalculation”), and necessarily conflicts with § 1329(b), as § 502(j) is not one of the Bankruptcy Code sections that Congress chose to incorporate into § 1329. As succinctly stated by the court in In re Arguin, “Nothing in ... § 502(j) ... allows a confirmed plan to be modified; only § 1329(a) allows plan modification.”

**Conclusion**

The issue of whether the allowed claim of a secured creditor may be modified post-confirmation by a debtor seeking to surrender the collateral is one that has sharply divided courts for a number of years. Both sides of the issue reference specific sections in support of their position. However, based on a plain reading of the Bankruptcy Code, had Congress intended to permit a broad application of plan modification under § 1329, it could have inserted language to do so. It did not, so a debtor must therefore not be allowed to modify the allowed claim of a secured creditor post-confirmation. 

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**Debtors Are Collaterally Estopped from Revaluing a Creditor’s Secured Claim After Confirmation**

Even if property is surrendered to a creditor after confirmation, a debtor is unable to modify the amount of the allowed secured claim post-confirmation. Since a confirmed plan fixes a secured claim’s value, “that issue cannot be revisited or revised” after confirmation.

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21 Id.
22 Id.
23 Id. (citing 11 U.S.C. § 1329(a)(5)(C)).
24 Id. at 653 (citing In re Jock, 95 B.R. 75, 77 (Bankr. M.D. Tenn. 1989); In re Rimmer, 143 B.R. 871, 876 (Bankr. W.D. Tenn. 1992)).
27 Id. at 244.
28 Id. (citing 11 U.S.C. § 1325(a)).
29 Id.
33 In re Adkins, 425 F.3d 296, 304 (6th Cir. 2005).
34 345 B.R. 876, 881 (Bankr. N.D. Ill. 2006).
35 Id.
This matter comes before the Court on the Debtors’ Motion for Leave to File Proof of Claim on Behalf of Creditor (Doc. 80) (the “Motion”) filed by James and Marie Braun (the “Debtors”) on March 13, 2019. Through the Motion, the Debtors seek authority to file a proof of claim on behalf of Ford Motor Credit Co. (“Ford”) pursuant to sections 105, 501 and 502 of Title 11, United States Code (the “Bankruptcy Code”), Rules 3002 and 3004 Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”) and Local Bankruptcy Rule 3001-1.

The Motion was served on the U.S. Trustee, the Chapter 13 Trustee, and Ford and its counsel, and no objection or responsive pleading to the Motion has been filed. The Court finds
that the Motion is well-taken and it is hereby GRANTED. The Debtors shall have fourteen (14) days from the entry of this Order in which to file a proof of claim on behalf of Ford. The proof of claim so filed shall be allowed and paid pursuant to Debtors’ Chapter 13 Plan the same as if the proof of claim had been timely filed pursuant to Bankruptcy Rule 3004.

IT IS SO ORDERED.

Submitted by:

/s/ John W. Kennedy
Myron N. Terlecky (0018628)
John W. Kennedy (0042672)
Strip, Hoppers, Leithart, McGrath & Terlecky Co., LPA
575 South Third St.
Columbus, OH 43215
T: (614) 228-6345
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Email: jwk@columbuslawyer.net
Attorneys for James and Marie Braun

Copies to Default List plus:

Ford Motor Credit Co.
PO Box 105704
Atlanta, GA 30348

Cynthia A. Jeffrey
Reimer Law Co.
30455 Solon Rd.
Solon, OH 44139
IT IS SO ORDERED.

Dated: April 16, 2019

John E. Hoffman, Jr.
United States Bankruptcy Judge
and neither the Debtor nor the Trustee filed one on its behalf. See Fed. R. Bankr. P. 3004 (permitting the debtor or trustee to file a proof of claim on a creditor’s behalf within 30 days after the expiration of the bar date).

TLOA now requests that the Court exercise its “equitable power to allow a proof of claim notwithstanding the bar date.” Mot. at 1 (citing Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P’ship, 507 U.S. 380 (1993)). But the Court does not have the equitable power to authorize the filing of a late proof of claim in a Chapter 13 case. Rule 3002(c) of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), which establishes the deadline to file a proof of claim in Chapter 13 cases, “is strictly construed as a statute of limitations barring the late filing of proofs of claim.” In re Cade, 552 B.R. 800, 803 (Bankr. S.D. Ohio 2014) (quoting In re Bailey, 151 B.R. 28, 30 (Bankr. N.D.N.Y. 1993)); United States v. Chavis (In re Chavis), 47 F.3d 818, 823–24 (6th Cir. 1995) (holding that the bankruptcy court properly disallowed a late-filed claim upon objection of Chapter 13 debtors); In re Tench, No. 15-8026, 2016 WL 2892497, at *5 (B.A.P. 6th Cir. May 11, 2016) (holding that excusable neglect does not provide a basis for allowance of an untimely proof of claim over Chapter 13 debtors’ objection). Unless one of the exceptions set forth in Bankruptcy Rule 3002(c) is applicable, the Court has no authority to extend the proof of claim bar date in a Chapter 13 case. Fed. R. Bankr. P. 9006(b)(3) (“The court may enlarge the time for taking action under [Rule 3002(c)] only to the extent and under the conditions stated in [that] rule[].” (emphasis added)).

1 Although it correctly points out that the Supreme Court in Pioneer discussed a bankruptcy court’s equitable power to authorize late-filed proofs of claim, TLOA fails to note that Pioneer was decided in the context of a Chapter 11 case, in which proofs of claim are governed by Bankruptcy Rule 3003 rather than 3002. The Supreme Court itself recognized this distinguishing feature, noting that Bankruptcy Rule 9006’s “excusable neglect” standard “governs late filings of proofs
Accordingly, the Motion is **DENIED**.²

**IT IS SO ORDERED.**

Copies to:

Default List
Austin B. Barnes, Attorney for TLOA Acquisitions, LLC–Series 2 (electronically)
TLOA Acquisitions LLC–Series 2, 11 Talcott Notch Road, Farmington, CT 06032-1817

# # #

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THE CO-DEBTOR

By Victoria A. Ferraro

As we travel down the road on our trip of car issues, we must consider questions related to the non-filing co-debtor, or our joint borrower and co-owner of the collateral, which was given as security in the underlying contract.

In the bankruptcy world, the word “co-debtor” is an undefined term. So… who is the co-debtor? A co-debtor is one of two (or more) borrowers that are primarily liable on the same debt. Upon a bankruptcy filing, an automatic stay goes into effect that prohibits a creditor’s ability to collect a consumer debt from the non-filing co-debtor. A codebtor is someone who must pay off a debt owed by the debtor (the person who files for bankruptcy) if the debtor fails to do so.

**The Co-Debtor Stay:**

- Pursuant to 11 U.S.C. §1301
- Applies to Consumer debts only (i.e., debt incurred for a personal, family, or household purpose)
- Like the automatic stay, applies to co-debtors on loans with a bankrupt debtor and prevents actions by creditors against non-filing co-obligor
- Remains in place until case is closed; dismissed; or converted to another chapter; or until the co-debtor stay is lifted by the court upon a creditor’s motion.

While this stay prevents the creditor from collecting against the co-debtor while it is in effect, what are the secured creditor’s rights after the stay is lifted and/or at the conclusion of the debtor’s bankruptcy case? Can the collection process against the co-debtor include executing the secured creditor’s lien upon the collateral? Naturally, it is safe to assume that the lien given to the secured creditor attaches to all the borrowers’ interest in the collateral outside the context of a bankruptcy; however, after the filing of a bankruptcy, does the lien remain an interest in the Collateral securing not only the debtor’s repayment of the amounts due under the Contract but also that of the non-filing co-debtor’s obligations under the Contract? What is the impact on the lien when there is a codebtor? Does the secured creditor’s lien still attach to the non-filing co-
debtor's interest? Can this lien be stripped off in its entirety simply because one borrower filed for bankruptcy relief? Do you feel like you are presently receiving the third degree?

Assume a mother and daughter enter into a Retail Installment Sales Contract for the purchase of a vehicle, and the mother shall be the primary driver. The bank is granted a purchase money security interest in the vehicle, and both the mother and daughter are noted as owners on the Certificate of Title. If the mother and daughter fail to pay the amounts due under the Contract outside of bankruptcy, then the bank may exercise its rights under the Contract, including, but not limited to, repossessing and selling the vehicle. But let's say that the mother files for protection under Chapter 13 and includes the vehicle in her chapter 13 plan to be paid in the full amount of the debt, but at a reduced rate of interest. What happens to the bank's lien? Section 1325(a)(5)(B)(i) appears to provide the debtor the power to strip off a lien at the earlier of discharge or payment under non-bankruptcy law, but our hypothetical involves a lien securing the indebtedness of a co-debtor. Several courts have reviewed this issue and have refused to allow lien stripping when the lien also secures the obligation of a non-filer.
In *In re Leonard*, 307 B.R. 611, (Bankr. E.D. Tenn. 2004), the debtors filed a motion requesting the entry of an order by the court directing the creditor to release its lien on a Collateral, and to turn over title to the debtor’ vehicle after they received a discharge. The Court noted that the debtor was no longer liable for any deficiency balance owing on the Collateral. However, because the contract balance was not paid in full, the creditor still retained a lien on the Collateral as to the non-filing co-debtor, and the non-filing co-debtor was still liable for the deficiency balance and any accruing interest. Although the creditor was enjoined by the discharge injunction from proceeding against the debtor, the Court noted that the creditor had every right to proceed against the non-filing co-debtor personally and against the Collateral in which the non-filing co-debtor had granted a security interest. Accordingly, the court found that the creditor was not required to release its lien and turn over title to any party until it was paid in full.

In *In re Books*, 304 B.R. 648 (Bankr. D. Me. 2006), the debtors’ confirmed plan provided the creditor a bifurcated claim with the unsecured portion being paid a 100% dividend. After confirmation, the debtors were granted an order authorizing them to sell the collateral free and clear of "liens, claims, encumbrances and other interests". The sale order authorized the debtors to sell their interest in the car, free and clear of the creditor’s lien. The Court stated that the sale order authorized the debtor to sell her interest in the car free and clear of the creditor’s lien, but it did not follow, however, that that authorization required the creditor to release its lien in a case such as this where a non-debtor remains liable on the debt. The Court, citing *In re Harris*, stated that while the creditor could not collect from the codebtor during the pendency of the bankruptcy, it has no obligation to release its lien until it is paid in full.\(^1\)

Likewise, in *In re Jackson*, 2012 WL 6623497 (Bankr.M.D.Ga. 2012), the Bankruptcy Court addressed the effect of a Chapter 13 plan's lien release provision on a Collateral partially owned by the debtor where the co-owner was also liable on the loan. In *Jackson*, the debtor's plan provided that "all holders of liens other than long term debt . . . shall cancel said liens within 15 days following notification of the debtor(s) discharge." *Id.* at *1. The creditor objected to the lien release provision in the plan, arguing that unless the debtor was proposing to pay the claim at the contract rate of interest, the creditor was entitled to recover from the co-signer the difference between the contract rate of interest and the rate of interest provided in the debtor's plan. The Court ruled that the lien release provision was only applicable to the Debtor’s interest in the property; however, the lien would remain in place and could be enforced as to the co-signer's interest in the Collateral until such time as the creditor received full payment of its claim at the contract rate. *Id.*

In *In re Faulkner*, 2013 Bankr. LEXIS 2018 (Bankr. C.D.Ill. 2013), the debtor’s confirmed chapter 13 plan provided the creditor a bifurcated secured claim. After the debtor’s

\(^{1}\) *Id.* at 654 citing *See In re Harris*, 199 B.R. 434, 438 (Bankr. D.N.H.1996) (recognizing that creditor's personal and in rem claims against non-filing co-debtor are not affected by Chapter 13, except by the co-debtor stay); 5 William L. Norton, Jr. *Norton Bankruptcy Law and Practice 2d* § 118:5 (1997 & Supp.2005) (secured creditor's right to collect debt from non-debtor third party endures unless debt is fully paid through Chapter 13 plan).
discharge, the creditor refused to release its lien on the collateral because the non-filing debtor had not satisfied the remaining amounts due under the contract. The debtor filed an adversary proceeding. The Court stated that nothing in Section 524 restricted the creditor from asserting its rights against the codebtor for any deficiency balance. The Court concluded that “the debtor’s plan, no matter how clear and conspicuous, can only serve to release [the secured creditors’]’s lien as to the debtor’s interest in the vehicle. . . [and the secured creditor]’s lien remains in place and can be enforced against the non-filing co-debtor’s interest in the vehicle” until the entire amount owed under the contract was paid in full.

The Faulkner Court reviewed 11 U.S.C. §524 as it relates to the codebtor. Section 524(e) makes clear that the “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” In our situation, the co-debtor is another entity fully liable for the entire Contract subject to discharge in this case. In addition, the secured creditor’s lien is property that wholly secures the co-debtor’s liability on the Contract. Analyzing Section 524(e), the debtor’s discharge of his/her obligation on the Contract does not affect the liability of the co-debtor or the secured creditor’s lien securing the liability of the co-debtor under the Contract. More importantly, Section 524(e) prohibits the debtor from affecting the co-debtor’s liability related to the debt. The co-debtor’s liability is both in personam and in rem. The co-debtor’s in rem liability is set forth in the Contract – and gives the secured creditor the right to pursue the co-debtor’s liability in rem – against the Collateral. Section 524(e) states that debtor’s discharge does not affect the co-debtor’s in rem liability under the Contract.

Another example of limitations regarding non-filers comes from cases interpreting jointly owned property under Section 1322(b)(2). The Fourth Circuit has held that Section 1322(b)(2)’s power to lien strip is not available when a non-filer had an interest in the property. Other courts have similarly disallowed lien stripping under Section 1322(b)(2) where a non-filer also had an interest in the property.

What is the impact of the vesting of property at confirmation or discharge on the debtor's car?

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2 “We hold that the bankruptcy court correctly determined that it lacked authority to strip off the debtor’s valueless lien because only the debtor’s interest in the estate, rather than the complete entireties estate, was before the bankruptcy court.” In re Alvarez, 733 F.3d 136, 138 (4th Cir. 2013).
3 See In re Hunter, 284 B.R. 806 (Bankr. E.D. Va. 2002); In re Pierre, 468 B.R. 419 (Bankr. M.D. Fla. 2012) and In re Erdman, 446 B.R. 861 (Bankr. N.D. Ill. 2011) (“only one spouse, Catherine, is eligible to strip the lien. Such result would leave the Defendant [mortgagee] with no lien on Catherine’s interest but “with an unmodified lien on [Alexander’s] interest – a split personality that probably isn’t easily described or digested under state property law” citing Lundin, §128.1 at ¶28).
11 U.S.C. §1327 suggests a mode of lien stripping…it provides that, except as otherwise provided in the plan or the order confirming the plan, the confirmation of the plan vests all property of the estate in the Debtor. 11 U.S.C. §1327(c) further states that property vesting in the Debtor is free and clear of any claim or interest of any creditor provided for by the plan. Courts have noted the difficulty in relying on “vesting” under 1327 to extinguish liens. In In re Scheierl, the court denied confirmation of a plan that would release an undersecured creditor’s lien upon payment of the secured portion of its claim. In response to the argument that confirmation restricts a secured creditor’s lien rights in a Chapter 13 case, the Court stated, “‘[R]evesting’ . . . does nothing to affect the extent of a creditor’s pre-existing secured rights in the subject asset. In itself, ‘revesting’ can only transfer legal title from the fictive possession of the bankruptcy estate back to the debtor; it cannot affect the status of liens.” 4 Section 1325(a)(5)(B)(i)’s negative inference is that liens go away at the earlier of payment under applicable non-bankruptcy law or discharge. But that could also be read as a lien retention provision to avoid the perceived result of Section 1327(c) vesting of property “free and clear” of the lien.

Most of my clients find the vesting of property free and clear of liens at confirmation problematic and thus, seek that the property vest in the Debtor only upon discharge. However, if a Codebtor is on the contract, we further seek to have the language in the plan modified to state that the Collateral shall not, at confirmation, vest in the Debtor free and clear of the Creditor’s lien under Section 1327(c), and that the lien on the Debtor's interest in the Collateral continues until the earlier of payment under applicable non-bankruptcy law or discharge but continues against the non-filing co-debtor's interest in the Collateral until payment in full under applicable non-bankruptcy law.

So, what has been your experience with how creditors handle an account when there is a Codebtor on the contract? Have you been faced with the question of whether the Creditor must release its lien in its entirety in conformity with the language in 11 U.S.C. §1325(a)(5)(B)(i) or whether its lien continues post-discharge until payment in full of the contract under applicable non-bankruptcy law based on the non-filing Codebtor’s interest? This is important to consider

because the debt is not always treated in full per the terms of the contract in a chapter 13 plan, and a remaining indebtedness will be left due and owing, which would still be secured by the collateral. Thus, should the chapter 13 plan be modified in these circumstances?

The Model Plan has raised some concerns related to the lien release when a codebtor is on the contract. Regarding the lien release provision, the model form mirrors the statute on the lien retention language but added, "at which time the lien will terminate and be released by the creditor." This language has opened the door for attacks when there is a non-filer on the account and the creditor seeks its lien to continue to secure the indebtedness of the non-filer. However, regardless of whether the plans simply note the section “11 USC 1325”; state that Each creditor listed below will retain its lien on the property interest of the debtor(s) or the estate(s); or in the language “at which time the lien will terminate and be released by the creditor,” the cases are still holding strong. The debtor does not have any power to modify the debt owed by the co-debtor. If there is not a full payment of the co-debtor’s indebtedness secured by the vehicle, then the creditor’s lien continues to secure the indebtedness of the co-debtor and may not be stripped off by the debtor.
To Debtors: This form sets out options that may be appropriate in some cases, but the presence of an option on the form does not indicate that the option is appropriate in your circumstances or that it is permissible in your judicial district. Plans that do not comply with local rules and judicial rulings may not be confirmable.

In the following notice to creditors, you must check each box that applies.

To Creditors: Your rights may be affected by this plan. Your claim may be reduced, modified, or eliminated. You should read this plan carefully and discuss it with your attorney if you have one in this bankruptcy case. If you do not have an attorney, you may wish to consult one.

If you oppose the plan's treatment of your claim or any provision of this plan, you or your attorney must file an objection to confirmation at least 7 days before the date set for the hearing on confirmation, unless otherwise ordered by the Bankruptcy Court. The Bankruptcy Court may confirm this plan without further notice if no objection to confirmation is filed. See Bankruptcy Rule 3015. In addition, you may need to file a timely proof of claim in order to be paid under any plan.

The following matters may be of particular importance. Debtors must check one box on each line to state whether or not the plan includes each of the following items. If an item is checked as “Not Included” or if both boxes are checked, the provision will be ineffective if set out later in the plan.

<table>
<thead>
<tr>
<th>Option</th>
<th>Included</th>
<th>Not Included</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 A limit on the amount of a secured claim, set out in Section 3.2, which may result in a partial payment or no payment at all to the secured creditor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2 Avoidance of a judicial lien or nonpossessory, nonpurchase-money security interest, set out in Section 3.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.3 Nonstandard provisions, set out in Part 8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Part 2: Plan Payments and Length of Plan

2.1 Debtor(s) will make regular payments to the trustee as follows:

$ ___________ per_______ for _____ months
[and $ ___________ per_______ for _____ months.] Insert additional lines if needed.

If fewer than 60 months of payments are specified, additional monthly payments will be made to the extent necessary to make the payments to creditors specified in this plan.
2.2 Regular payments to the trustee will be made from future income in the following manner:

Check all that apply.

☑ Debtor(s) will make payments pursuant to a payroll deduction order.
☑ Debtor(s) will make payments directly to the trustee.
☐ Other (specify method of payment): ________________________________.

2.3 Income tax refunds.

Check one.

☐ Debtor(s) will retain any income tax refunds received during the plan term.
☐ Debtor(s) will supply the trustee with a copy of each income tax return filed during the plan term within 14 days of filing the return and will turn over to the trustee all income tax refunds received during the plan term.
☐ Debtor(s) will treat income tax refunds as follows:

____________________________________________________________________________________
____________________________________________________________________________________

2.4 Additional payments.

Check one.

☐ None. If “None” is checked, the rest of § 2.4 need not be completed or reproduced.
☐ Debtor(s) will make additional payment(s) to the trustee from other sources, as specified below. Describe the source, estimated amount, and date of each anticipated payment.

____________________________________________________________________________________
____________________________________________________________________________________

2.5 The total amount of estimated payments to the trustee provided for in §§ 2.1 and 2.4 is $ ________________.

Part 3: Treatment of Secured Claims

3.1 Maintenance of payments and cure of default, if any.

Check one.

☐ None. If “None” is checked, the rest of § 3.1 need not be completed or reproduced.
☐ The debtor(s) will maintain the current contractual installment payments on the secured claims listed below, with any changes required by the applicable contract and noticed in conformity with any applicable rules. These payments will be disbursed either by the trustee or directly by the debtor(s), as specified below. Any existing arrearage on a listed claim will be paid in full through disbursements by the trustee, with interest, if any, at the rate stated. Unless otherwise ordered by the court, the amounts listed on a proof of claim filed before the filing deadline under Bankruptcy Rule 3002(c) control over any contrary amounts listed below as to the current installment payment and arrearage. In the absence of a contrary timely filed proof of claim, the amounts stated below are controlling. If relief from the automatic stay is ordered as to any item of collateral listed in this paragraph, then, unless otherwise ordered by the court, all payments under this paragraph as to that collateral will cease, and all secured claims based on that collateral will no longer be treated by the plan. The final column includes only payments disbursed by the trustee rather than by the debtor(s).

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
<th>Current installment payment (including escrow)</th>
<th>Amount of arrearage (if any)</th>
<th>Interest rate on arrearage (if applicable)</th>
<th>Monthly plan payment on arrearage</th>
<th>Estimated total payments by trustee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$_________________</td>
<td>$_________</td>
<td>______%</td>
<td>$_________</td>
<td>$_________</td>
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<tr>
<td>Disbursed by:</td>
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<td></td>
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</tr>
<tr>
<td>☐ Trustee</td>
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</tr>
<tr>
<td>☐ Debtor(s)</td>
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<td>$_________________</td>
<td>$_________</td>
<td>______%</td>
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<td>$_________</td>
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<tr>
<td>Disbursed by:</td>
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<tr>
<td>☐ Trustee</td>
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</tr>
<tr>
<td>☐ Debtor(s)</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.
3.2 Request for valuation of security, payment of fully secured claims, and modification of undersecured claims. Check one.

☑ None. If “None” is checked, the rest of § 3.2 need not be completed or reproduced.

The remainder of this paragraph will be effective only if the applicable box in Part 1 of this plan is checked.

☑ The debtor(s) request that the court determine the value of the secured claims listed below. For each non-governmental secured claim listed below, the debtor(s) state that the value of the secured claim should be as set out in the column headed Amount of secured claim. For secured claims of governmental units, unless otherwise ordered by the court, the value of a secured claim listed in a proof of claim filed in accordance with the Bankruptcy Rules controls over any contrary amount listed below. For each listed claim, the value of the secured claim will be paid in full with interest at the rate stated below.

The portion of any allowed claim that exceeds the amount of the secured claim will be treated as an unsecured claim under Part 5 of this plan. If the amount of a creditor’s secured claim is listed below as having no value, the creditor’s allowed claim will be treated in its entirety as an unsecured claim under Part 5 of this plan. Unless otherwise ordered by the court, the amount of the creditor’s total claim listed on the proof of claim controls over any contrary amounts listed in this paragraph.

The holder of any claim listed below as having value in the column headed Amount of secured claim will retain the lien on the property interest of the debtor(s) or the estate(s) until the earlier of:

(a) payment of the underlying debt determined under nonbankruptcy law, or
(b) discharge of the underlying debt under 11 U.S.C. § 1328, at which time the lien will terminate and be released by the creditor.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Estimated amount of creditor’s total claim</th>
<th>Collateral</th>
<th>Value of collateral</th>
<th>Amount of claims senior to creditor’s claim</th>
<th>Amount of secured claim</th>
<th>Interest rate</th>
<th>Monthly payment to creditor</th>
<th>Estimated total of monthly payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$________</td>
<td>$_______</td>
<td>$_______</td>
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<td>__%</td>
<td>$_______</td>
<td>$_______</td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

3.3 Secured claims excluded from 11 U.S.C. § 506.

Check one.

☐ None. If “None” is checked, the rest of § 3.3 need not be completed or reproduced.

☐ The claims listed below were either:

(1) incurred within 910 days before the petition date and secured by a purchase money security interest in a motor vehicle acquired for the personal use of the debtor(s), or

(2) incurred within 1 year of the petition date and secured by a purchase money security interest in any other thing of value.

These claims will be paid in full under the plan with interest at the rate stated below. These payments will be disbursed either by the trustee or directly by the debtor(s), as specified below. Unless otherwise ordered by the court, the claim amount stated on a proof of claim filed before the filing deadline under Bankruptcy Rule 3002(c) controls over any contrary amount listed below. In the absence of a contrary timely filed proof of claim, the amounts stated below are controlling. The final column includes only payments disbursed by the trustee rather than by the debtor(s).

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
<th>Amount of claim</th>
<th>Interest rate</th>
<th>Monthly plan payment</th>
<th>Estimated total payments by trustee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>------------</td>
<td>----------------</td>
<td>--------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$________</td>
<td>__%</td>
<td>$________</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Disbursed by:

☑ Trustee
☑ Debtor(s)

| Name of creditor | Collateral | Amount of claim | Interest rate | Monthly plan payment | Estimated total payments by trustee |
|------------------|------------|----------------|--------------|                      |                                   |
|                   | $________ | __%            | $________    |                      |                                   |

Disbursed by:

☑ Trustee
☑ Debtor(s)

Insert additional claims as needed.
### 3.4 Lien avoidance.

**Check one.**

- None. If “None” is checked, the rest of § 3.4 need not be completed or reproduced.

  **The remainder of this paragraph will be effective only if the applicable box in Part 1 of this plan is checked.**

- The judicial liens or nonpossessory, nonpurchase money security interests securing the claims listed below impair exemptions to which the debtor(s) would have been entitled under 11 U.S.C. § 522(b). Unless otherwise ordered by the court, a judicial lien or security interest securing a claim listed below will be avoided to the extent that it impairs such exemptions upon entry of the order confirming the plan. The amount of the judicial lien or security interest that is avoided will be treated as an unsecured claim in Part 5 to the extent allowed. The amount, if any, of the judicial lien or security interest that is not avoided will be paid in full as a secured claim under the plan. See 11 U.S.C. § 522(f) and Bankruptcy Rule 4003(d). *If more than one lien is to be avoided, provide the information separately for each lien.*

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Information regarding judicial lien or security interest</th>
<th>Calculation of lien avoidance</th>
<th>Treatment of remaining secured claim</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a. Amount of lien</td>
<td>$_________________________</td>
<td>Amount of secured claim after avoidance (line a minus line f)</td>
</tr>
<tr>
<td></td>
<td>b. Amount of all other liens</td>
<td>$_________________________</td>
<td>Interest rate (if applicable)</td>
</tr>
<tr>
<td></td>
<td>c. Value of claimed exemptions</td>
<td>+ $_____________________</td>
<td>%</td>
</tr>
<tr>
<td></td>
<td>d. Total of adding lines a, b, and c</td>
<td>$_______________________</td>
<td>Monthly payment on secured claim</td>
</tr>
<tr>
<td></td>
<td>e. Value of debtor(s)' interest in property</td>
<td>$_______________________</td>
<td>$_________________________</td>
</tr>
<tr>
<td></td>
<td>f. Subtract line e from line d.</td>
<td>$_______________________</td>
<td>Estimated total payments on secured claim</td>
</tr>
</tbody>
</table>

**Extent of exemption impairment (Check applicable box):**

- Line f is equal to or greater than line a.
  - The entire lien is avoided. *(Do not complete the next column.)*

- Line f is less than line a.
  - A portion of the lien is avoided. *(Complete the next column.)*

*Insert additional claims as needed.*

### 3.5 Surrender of collateral.

**Check one.**

- None. If “None” is checked, the rest of § 3.5 need not be completed or reproduced.

- The debtor(s) elect to surrender to each creditor listed below the collateral that secures the creditor's claim. The debtor(s) request that upon confirmation of this plan the stay under 11 U.S.C. § 362(a) be terminated as to the collateral only and that the stay under § 1301 be terminated in all respects. Any allowed unsecured claim resulting from the disposition of the collateral will be treated in Part 5 below.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Insert additional claims as needed.*
Part 4: Treatment of Fees and Priority Claims

4.1 General
Trustee’s fees and all allowed priority claims, including domestic support obligations other than those treated in § 4.5, will be paid in full without postpetition interest.

4.2 Trustee’s fees
Trustee’s fees are governed by statute and may change during the course of the case but are estimated to be _______% of plan payments; and during the plan term, they are estimated to total $___________.

4.3 Attorney’s fees
The balance of the fees owed to the attorney for the debtor(s) is estimated to be $___________.

4.4 Priority claims other than attorney’s fees and those treated in § 4.5.
Check one.
☑ None. If “None” is checked, the rest of § 4.4 need not be completed or reproduced.
☐ The debtor(s) estimate the total amount of other priority claims to be ____________.

4.5 Domestic support obligations assigned or owed to a governmental unit and paid less than full amount.
Check one.
☑ None. If “None” is checked, the rest of § 4.5 need not be completed or reproduced.
☐ The allowed priority claims listed below are based on a domestic support obligation that has been assigned to or is owed to a governmental unit and will be paid less than the full amount of the claim under 11 U.S.C. § 1322(a)(4). This plan provision requires that payments in § 2.1 be for a term of 60 months; see 11 U.S.C. § 1322(a)(4).

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Amount of claim to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$________________________</td>
</tr>
<tr>
<td></td>
<td>$________________________</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

Part 5: Treatment of Nonpriority Unsecured Claims

5.1 Nonpriority unsecured claims not separately classified.
Allowed nonpriority unsecured claims that are not separately classified will be paid, pro rata. If more than one option is checked, the option providing the largest payment will be effective. Check all that apply.

☑ The sum of $___________.
☑ _______% of the total amount of these claims, an estimated payment of $___________.
☑ The funds remaining after disbursements have been made to all other creditors provided for in this plan.

If the estate of the debtor(s) were liquidated under chapter 7, nonpriority unsecured claims would be paid approximately $___________. Regardless of the options checked above, payments on allowed nonpriority unsecured claims will be made in at least this amount.
5.2 Maintenance of payments and cure of any default on nonpriority unsecured claims. Check one.

☐ None. If "None" is checked, the rest of § 5.2 need not be completed or reproduced.

☐ The debtor(s) will maintain the contractual installment payments and cure any default in payments on the unsecured claims listed below on which the last payment is due after the final plan payment. These payments will be disbursed either by the trustee or directly by the debtor(s), as specified below. The claim for the arrearage amount will be paid in full as specified below and disbursed by the trustee. The final column includes only payments disbursed by the trustee rather than by the debtor(s).

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Current installment payment</th>
<th>Amount of arrearage to be paid</th>
<th>Estimated total payments by trustee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$__________________________</td>
<td>$___________________________</td>
<td>$_______________________________</td>
</tr>
<tr>
<td>Disbursed by:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Trustee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Debtor(s)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$__________________________</td>
<td>$___________________________</td>
<td>$_______________________________</td>
</tr>
<tr>
<td>Disbursed by:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Trustee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Debtor(s)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

5.3 Other separately classified nonpriority unsecured claims. Check one.

☐ None. If "None" is checked, the rest of § 5.3 need not be completed or reproduced.

☐ The nonpriority unsecured allowed claims listed below are separately classified and will be treated as follows

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Basis for separate classification and treatment</th>
<th>Amount to be paid on the claim</th>
<th>Interest rate (if applicable)</th>
<th>Estimated total amount of payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$___________________________</td>
<td>%</td>
<td>$_______________________________</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$___________________________</td>
<td>%</td>
<td>$_______________________________</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

Part 6: Executory Contracts and Unexpired Leases

6.1 The executory contracts and unexpired leases listed below are assumed and will be treated as specified. All other executory contracts and unexpired leases are rejected. Check one.

☐ None. If "None" is checked, the rest of § 6.1 need not be completed or reproduced.

☐ Assumed items. Current installment payments will be disbursed either by the trustee or directly by the debtor(s), as specified below, subject to any contrary court order or rule. Arrearage payments will be disbursed by the trustee. The final column includes only payments disbursed by the trustee rather than by the debtor(s).
Name of creditor | Description of leased property or executory contract | Current installment payment | Amount of arrearage to be paid | Treatment of arrearage (Refer to other plan section if applicable) | Estimated total payments by trustee
--- | --- | --- | --- | --- | ---
 | | | $________ | $________ | $________ |
Disbursed by:  
- Trustee  
- Debtor(s)
 | | | $________ | $________ | $________ |
Disbursed by:  
- Trustee  
- Debtor(s)

Insert additional contracts or leases as needed.

**Part 7: Vesting of Property of the Estate**

7.1 Property of the estate will vest in the debtor(s) upon

*Check the applicable box:*

- [ ] plan confirmation.
- [ ] entry of discharge.
- [ ] other: ________________________________

**Part 8: Nonstandard Plan Provisions**

8.1 Check “None” or List Nonstandard Plan Provisions

- [ ] None. If “None” is checked, the rest of Part 8 need not be completed or reproduced.

*Under Bankruptcy Rule 3015(c), nonstandard provisions must be set forth below. A nonstandard provision is a provision not otherwise included in the Official Form or deviating from it. Nonstandard provisions set out elsewhere in this plan are ineffective.*

*The following plan provisions will be effective only if there is a check in the box “Included” in § 1.3.*

__________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________________
Part 9: Signature(s):

9.1 Signatures of Debtor(s) and Debtor(s)’ Attorney

If the Debtor(s) do not have an attorney, the Debtor(s) must sign below; otherwise the Debtor(s) signatures are optional. The attorney for the Debtor(s), if any, must sign below.

[x] __________________________________________
Signature of Debtor 1

Executed on _________________
MM / DD / YYYY

[x] __________________________________________
Signature of Debtor 2

Executed on _________________
MM / DD / YYYY

[x] __________________________________________
Signature of Attorney for Debtor(s)

Date _________________
MM / DD / YYYY

By filing this document, the Debtor(s), if not represented by an attorney, or the Attorney for Debtor(s) also certify(ies) that the wording and order of the provisions in this Chapter 13 plan are identical to those contained in Official Form 113, other than any nonstandard provisions included in Part 8.
### Exhibit: Total Amount of Estimated Trustee Payments

The following are the estimated payments that the plan requires the trustee to disburse. If there is any difference between the amounts set out below and the actual plan terms, the plan terms control.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. <strong>Maintenance and cure payments on secured claims</strong> (Part 3, Section 3.1 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>b. <strong>Modified secured claims</strong> (Part 3, Section 3.2 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>c. <strong>Secured claims excluded from 11 U.S.C. § 506</strong> (Part 3, Section 3.3 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>d. <strong>Judicial liens or security interests partially avoided</strong> (Part 3, Section 3.4 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>e. <strong>Fees and priority claims</strong> (Part 4 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>f. <strong>Nonpriority unsecured claims</strong> (Part 5, Section 5.1, highest stated amount)</td>
<td>$_____________</td>
</tr>
<tr>
<td>g. <strong>Maintenance and cure payments on unsecured claims</strong> (Part 5, Section 5.2 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>h. <strong>Separately classified unsecured claims</strong> (Part 5, Section 5.3 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>i. <strong>Trustee payments on executory contracts and unexpired leases</strong> (Part 6, Section 6.1 total)</td>
<td>$_____________</td>
</tr>
<tr>
<td>j. <strong>Nonstandard payments</strong> (Part 8, total)</td>
<td>$_____________</td>
</tr>
<tr>
<td><strong>Total of lines a through j</strong></td>
<td>$_____________</td>
</tr>
</tbody>
</table>
[Local Form 3015.1]
IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re
Enter Name of Debtor 1
Debtor 1

(If spouse is filing:)
Enter Name of Debtor 2
Debtor 2

Case No. Enter Number
Chapter 13

Check if applicable:
☐ Preconfirmation Amended Plan
☐ Postconfirmation Modified Plan

CHAPTER 13 PLAN

Part 1: Notices

The use of this chapter 13 plan form is mandatory for chapter 13 cases filed in the Eastern District of Tennessee.

To Debtor(s): Bankruptcy law is complex; you are urged to consult an attorney. This form sets out options that may be appropriate in some cases, but the presence of an option on the form does not indicate that the option is appropriate in your circumstances. Plans that do not comply with local rules and judicial rulings may not be confirmable.

To Creditors: Bankruptcy law is complex; you are urged to consult an attorney. Your rights may be affected by this plan. Your claim may be reduced, modified, or eliminated. If you oppose this plan, you or your attorney must file an objection with the clerk of court before the scheduled time of the 11 U.S.C. § 341(a) meeting of creditors, or the objection must be lodged with the chapter 13 trustee at the meeting unless otherwise ordered by the court. See E.D. Tenn. LBR 3015-3(a) or E.D. Tenn. LBR 3015-2(a)(5) and (b), as applicable. If no objection to confirmation is filed, the Bankruptcy Court may confirm this plan without further notice. See Federal Rule of Bankruptcy Procedure 3015. Regardless of plan treatment, creditors will need to file a proof of claim before any claim can be paid under the plan. See Federal Rule of Bankruptcy Procedure 3002. Further, nothing in this plan precludes or otherwise limits the filing of an objection or complaint, as appropriate, contesting the allowance of such claim or the validity of any lien or right of setoff or seeking to avoid any lien under any applicable section of the Bankruptcy Code.

This plan: (Debtor(s) must complete the following by checking one box on each line.)

| 1.1 Limits the amount of a secured claim, which may result in a partial payment or no payment at all to the secured creditor. [See plan provision in Section 3.2.] | ☐ Yes ☐ No |
| 1.2 Avoids a judicial lien or security interest. [See plan provision in Section 3.4.] | ☐ Yes ☐ No |
| 1.3 Contains a Nonstandard Plan Provision. [See plan provision in Section 8.1.] | ☐ Yes ☐ No |

Part 2: Plan Payments and Length of Plan

2.1 Debtor(s) will make regular payments to the trustee as follows:

Debtor 1 $ Enter Amount ☐ weekly, ☐ biweekly, ☐ semi-monthly, or ☐ monthly for Enter Number months by ☐ payroll deduction or ☐ direct payment to the trustee (and, complete if applicable)
Debtor 2  $ Enter Amount  ☐ weekly, ☐ biweekly, ☐ semi-monthly, or ☐ monthly for Enter Number months by ☐ payroll deduction or ☐ direct payment to the trustee.

Future payment changes (Complete if applicable.)

Select Debtor  Beginning Select Date, plan payments will change to: $ Enter Amount  ☐ weekly, ☐ biweekly, ☐ semi-monthly, or ☐ monthly for Enter Number months by ☐ payroll deduction or ☐ direct payment to the trustee.

2.2 Federal Income Tax Refunds
In addition to the payments in Section 2.1, the debtor(s) will pay to the trustee federal income tax refunds as follows:
☐ none, ☐ all, or ☐ Enter Amount or Description.

If tax refunds are being paid to the trustee, the debtor(s) will furnish to the trustee a copy of each federal income tax return filed by the debtor(s) during the pendency of the case and every request for extension of time to file a return, within 14 days of the filing of the return or the mailing of the request. In order to expedite the trustee’s receipt of the refunds, the trustee may request that the court enter a tax intercept order so that the IRS will send the tax refunds directly to the trustee. If an amount other than “all” is to be paid into the plan, the trustee will refund the balance to the debtor(s) within 60 days of receipt, if the debtor(s) are current in the plan payments under Section 2.1 and if the debtor(s) have provided a copy of their tax return to the trustee. Otherwise, the trustee may apply the balance due to the debtor(s) to cure any arrearage. If the trustee is unable to determine the amount due to the debtor(s) because the debtor(s) have not provided to the trustee a copy of the federal tax return within 60 days of the trustee’s receipt of a tax refund, then the debtor(s) are deemed to have forfeited the amount due to them, and the trustee may disburse this amount to creditors as an additional tax refund contributed to the plan.

2.3 Additional Payments (Complete if applicable.)
The debtor(s) will make the following additional payments to the trustee: (Describe the source, estimated amount, and estimated date of payment.)
Enter Information

Part 3: Treatment of Secured Claims

3.1 Maintenance of Payments and Cure of Default, If Any (Complete if applicable.)
Installment payments on the secured claims listed in this section, which will extend beyond the life of the plan, will be maintained during the plan, with payments disbursed by the trustee unless “Yes” is listed under “Direct Pay by Debtor(s)?” The holders of the secured claims will retain their liens following the completion of payments under the plan, and any unpaid balance of the claims is not subject to discharge. Any existing arrearage on a listed claim will be paid in full through disbursements by the trustee, with interest, if any, at the rate stated. Any postpetition installment payment changes and fees, expenses, and charges noticed in conformity with Federal Rule of Bankruptcy Procedure 3002.1 will be paid without plan modification by the party designated below to make the installment payment unless otherwise ordered by the court.

The installment payment and amount of arrearage stated in an allowed claim, proof of which is filed, control over any contrary amounts listed below.

If relief from the automatic stay is ordered as to any collateral described below, all payments under this section to creditors secured solely by that collateral will cease unless otherwise ordered by the court.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Collateral Description</th>
<th>Principal Residence?</th>
<th>Installment Payment</th>
<th>Direct Pay by Debtor(s)?</th>
<th>Amount of Arrearage</th>
<th>Int. Rate on Arrearage</th>
<th>Arrearage Payment</th>
</tr>
</thead>
</table>

Enter Information
3.2 Request for Valuation of Security, Payment of Fully Secured Claims, and Modification of Undersecured Claims

(Complete if applicable and check “Yes” in Section 1.1. The following provisions will be effective only if there is a check in the “Yes” box in Section 1.1.)

For each creditor listed in this section, the “Secured Amount” was calculated by valuing the creditor’s collateral and subtracting superior liens. For nongovernmental creditors, the debtor(s) request that the Secured Amount be the determinative amount of the creditor’s secured claim under Federal Rule of Bankruptcy Procedure 3012 and 11 U.S.C. § 506(a). For governmental creditors, the listed Secured Amount is an estimate with no binding effect; rather, the amount of the governmental creditor’s secured claim under Federal Rule of Bankruptcy Procedure 3012 and 11 U.S.C. § 506(a) will be determined by the amount the creditor states in response to Question No. 9 on its proof of claim for “Amount of the claim that is secured” unless otherwise ordered by the court under Federal Rule of Bankruptcy Procedure 3012(c).

If the Secured Amount is greater than the creditor’s total claim, the total allowed claim will be paid in full with interest at the rate stated below. If the Secured Amount is less than the creditor’s total claim, only the allowed Secured Amount will be paid in full with interest at the rate stated below. Any portion of the creditor’s total allowed claim that exceeds the Secured Amount will be treated as an unsecured claim under Section 5.1 of this plan. If the Secured Amount is listed as “Zero” or “None,” the creditor’s allowed claim will be treated entirely as an unsecured claim under Section 5.1 of this plan.

Monthly payments will be disbursed by the trustee unless “Yes” is listed under “Direct Pay by Debtor(s)?”

Each creditor listed below will retain its lien on the property interest of the debtor(s) or the estate(s) until the earlier of:

(a) payment of the underlying debt determined under nonbankruptcy law, or
(b) discharge of the underlying debt under 11 U.S.C. § 1328,

at which time the lien will terminate and be released by the creditor.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Collateral Description</th>
<th>Secured Amount</th>
<th>Interest Rate</th>
<th>Monthly Payment</th>
<th>Direct Pay by Debtor(s)?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter Information</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.3 Secured Claims Excluded from 11 U.S.C. § 506

(Complete if applicable.)

The claims listed in this section were either:

(a) incurred within 910 days before the petition date and secured by a purchase money security interest in a motor vehicle acquired for the personal use of the debtor(s), or
(b) incurred within 1 year of the petition date and secured by a purchase money security interest in any other thing of value.

These claims will be paid in full with interest at the rate stated below with payments disbursed by the trustee unless “Yes” is listed under “Direct Pay by Debtor(s)?” The amount of the creditor’s claim stated on its proof of claim, if allowed, controls over any contrary amount listed below.

Each creditor listed below will retain the lien on the property interest of the debtor(s) or the estate(s) until the earlier of:

(a) payment of the underlying debt determined under nonbankruptcy law, or
(b) discharge of the underlying debt under 11 U.S.C. § 1328,

at which time the lien will terminate and be released by the creditor.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Collateral Description</th>
<th>Amount of Claim</th>
<th>Interest Rate</th>
<th>Monthly Payment</th>
<th>Direct Pay by Debtor(s)?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter Information</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.4 Lien Avoidance

(Complete if applicable and check “Yes” in Section 1.2. The following provisions will be effective only if there is a check in the “Yes” box in Section 1.2.)

The judicial liens and nonpossessory, nonpurchase money security interests securing the claims listed in this section
impair exemptions to which the debtor(s) would be entitled under 11 U.S.C. § 522(b). Upon entry of an order confirming this plan, the liens listed will be avoided to the extent they impair such exemptions. The amount of a lien avoided will be treated as an unsecured claim in Section 5.1 of this plan. The amount, if any, of the lien interest that is not avoided will be paid in full as a secured claim with payments disbursed by the trustee. If multiple liens on the same collateral impairing the same exemption are being avoided, the liens should be listed and avoided in reverse order of priority, i.e., start with lowest priority lien and proceed to the highest.

If a lien has been avoided, it should not be included in (B). Add (A) plus (B) plus (C) and then subtract (D) to determine (E) Extent of Impairment. If (E) is equal to or greater than (A), the entire lien is avoided and the amount of (F) Secured Claim will be $0. If (E) is less than (A), only the amount in (E) is avoidable. The difference between (A) and (E) is the amount of (F) Secured Claim.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Amount of Lien</th>
<th>Total of All Other Liens</th>
<th>Amount of Exemption</th>
<th>Value of Property</th>
<th>Extent of Impairment</th>
<th>Secured Claim</th>
<th>Interest Rate</th>
<th>Monthly Payment</th>
</tr>
</thead>
</table>

Further identify below each judicial lien by property address and recordation information, and list the collateral covered by each nonpossessory, nonpurchase money security interest.

3.5 Surrender of Collateral *(Complete if applicable.)*

The debtor(s) surrender the collateral listed in this section. The debtor(s) request that the automatic stay under 11 U.S.C. § 362(a) be terminated as to this collateral and the codebtor stay under § 1301 be terminated in all respects upon entry of an order confirming this plan. Any allowed deficiency balance resulting from a creditor’s disposition of the collateral will be treated as an unsecured claim in Section 5.1 of this plan if the creditor amends its previously-filed claim within 120 days from entry of the order confirming this plan or by such additional time as the creditor may be granted upon motion filed within that 120-day period.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Collateral Description</th>
</tr>
</thead>
</table>

3.6 Secured Claims Paid by Third Party *(Complete if applicable.)*

The following secured claims will be paid directly by the designated third party. The trustee will make no payment on the claim unless the creditor amends its previously-filed claim to assert a deficiency balance that will be treated as an unsecured claim in Section 5.1 of this plan.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Collateral Description</th>
<th>Third Party</th>
</tr>
</thead>
</table>

Part 4: Treatment of Priority Claims

4.1 General

Allowed claims entitled to priority under 11 U.S.C. § 507, including filing fees, attorney’s fees for debtor(s), certain taxes, and domestic support obligations except as provided below in Section 4.3 or 8.1, will be paid in full without postpetition interest by deferred cash payments before payment of nonpriority unsecured claims in Section 5.1. Notwithstanding the foregoing, the trustee will pay in full allowed claims for prepetition real property taxes filed by a governmental entity at the applicable statutory interest rate, regardless of whether the claim is filed as priority or secured.

4.2 Attorney’s Fees

The attorney for the debtor(s) requests a flat fee in the amount of:

$ Enter Amount, which will be paid in full less $ Enter Amount previously paid by the debtor(s).
If no amounts are included, the attorney for the debtor(s) is not seeking a flat fee and will instead be filing a fee application as contemplated by E.D. Tenn. LBR 2016-1(c).

4.3 Domestic Support Obligations *(Complete if applicable.)*

The automatic stay does not preclude the establishment or modification of a domestic support obligation order as permitted by 11 U.S.C. § 362(b)(2)(A)(ii).

The debtor(s) will continue to pay directly or by payroll deduction domestic support obligations that are due and payable postpetition, regardless of whether a proof of claim is filed.

If a claim for a prepetition domestic support obligation arrearage is filed, the allowed claim will be paid in full by the trustee unless the obligation has been assigned to, or is owned by, a governmental unit and may be paid less under 11 U.S.C. § 1322(a)(4). If 11 U.S.C. § 1322(a)(4) applies, the allowed claim will be paid by the trustee as follows:

Enter Information

### Part 5: Treatment of Nonpriority Unsecured Claims

5.1 Nonpriority Unsecured Claims Not Separately Classified

Allowed nonpriority unsecured claims that are not separately classified will be paid:

- [ ] in full
- [ ] Enter Percentage %
- [ ] pro rata on a funds available basis after payment of all other separately-classified claims
- [ ] other: Enter Information

If more than one option is checked above, the option providing the largest payment will be effective.

5.2 Postpetition Claims

Postpetition claims allowed under 11 U.S.C. § 1305, proofs of which are filed by creditors, will be paid as follows:

- [ ] § 1305(a)(1) tax claims to be paid in full by the trustee
- [ ] § 1305(a)(1) tax claims will *not* be paid by the trustee
- [ ] § 1305(a)(2) consumer debt claims to be paid in full by the trustee
- [ ] § 1305(a)(2) consumer debt claims to be paid by the trustee as provided in Section 5.1; however, if Section 5.1 provides for pro rata distribution only, the amount of the pro rata distribution on the § 1305(a)(2) claims will be determined as of the date the postpetition claim is filed
- [ ] § 1305(a)(2) consumer debt claims will *not* be paid by the trustee

Check above all that apply.

### Part 6: Executory Contracts and Unexpired Leases

6.1 The executory contracts and unexpired leases listed below are assumed and will be treated as specified. All other executory contracts and unexpired leases are rejected, with any claim arising from the rejection to be treated as an unsecured claim in Section 5.1 of this plan. *(Complete if applicable.)*

Contractual installment payments will be disbursed by the trustee unless “Yes” is listed under “Direct Pay by Debtor(s)?” Any arrearage will be paid in full with payments disbursed by the trustee. The installment payment and amount of
arrearage stated in an allowed claim, proof of which is filed, control over any contrary amounts listed below. A claim arising from the rejection of an executory contract or unexpired lease will be paid as unsecured in Section 5.1 of this plan if the creditor files a proof of claim within 60 days from entry of the order confirming the plan that first rejects the executory contract or unexpired lease.

<table>
<thead>
<tr>
<th>Name of Creditor</th>
<th>Description of Contract or Lease</th>
<th>Installment Payment</th>
<th>Direct Pay by Debtor(s)?</th>
<th>Amount of Arrearage Payment</th>
</tr>
</thead>
</table>

Part 7: Vesting of Property of the Estate

7.1 Property of the estate will not vest in the debtor(s) until completion of the plan as evidenced by the trustee’s filing of a certificate of final payment.

Part 8: Nonstandard Plan Provisions

8.1 Nonstandard Provisions. (Complete if applicable and check “Yes” in Section 1.3. The following provisions will be effective only if there is a check in the “Yes” box in Section 1.3.)

Enter Information

Any nonstandard provision placed in this plan other than in this Section 8.1 is void. If there is a conflict between a provision listed in this section and a standard provision of this plan, the provision listed here controls to the extent of the conflict.

Part 9: Signatures

9.1 Signatures of Debtor(s) and Attorney for the Debtor(s). (If the debtor(s) do not have an attorney, the debtor(s) must sign below; otherwise the debtor(s) signatures are optional. The attorney for the debtor(s), if any, must sign below. By signing, the attorney certifies that the debtor(s) consent to the provisions in the plan and have authorized its filing.)

Signature of Debtor 1

Executed on: _______________

Signature of Attorney for Debtor(s)

______________________________

Date: _______________

Signature of Debtor 2

Executed on: _______________

______________________________

By filing this document, the debtor(s), if not represented by an attorney, or the attorney for the debtor(s) certify that the wording and order of the provisions in this plan are identical to the court’s form plan, other than any nonstandard provisions included in Section 8.1.
Chapter 13 Plan

Part 1: Notices

To Debtor(s): This form sets out options that are appropriate in some cases but not in others. The presence of an option does not indicate that the option is appropriate in your circumstances.

To Creditors: Your rights are affected by this plan. Your claim may be reduced, modified, or eliminated.

If you oppose the treatment of your claim or any provision of this plan, you or your attorney must file an objection to confirmation at least 5 days before the meeting of creditors or raise an objection on the record at the meeting of creditors. The Bankruptcy Court may confirm this plan without further notice if no timely objection to confirmation is made. In addition, a timely proof of claim must be filed before your claim will be paid under the plan.

Debtor(s) must check one box on each line to state whether the plan includes each of the following items. If an item is not checked as “Included” or if both boxes are checked, the provision will not be effective if set out later in the plan.

1.1 A limit on the amount of a secured claim, set out in § 3.2, which may result in partial payment or no payment to the secured creditor.

<table>
<thead>
<tr>
<th>Included</th>
<th>Not included</th>
</tr>
</thead>
</table>

1.2 Avoidance of a judicial lien or nonpossessory, nonpurchase-money security interest, set out in § 3.4.

<table>
<thead>
<tr>
<th>Included</th>
<th>Not included</th>
</tr>
</thead>
</table>

1.3 Nonstandard provisions, set out in Part 9.

<table>
<thead>
<tr>
<th>Included</th>
<th>Not included</th>
</tr>
</thead>
</table>

Part 2: Plan Payments and Length of Plan

2.1 Debtor(s) will make payments to the trustee as follows:

<table>
<thead>
<tr>
<th>Payments made by</th>
<th>Amount of each payment</th>
<th>Frequency of payments</th>
<th>Duration of payments</th>
<th>Method of payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debtor 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debtor 2</td>
<td>$_____________</td>
<td>_______________</td>
<td>__ months</td>
<td>Debtor will make payment directly to trustee</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Debtor consents to payroll deduction from:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>__________________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>__________________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>__________________</td>
</tr>
</tbody>
</table>

Debtor(s) must check one box on each line to state whether the payments will be made directly to the trustee or if the payments will be made through payroll deduction.

Insert additional lines as needed.

2.2 Income tax refunds and returns. Check all that apply.

- Debtor(s) will retain any income tax refunds received during the plan term.
- Debtor(s) will supply the trustee with a copy of each income tax return filed during the plan term within 14 days of filing the return and will turn over to the trustee all income tax refunds received during the plan term.
- Debtor(s) will treat income tax refunds as follows:

________________________________________

________________________________________

________________________________________

________________________________________

________________________________________

________________________________________
2.3 Additional payments. Check one.
- None. If “None” is checked, the rest of § 2.3 need not be completed or reproduced.
- Debtor(s) will make additional payment(s) to the trustee specified below. Describe the source, estimated amount, and date of each payment.

2.4 The total amount of estimated payments to the trustee provided for in §§ 2.1 and 2.3 is $___________.

Part 3: Treatment of Secured Claims

3.1 Maintenance of payments and cure of default. Check one.
- None. If “None” is checked, the rest of § 3.1 need not be completed or reproduced.
- Installment payments on the secured claims listed below will be maintained, and any arrearage through the month of confirmation will be paid in full as stated below. Both the installment payments and the amounts to cure the arrearage will be disbursed by the trustee.

Amounts stated on a proof of claim filed in accordance with the Bankruptcy Rules control over any contrary amounts listed below as to the current installment payment and arrearage. After confirmation of the plan, the trustee shall adjust the installment payments below in accordance with any such proof of claim and any Notice of Mortgage Payment Change filed under Rule 3002.1. The trustee shall adjust the plan payment in Part 2 in accordance with any adjustment to an installment payment and shall file a notice of the adjustment and deliver a copy to the debtor, the debtor’s attorney, the creditor, and the U.S. Trustee, but if an adjustment is less than $25 per month, the trustee shall have the discretion to adjust only the installment payment without adjusting the payments under Part 2. The trustee is further authorized to pay any postpetition fee, expense, or charge, notice of which is filed under Bankruptcy Rule 3002.1 and as to which no objection is raised, at the same disbursement level as the arrearage.

Confirmation of this Plan imposes on any claimholder listed below the obligation to:
- Apply arrearage payments received from the trustee only to such arrearages.
- Treat the obligation as current at confirmation such that future payments, if made pursuant to the plan, shall not be subject to late fees, penalties, or other charges.

If relief from the automatic stay is ordered as to any collateral listed below, all payments under this section to creditors secured by that collateral will cease.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
<th>Current installment payment (including escrow)</th>
<th>Amount of arrearage, if any</th>
<th>Interest rate on arrearage (if applicable)</th>
<th>Monthly payment on arrearage, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>________________</td>
<td>__________</td>
<td>$________</td>
<td>Prepetition: <em><strong><strong><strong>% $</strong></strong></strong></em>_</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Gap payments: $________</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Last month in gap: _______</td>
<td></td>
<td></td>
</tr>
<tr>
<td>________________</td>
<td>__________</td>
<td>$________</td>
<td>Prepetition: <em><strong><strong><strong>% $</strong></strong></strong></em>_</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Gap payments: $________</td>
<td>$________</td>
<td>$________</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Last month in gap: _______</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.
3.2 Request for valuation of security and claim modification. Check one.

☐ None. If “None” is checked, the rest of § 3.2 need not be completed or reproduced.

The remainder of this section will be effective only if the applicable box in § 1.1 is checked.

☐ For each claim listed below, the debtor(s) request that the court determine the value of the creditor’s interest in any property securing the claim based on the amount stated in the column headed Value securing claim. If this amount exceeds any allowed claim amount, the claim will be paid in full with interest at the rate stated below. If the amount is less than the allowed claim amount, the claim will be paid the full value securing the claim, with interest at the rate stated below.

The portion of any allowed claim that exceeds the value securing the claim will be treated as an unsecured claim under § 5.1. If the value securing a creditor’s claim is listed as zero or no value, the creditor’s allowed claim will be treated entirely as an unsecured claim under § 5.1. The avoidance of any lien because it is not secured by any value must be addressed in Part 9. The amount of a creditor’s total claim stated on a proof of claim filed in accordance with the Bankruptcy Rules controls over any contrary amount stated below.

The holder of any claim listed below as secured by any value will retain the lien until the earlier of:
(a) payment of the underlying debt determined under nonbankruptcy law, or
(b) discharge under 11 U.S.C. § 1328, at which time the lien will terminate and be released by the creditor.

If relief from the automatic stay is ordered as to any collateral listed below, all payments under this section to creditors secured by that collateral will cease.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Estimated amount of creditor’s total claim</th>
<th>Collateral</th>
<th>Value of collateral</th>
<th>Amount of claims senior to creditor’s claim</th>
<th>Value securing claim</th>
<th>Interest rate</th>
<th>Monthly payment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$__________</td>
<td>__________</td>
<td>$______</td>
<td>$______</td>
<td>$______</td>
<td>___%</td>
<td>$______</td>
</tr>
<tr>
<td></td>
<td>$__________</td>
<td>__________</td>
<td>$______</td>
<td>$______</td>
<td>$______</td>
<td>___%</td>
<td>$______</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

3.3 Secured claims excluded from 11 U.S.C. § 506. Check one.

☐ None. If “None” is checked, the rest of § 3.3 need not be completed or reproduced.

☐ The claims listed below were either:

(1) incurred within 910 days before the petition date and secured by a purchase money security interest in a motor vehicle acquired for the personal use of the debtor(s), or

(2) incurred within 1 year before the petition date and secured by a purchase money security interest in any other thing of value.

These claims will be paid in full through the trustee as stated below. The claim amount stated on a proof of claim filed in accordance with the Bankruptcy Rules controls over any contrary amount listed below.

If relief from the automatic stay is ordered as to any collateral listed below, all payments under this section to creditors secured by that collateral will cease.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
<th>Amount of claim</th>
<th>Interest rate</th>
<th>Monthly payment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>__________</td>
<td>$__________</td>
<td>___%</td>
<td>$______</td>
</tr>
<tr>
<td></td>
<td>__________</td>
<td>$__________</td>
<td>___%</td>
<td>$______</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.
3.4 Lien avoidance. Check one.

☐ None. If “None” is checked, the rest of § 3.4 need not be completed or reproduced.

The remainder of this section will be effective only if the applicable box in § 1.2 is checked.

☐ The judicial liens or nonpossessory, nonpurchase money security interests listed below impair exemptions to which the debtor(s) would be entitled under 11 U.S.C. § 522(b). The judicial liens or security interests listed below will be avoided to the extent they impair exemptions upon entry of the order confirming the plan. The amount of the judicial lien or security interest that is avoided will be treated as an unsecured claim under § 5.1. The amount, if any, of the judicial lien or security interest that is not avoided will be paid in full as a secured claim under the plan.

<table>
<thead>
<tr>
<th>Information regarding judicial lien or security interest</th>
<th>Calculation of lien avoidance</th>
<th>Treatment of remaining secured claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of creditor</td>
<td>a. Amount of lien $___________</td>
<td>Amount of secured claim after avoidance (line a minus line f) $___________</td>
</tr>
<tr>
<td></td>
<td>b. Amount of all other liens $___________</td>
<td></td>
</tr>
<tr>
<td>Collateral</td>
<td>c. Value of claimed exemptions + $___________</td>
<td>Interest rate (if applicable) %</td>
</tr>
<tr>
<td></td>
<td>d. Total of adding lines a, b, and c $___________</td>
<td></td>
</tr>
<tr>
<td>Lien identification (such as judgment date, date of lien recording, book and page number)</td>
<td>e. Value of debtor’s interest in property $___________</td>
<td>Monthly plan payment $___________</td>
</tr>
<tr>
<td></td>
<td>f. Subtract line e from line d. $___________</td>
<td>Estimated total payments on secured claim $___________</td>
</tr>
</tbody>
</table>

Extent of exemption impairment

☐ Line f is equal to or greater than line a.
The entire lien is avoided. (Do not complete the next column.)

☐ Line f is less than line a.
A portion of the lien is avoided. (Complete the next column.)

Insert additional claims as needed.

3.5 Surrender of collateral. Check one.

☐ None. If “None” is checked, the rest of § 3.5 need not be completed or reproduced.

☐ The debtor(s) surrender to each creditor below the listed collateral. Upon confirmation of this plan the stay under 11 U.S.C. § 362(a) will be terminated as to the collateral only and the stay under § 1301 will be terminated in all respects. Any allowed unsecured claim resulting from disposition of surrendered collateral will be treated as an unsecured claim under § 5.1.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Collateral</th>
<th>Anticipated Deficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$____________________</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.
**Part 4: Treatment of Priority Claims (including Attorney’s Fees and Domestic Support Obligations)**

4.1 Attorney’s fees.

The balance of fees owed to the attorney for the debtor(s) is estimated to be $___________. The remaining fees and any additional fees that may be awarded shall be paid through the trustee as specified below. Check one.

- □ The attorney for the debtor(s) shall receive a monthly payment of $___________.
- □ The attorney for the debtor(s) shall receive available funds.

4.2 Domestic support obligations.

(a) Pre- and postpetition domestic support obligations to be paid in full. Check one.

- □ None. If “None” is checked, the rest of § 4.2(a) need not be completed or reproduced.
  - □ The debtor(s) will maintain postpetition payments on the domestic support obligation(s) listed below. These payments will be disbursed either by the trustee or directly by the debtor, as specified. Any arrearage on a listed claim will be paid in full through the trustee. If no monthly payment is stated, the trustee will disburse available funds to cure the arrearage. Amounts stated on a proof of claim filed in accordance with the Bankruptcy Rules control over any contrary amounts listed below as to the postpetition payment and arrearage. Unless a proof of claim filed in accordance with the Bankruptcy Rules states an arrearage through a later month, the arrearage will only include amounts due as of the petition date.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Current monthly payment</th>
<th>Amount of arrearage, if any</th>
<th>Monthly payment on arrearage, if any</th>
<th>When ongoing obligation terminates</th>
</tr>
</thead>
<tbody>
<tr>
<td>_________________</td>
<td>$__________</td>
<td>$__________</td>
<td>$__________</td>
<td>__________________</td>
</tr>
<tr>
<td>Disbursed by:</td>
<td>Trustee</td>
<td>Trustee</td>
<td>Trustee</td>
<td>Trustee</td>
</tr>
<tr>
<td></td>
<td>Debtors</td>
<td>Debtors</td>
<td>Debtors</td>
<td>Debtors</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

(b) Domestic support obligations assigned or owed to a governmental unit and paid less than full amount. Check one.

- □ None. If “None” is checked, the rest of § 4.2(b) need not be completed or reproduced.

The claims listed below are based on a domestic support obligation that has been assigned to or is owed to a governmental unit and will be paid less than in full under 11 U.S.C. § 1322(a)(4).

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Amount of claim to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>_________________</td>
<td></td>
</tr>
<tr>
<td>_________________</td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

4.3 Other priority claims. Check one.

- □ None. If “None” is checked, the rest of § 4.3 need not be completed or reproduced.

The priority claims listed below will be paid in full through the trustee. Amounts stated on a proof of claim filed in accordance with the Bankruptcy Rules control over any contrary amounts listed below.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Estimated amount of claim to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>_________________</td>
<td></td>
</tr>
<tr>
<td>_________________</td>
<td></td>
</tr>
</tbody>
</table>

Insert additional claims as needed.
Part 5: Treatment of Nonpriority Unsecured Claims and Postpetition Claims

5.1 Nonpriority unsecured claims not separately classified.

Allowed nonpriority unsecured claims that are not separately classified will be paid pro rata. If more than one option is checked, the option providing the largest payment will be effective. Check all that apply.

- The sum of $__________.
- _______% of the total amount of these claims.
- The funds remaining after disbursements have been made to all other creditors provided for in this plan.

5.2 Interest on allowed nonpriority unsecured claims not separately classified. Check one.

- None. If “None” is checked, the rest of § 5.2 need not be completed or reproduced.
- Interest on allowed nonpriority unsecured claims that are not separately classified will be paid at an annual percentage rate of ___%.

5.3 Maintenance of payments and cure of default on nonpriority unsecured claims. Check one.

- None. If “None” is checked, the rest of § 5.3 need not be completed or reproduced.
- The debtor(s) will maintain installment payments and cure any default in payments on the unsecured claims listed below on which the last payment is due after the final plan payment. These payments will be disbursed by the trustee. The allowed claim for the arrearage amount will be paid in full through the trustee. Amounts stated on a proof of claim filed in accordance with the Bankruptcy Rules control over any contrary amounts listed below as to the current installment payment and arrearage.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Current installment payment</th>
<th>Amount of arrearage to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$__________</td>
<td>$______________</td>
</tr>
<tr>
<td></td>
<td>$__________</td>
<td>$______________</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

5.4 Separately classified nonpriority unsecured claims. Check one.

- None. If “None” is checked, the rest of § 5.4 need not be completed or reproduced.
- Nonpriority unsecured claims listed below are separately classified and treated as follows:

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Basis for separate classification and treatment</th>
<th>Amount to be paid on the claim</th>
<th>Interest rate (if applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$__________</td>
<td>___%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$__________</td>
<td>___%</td>
</tr>
</tbody>
</table>

Insert additional claims as needed.

5.5 Postpetition claims allowed under 11 U.S.C. § 1305.

Claims allowed under 11 U.S.C. § 1305 will be paid in full through the trustee.
Part 6: Executory Contracts and Unexpired Leases

6.1 The executory contracts and unexpired leases listed below are assumed and treated as specified. All other executory contracts and unexpired leases are rejected. Check one.

☐ None. If “None” is checked, the rest of § 6.1 need not be completed or reproduced.

☐ Assumed contracts or leases. Current installment payments will be disbursed by the trustee or directly by the debtor, as specified below. Arrearage payments will be paid in full through the trustee. Amounts stated on a proof of claim filed in accordance with the Bankruptcy Rules control over any contrary amounts listed below as to the installment payment and arrearage.

<table>
<thead>
<tr>
<th>Name of creditor</th>
<th>Description of leased property or executory contract</th>
<th>Current installment payment</th>
<th>Amount of arrearage to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$_________________________</td>
<td>$__________________________</td>
</tr>
<tr>
<td>Disbursed by:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Trustee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Debtor(s)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$_________________________</td>
<td>$__________________________</td>
</tr>
<tr>
<td>Disbursed by:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Trustee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>☐ Debtor(s)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Insert additional contracts or leases as needed.

Part 7: Order of Distribution of Available Funds by Trustee

7.1 The trustee will make monthly disbursements of available funds in the order specified. Check one.

☐ Regular order of distribution:

a. Filing fees paid through the trustee
b. Current monthly payments on domestic support obligations
c. Other fixed monthly payments
   If available funds in any month are not sufficient to disburse all fixed monthly payments due under the plan, the trustee will allocate available funds in the order specified below or pro rata if no order is specified. If available funds in any month are not sufficient to disburse any current installment payment due under § 3.1, the trustee will withhold the partial payment amount and treat the amount as available funds in the following month.
   1. _____________________________________________
   2. _____________________________________________
   Insert additional lines as needed.

d. Disbursements without fixed monthly payments, except under §§ 5.1 and 5.5
   The trustee will make these disbursements in the order specified below or pro rata if no order is specified.
   1. _____________________________________________
   2. _____________________________________________
   Insert additional lines as needed.

e. Disbursements to nonpriority unsecured claims not separately classified (§ 5.1)
f. Disbursements to claims allowed under § 1305 (§ 5.5)

☐ Alternative order of distribution:

a. _____________________________________________

b. _____________________________________________
   Insert additional lines as needed.
Part 8:  Vesting of Property of the Estate

8.1 Property of the estate will vest in the debtor(s) upon discharge or closing of the case, whichever occurs earlier, unless an alternative vesting date is selected below. Check the applicable box to select an alternative vesting date:

☐ plan confirmation.
☐ other: ____________________________________________.


☐ None. If “None” is checked, the rest of Part 9 need not be completed or reproduced.

Nonstandard provisions must be set forth below.

These plan provisions will be effective only if the applicable box in § 1.3 is checked.

Part 10:  Signatures:

X ____________________________________________ Date

X ____________________________________________ Date

Signature of Attorney for Debtor(s)

X ____________________________________________ Date

X ____________________________________________ Date

Signature(s) of Debtor(s) (required if not represented by an attorney; otherwise optional)

By filing this document, the Attorney for Debtor(s) or Debtor(s) themselves, if not represented by an attorney, also certify(ies) that the wording and order of the provisions in this Chapter 13 plan are identical to those contained in the form required under the Local Rules for the Bankruptcy Court for the Middle District of Tennessee, other than any nonstandard provisions included in Part 9.
In re: (1) Case No. (2)
Debtor(s).

Chapter 13

CHAPTER 13 PLAN

ADDRESS: (1) ____________________________ (2) __________________________________________
________________________________________

PLAN PAYMENT:

DEBTOR (1) shall pay $___________ ( ) weekly, ( ) every two weeks, ( ) semi-monthly, or ( ) monthly, by:

( ) PAYROLL DEDUCTION from: ________________________________ OR ( ) DIRECT PAY.
________________________________________

DEBTOR (2) shall pay $___________ ( ) weekly, ( ) every two weeks, ( ) semi-monthly, or ( ) monthly, by:

( ) PAYROLL DEDUCTION from: ________________________________ OR ( ) DIRECT PAY.
________________________________________

1. THIS PLAN [Rule 3015.1 Notice]:

(A) CONTAINS A NON-STANDARD PROVISION. [See plan provision #19] ( ) YES ( ) NO

(B) LIMITS THE AMOUNT OF A SECURED CLAIM BASED ON A VALUATION OF THE COLLATERAL FOR THE CLAIM. [See plan provisions #7 and #8] ( ) YES ( ) NO

(C) AVOIDS A SECURITY INTEREST OR LIEN. [See plan provision #12]. ( ) YES ( ) NO

2. ADMINISTRATIVE EXPENSES: Pay filing fee and Debtor(s)’ attorney fee pursuant to Confirmation Order.

3. AUTO INSURANCE: ( ) Included in Plan; OR ( ) Not included in Plan; Debtor(s) to provide proof of insurance at §341 meeting.

4. DOMESTIC SUPPORT: Paid by: ( ) Debtor(s) directly, ( ) Wage Assignment, OR ( ) Trustee to: Monthly Plan Payment:

________________________________________: ongoing payment begins __________________; Approximate arrearage: $__________________

________________________________________: ongoing payment begins __________________; Approximate arrearage: $__________________

5. PRIORITY CLAIMS:

________________________________________ Amount: $__________________

________________________________________ Amount: $__________________

6. HOME MORTGAGE CLAIMS: ( ) Paid directly by Debtor(s); OR ( ) Paid by Trustee to:

________________________________________: ongoing payment begins __________________; Interest ________________%

________________________________________: ongoing payment begins __________________; Interest ________________%

Approximate arrearage: $__________________

Approximate arrearage: $__________________

7. SECURED CLAIMS:

[Retain lien 11 U.S.C. §1325 (a)(5)] Value of Collateral: Rate of Interest: Monthly Plan Payment:

________________________________________ $__________________

________________________________________ $__________________

________________________________________ $__________________
8. SECURED AUTOMOBILE CLAIMS FOR DEBT INCURRED WITHIN 910 DAYS OF FILING, AND OTHER SECURED CLAIMS FOR DEBT INCURRED WITHIN ONE YEAR OF FILING:

<table>
<thead>
<tr>
<th>Value of Collateral:</th>
<th>Rate of Interest:</th>
<th>Monthly Plan Payment:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9. SECURED CLAIMS FOR WHICH COLLATERAL WILL BE SURRENDERED; STAY IS TERMINATED UPON CONFIRMATION FOR THE LIMITED PURPOSE OF GAINING POSSESSION AND COMMERCIALLY REASONABLE DISPOSAL OF COLLATERAL:

<table>
<thead>
<tr>
<th>Collateral:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

10. SPECIAL CLASS UNSECURED CLAIMS:

<table>
<thead>
<tr>
<th>Amount:</th>
<th>Rate of Interest:</th>
<th>Monthly Plan Payment:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

11. STUDENT LOAN CLAIMS AND OTHER LONG TERM CLAIMS:

<table>
<thead>
<tr>
<th>Amount:</th>
<th>Rate of Interest:</th>
<th>Monthly Plan Payment:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

12. THE JUDICIAL LIENS OR NON-POSSESSORY, NON-PURCHASE MONEY SECURITY INTEREST(S) HELD BY THE FOLLOWING CREDITORS ARE AVOIDED TO THE EXTENT ALLOWABLE PURSUANT TO 11 U.S.C.§522(f):

<table>
<thead>
<tr>
<th>Collateral:</th>
<th>Assumed</th>
<th>Rejected</th>
<th>OR</th>
<th>General unsecured creditor</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

13. ABSENT A SPECIFIC COURT ORDER OTHERWISE, ALL TIMELY FILED CLAIMS, OTHER THAN THOSE SPECIFICALLY PROVIDED FOR ABOVE, SHALL BE PAID AS GENERAL UNSECURED CLAIMS.

14. ESTIMATED TOTAL GENERAL UNSECURED CLAIMS: ________________.

15. THE PERCENTAGE TO BE PAID WITH RESPECT TO NON-PRIORITY, GENERAL UNSECURED CLAIMS IS:

( ) ______% , OR,

( ) THE TRUSTEE SHALL DETERMINE THE PERCENTAGE TO BE PAID AFTER THE PASSING OF THE FINAL BAR DATE.

16. THIS PLAN ASSUMES OR REJECTS EXECUTORY CONTRACTS:

<table>
<thead>
<tr>
<th>Assumed</th>
<th>Rejected</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

17. COMPLETION: Plan shall be completed upon payment of the above, approximately _________ months.

18. FAILURE TO TIMELY FILE A WRITTEN OBJECTION TO CONFIRMATION SHALL BE DEEMED ACCEPTANCE OF PLAN.

19. NON-STANDARD PROVISION(S):

<table>
<thead>
<tr>
<th>Provision:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

ANY NON-STANDARD PROVISION STATED ELSEWHERE IS VOID.

20. CERTIFICATION: THIS PLAN CONTAINS NO NON-STANDARD PROVISIONS EXCEPT THOSE STATED IN PROVISION 19.

Debtor(s)’ Attorney Signature or Pro Se Debtor(s)’ Signature(s)

DATE: _______________________.

Page 980 of 1015
Return of Vehicles Seized Before a Chapter 13 Filing

Does the Debtor Have to File a Turnover Motion?

Editor’s Note: This topic was one of the issues presented at the 27th Annual Duberstein Moot Court Competition, held in New York in early March. To learn more about the competition (jointly sponsored by ABI and St. John’s University School of Law), please visit stjohns.edu/law/center-bankruptcy-studies/27th-annual-duberstein-moot-court-competition.

On of the significant unresolved issues in consumer bankruptcy law is the right of a chapter 13 debtor to obtain the return of a vehicle seized before the bankruptcy was filed. The majority of the courts that have ruled on the issue, including the Seventh Circuit in Thompson v. GMAC and several other circuit courts, have held that creditors have a duty to return the seized vehicle to the debtor under the automatic stay set out in § 362(a)(3).

However, the Tenth Circuit’s recent Cowen decision adopted a minority interpretation, holding that the automatic stay does not apply to vehicles seized pre-petition and that a creditor need only return the collateral to achapter 13 debtor if the bankruptcy court grants a debtor’s motion for turnover. ABI’s Rochelle’s Daily Wire, in reporting both this decision and a subsequent one by the Tenth Circuit, noted the potential for a grant of certiorari to resolve the circuit split.

Before any consideration by the U.S. Supreme Court, the Seventh Circuit is being asked to address the issue. The City of Chicago has enacted ordnances that (1) allow the city to seize vehicles for parking, revenue and camera-recorded driving violations, and (2) grant the city a possessory lien on the seized vehicles. Vigorous enforcement of these ordinances has resulted in thousands of chapter 13 filings in Chicago.

In these cases, the debtors have cited the Thompson decision as requiring the city to return seized vehicles to them when it receives notice of their bankruptcy filings. However, the city has contested Thompson’s applicability, arguing that in order to retain its possessory lien, it is allowed to continue holding seized vehicles under § 362(b)(3), an exception to the automatic stay that allows creditor action to maintain lien perfection. The city’s more basic argument is that Thompson was incorrectly decided, and that the Seventh Circuit should overrule it and adopt the minority interpretation of § 362(a)(3). Five bankruptcy judges have ruled on the city’s arguments, and one found that the automatic stay exception applied. The other four rejected that argument. However, none of the judges found that Thompson should be overruled. The city has appealed the four decisions that denied it relief, and the Seventh Circuit has consolidated the cases for direct appeal.

The narrow issue — application of the stay exception in § 362(b)(3) — will only be relevant in the appeal if Thompson is upheld. Unless § 362(a)(3) generally requires the return of seized collateral, there would be no need to consider a special exception for collateral subject to a possessory lien. The applicability of § 362(a)(3) would be unnecessary.

1 See Thompson v. Gen. Motors Acceptance Corp., 566 F.3d 699 (7th Cir. 2009); Weaber v. SEFCU (In re Weaber), 719 F.3d 72 (2d Cir. 2013); Calif. Emp’t Dev. Dept. v. Taxel (In re Del Mission Ltd.), 98 B.R. 1147 (9th Cir. 1989) (expressly adopting Abrams v. Sw. Leasing & Rental Inc. (In re Abrams), 127 B.R. 259 (B.A.P. 9th Cir. 1991), which holds that failure to return repossessed car after receiving notice of debtor’s bankruptcy violates § 362(a)(3)).

2 Knau v. Concordia Lumber Corp. (In re Knau), 889 F.2d 773 (8th Cir. 1989), applied the same reasoning of § 362(a)(3) to require the return of collateral to a chapter 11 debtor. See also Motors Acceptance Corp. v. Rosier, 348 F.3d 1305 (11th Cir. 2003); Rosier v. Motors Acceptance Corp. (In re Rosier), 376 B.R. 1233 (11th Cir. 2004) (inquiring return of collateral obtained pre-petition as long as collateral remained estate property after repossession).


7 See Melissa Sanchez and Sandhya Kamtahampat, “Driven Into Debt: How Chicago Ticket Debt Sends Black Motorists into Bankruptcy,” ProPublica Illinois (Feb. 27, 2018), available at features.propublica.org/driven-into-debt/chicago-ticket-debt-bankruptcy (“In 2007, an estimated 1,000 Chapter 13 bankruptcies included debts to the city, usually for unpaid tickets, with the median amount claimed around $1,500 per case. By last year, the number of cases surpassed 10,000, with the typical debt to the city around $3,900.”);


9 In re Sanjee, 590 B.R. 467 (Bankr. N.D. Ill. 2018); In re Peake, 588 B.R. 811 (Bankr. N.D. Ill. 2018); In re Fulton, 588 B.R. 834 (Bankr. N.D. Ill. 2018); In re Howard, 584 B.R. 252 (Bankr. N.D. Ill. 2018).

10 City of Chicago v. Robles L. Fulton, No. 18-2527, Docket Nos. 2, 6 and 14. The author is serving as counsel to debtors in this appeal.

then becomes the principal issue to be determined by the
Seventh Circuit, and it is a major issue for consumer bank-
ruptcy, since it affects not only Chicago vehicle seizures
but the repossession of vehicles for ordinary auto loan
defaults across the nation. There are three major arguments
about the application of § 362(a)(3) to repossessed collateral:
(1) the requirements for turnover under § 542(a); (2) the
meaning of § 362(a)(3); and (3) compliance with general
bankruptcy policy.

Turnover Under § 542(a)

Section 542(a) provides that a party holding property
that a trustee can use under § 363 must deliver that property
to the trustee unless it has inconsequential benefit to the
estate.10 Section 1306(b) generally places chapter 13 debtors
in possession of estate property; § 1303 gives them the
general rights of a trustee under § 363; and § 542(a) gives them
the right to receive property that a trustee could use under
§ 363. Minority decisions acknowledge that chapter 13 debtors
have the property rights of trustees, but argue that § 542
requires the debtors to obtain a court order before creditors
are required to turn over seized property to the debtor.11

The difficulty with this argument is that it contradicts
the text of the statute. Section 542(a) does not condition its
turnover requirement on court orders, but simply states that
that property that can be used under § 363 “shall” be delivered.
The congressional reports setting out the effect of § 542(a)
confirm its plain meaning,12 and the majority decisions
have interpreted § 542(a) accordingly.13 Cowen expressly
decides to challenge this interpretation and only asserts
that if it is correct, § 362(a)(3) is not necessary to enforce
the turnover obligation, since § 105(a) would allow debtors
to seek sanctions for a creditor’s failure to turn over prop-
erty voluntarily.14

The Meaning of § 362(a)

The majority interpretation of § 362(a)(3) is also ground-
ed in the plain meaning of its terms. Section 362(a)(3) applies
the automatic stay to “any act to obtain possession of property
of the estate or of property from the estate or to exercise
control over property of the estate,” and the majority de-
sions hold that a creditor “exercises control” over a debtor’s
vehicle by continuing to hold it after the bankruptcy filing.
Thompson made the point this way:

Webster’s Dictionary defines “control” as, among other things, “to exercise restraining or directing
influence over” or “to have power over.” Merriam-Webster’s Collegiate Dictionary (11th ed. 2003).

On the other hand, Cowen focused on the action prohibited
by the paragraph:

[Section] 362(a)(3) prohibits “any act to obtain possess-
ion of property” or “any act to exercise control over
property.” “Act,” in turn, commonly means to “take
action” or “do something.” New Oxford American
Dictionary 15 (3d ed. 2010)....

This section, then, stays entities from doing something to obtain possession of
or to exercise control over the estate’s property. It does not cover “the act of passively holding onto an asset,”
Thompson, 566 F.3d at 703, nor does it impose an affirm-
ative obligation to turn over property to the estate.16

The difficulty with Cowen’s approach to the language
is that a creditor does more than “passively hold” a seized
vehicle by refusing to return it; the creditor actively pre-
vents the debtor from regaining possession by keeping the
vehicle locked or guarded. Only if the creditor were truly
passive, allowing the debtor free access to the vehicle,
would there be no exercise of control. In at least one bank-
ruptcy decision, the minority interpretation is supported
with an alternative argument that “property of the estate”
does not include all the rights of property ownership, but
only the rights to which the debtor was entitled when the
bankruptcy case was filed. If the debtor had no right to pos-
sess seized property before the bankruptcy case was filed,
the argument continues, the right of possession would not
become property of the estate, and the creditor would not
“exercise control over property of the estate” by preventing
the debtor from obtaining the property.17

Cowen does not make this argument, so it avoids
addressing the difficulty with the argument presented
by § 542(a). While a chapter 13 debtor would not have
had the right to possess seized property before the bank-
ruptcy filing, § 542(a) conveys that right as soon as the bank-
ruptcy case is filed. Thompson makes the point that
§ 542(a) “draw[s] back into the estate a right of posses-
sion that is claimed by a lien creditor pursuant to a pre-
petition seizure.”18 So, by depriving the debtor of the
right to possess property that § 542(a) accords, a creditor
would clearly exercise control over “estate property,”
violating § 362(a)(3).

10 Section 542(a) provides, in relevant part “[A]n entity ... in possession, custody, or control, during
the case, of property that the trustee may use, sell, or lease under section 363 ... shall deliver to the
trustee ... such property ... unless such property is of inconsequential value or benefit to the estate.”
11 For example, In re Hall, 502 B.R. at 654-64, sets out a lengthy argument that § 542(a) continues
a pre-Bankruptcy Code practice requiring trustees and debtors in possession to obtain turnover of
estate property by moving for a court order. Pre-Code practice might inform the interpretation of
ambiguous statutory Code provision language, but it may not be used to contradict the Code’s lan-
guage. See Hartford Underwriters Ins. Co, v. Union Planters Bank, 530 U.S. 1, 120 S. Ct. 1942,
its cannot overcame that language. It is a tool of construction, not an extratextual supplement.”
(1977) (“Subsection (a) of this section requires anyone holding property of the estate on the date of
the filing of the petition, or property that the trustee may use, sell, or lease under section 363, to deliver it to
the trustee.”).
13 See, e.g., In re Khan, 889 F.2d at 775 (“The duty to turn over the property is not contingent upon ... any
order of the bankruptcy court...”); Thompson, 566 F.3d at 704 (under § 542(a) “turnover of a seized
asset is compulsory”).
14 Cowen, 849 F.3d at 950.
15 Thompson, 566 F.3d at 702.
16 Cowen, 849 F.3d at S49.
17 Hall, 502 B.R. at 667-69.
18 Thompson, 566 F.3d at 704 (quoting In re Sharon, 234 B.R. at 683).
Bankruptcy Policy

The policies underlying §§ 362(a)(3) and 542(a), as Thompson explains, are to “allow the debtor to reorganize and repay the majority of his debts without having to liquidate his assets” and so let the debtor “retain the beneficial use of productive assets.” For chapter 13 debtors, enforcing this policy by applying the automatic stay to seized vehicles is particularly important. Chapter 13 debtors often need their vehicles to get to work or care for their children, but they typically have limited financial resources, so they would often lack the additional funds needed to obtain alternative transportation while a motion to enforce turnover was being considered by the court. Requiring a motion to be granted before the debtor can obtain the return of a seized vehicle would often make bankruptcy unable to address the debtor’s financial distress.20

For creditors, on the other hand, complying with § 362(a)(3) imposes no extraordinary burden. The major concern raised by the minority decisions is that the creditor might be required to return a vehicle without a court order providing adequate protection. However, this situation is not significantly different from that faced by any creditor whose collateral is not adequately protected while a chapter 13 case is pending.21

The remedy is for the creditor to seek a court order for relief from the automatic stay, which (if the creditor is threatened with immediate and irreparable loss) can be obtained without notice to the debtor.22 The most troubling situation for a creditor is a request for the return of a repossessed vehicle that is uninsured.23 However, a loss of insurance (caused by the debtor’s failure to pay premiums) can also occur during a case, and again, the remedy is stay relief. Creditors who have repossessed an uninsured vehicle before filing have an additional alternative: to retain the vehicle and respond to any motion for enforcement of the automatic stay with a request for stay annulment, which would retroactively validate the vehicle retention.24 There appear to be no published decisions imposing sanctions for a creditor’s refusal to return an uninsured vehicle, and there is ample indication that no such turnover would be ordered.25

Conclusion

Each of the arguments discussed herein will likely be addressed in the Seventh Circuit’s decision in the pending appeal, and that decision might have a major effect on chapter 13 practice. abi

20 Id. at 705.
21 Id. at 707 (“If a debtor’s car remains in the hands of a creditor, it could hamper the debtor from either attending or finding work, which is crucial for garnering the funds necessary to pay off his debts.”).
22 See In re Yates, 332 B.R. at 5 (“As a practical matter, there is little difference between a creditor who obtains property of the estate before bankruptcy is filed, or after bankruptcy is filed.”).
23 See Hall, 502 B.R. at 660 (“If immediate turnover were required, an accident might result in the collateral being destroyed, with no insurance proceeds recovered, and the lien being rendered worthless.”).
24 Annulment is one of the forms of stay relief authorized by § 362(d), and its effect of retroactive validation is well recognized. See, e.g., In re Siciliano, 13 F.3d 748, 751 (3d Cir. 1994) (“[I]nclusion of the word ‘annulling’ in the statute ... indicates a legislative intent to apply certain types of relief retroactively and validate proceedings that would otherwise be void ab initio.”).
25 While adopting the majority interpretation of § 362(a)(3), one court bluntly stated that it “takes the lack of insurance seriously and will not permit a debtor to obtain or retain possession of a vehicle that is not adequately insured.” Stephens v. Guaranteed Auto Inc. (In re Stephens), 495 B.R. 608, 615 (Bankr. N.D. Ga. 2013). Another court, though otherwise accepting the minority interpretation of § 362(a)(3), upheld the district’s practice of finding a violation of the automatic stay by a creditor that refuses to return a seized vehicle, but only after the debtor produces proof of insurance. In re Denby-Peterson, 576 B.R. 66, 81–82 (Bankr. D.N.J. 2017).
In re Fulton, 926 F.3d 916 (2019)
67 Bankr.Ct.Dec. 100

926 F.3d 916
United States Court of Appeals, Seventh Circuit.

IN RE: Robbin L. FULTON, Debtor-Appellee.
  Appeal of: City of Chicago
In re: Jason S. Howard, Debtor-Appellee.
  Appeal of: City of Chicago
In re: George Peake, Debtor-Appellee.
  Appeal of: City of Chicago
In re: Timothy Shannon, Debtor-Appellee.
  Appeal of: City of Chicago

No. 18-2527, No. 18-2793, No. 18-2835, No. 18-3023
| Argued May 14, 2019
| Decided June 19, 2019

Synopsis

Background: Bankruptcy court issued rule to show cause why city should not be sanctioned for refusing to release Chapter 13 debtor's vehicle, which had been impounded because of unpaid parking tickets. The United States Bankruptcy Court for the Northern District of Illinois, Jacqueline P. Cox, J., 584 B.R. 252, entered judgment in favor of debtor, and city appealed. In separate Chapter 13 case, debtor moved to enforce automatic stay by requiring city to release vehicle, and the United States Bankruptcy Court for the Northern District of Illinois, Deborah Lee Thorne, J., 588 B.R. 811, granted motion. City appealed. In yet another case, debtor again filed motion to enforce stay against city, which motion was granted by the United States Bankruptcy Court for the Northern District of Illinois, Carol A. Doyle, J., 590 B.R. 467, and city appealed. Finally, city appealed from a grant of like relief by the United States Bankruptcy Court for the Northern District of Illinois, Jack B. Schmetterer, J., 2018 WL 2570109, and city appealed.

Holdings: Consolidating cases for purposes of appeal, the Court of Appeals, Flaum, Circuit Judge, held that:

[1] city violated stay by its continued postpetition retention of motor vehicles impounded prepetition;

[2] stay exception for “any act to perfect, or to maintain or continue the perfection of, an interest in property” did not permit city to continue to retain possession of motor vehicles; and

[3] “police or regulatory power” exception to automatic stay did not apply.

Affirmed.

West Headnotes (21)

[1] Bankruptcy
  Moot questions
  Issues relating to creditor's alleged violation of automatic stay are not mooted by dismissal of underlying bankruptcy case. 11 U.S.C.A. § 362(a).

Cases that cite this headnote

[2] Bankruptcy
  Sanctions, in general
  Court must have the power to compensate victims for violations of automatic stay and to punish the violators, even after conclusion of underlying bankruptcy case. 11 U.S.C.A. § 362(a).

Cases that cite this headnote

[3] Bankruptcy
  Conclusions of law; de novo review
  Bankruptcy
  Clear error
  On appeal in bankruptcy case, the Court of Appeals reviews bankruptcy court’s factual findings for clear error and its conclusions of law de novo. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[4] Bankruptcy
  Repossession
  Creditor “exercises control” over property of the estate in violation of automatic stay when, subsequent to filing of bankruptcy petition,
creditor refuses to return property of debtor that it has repossessed prepetition. 11 U.S.C.A. § 362(a)(3).

Cases that cite this headnote

[5] Bankruptcy

✉️ Notice to creditors; commencement

Stay provision that bars creditor from exercising control over property of the estate becomes effective immediately upon filing bankruptcy petition and is not dependent upon the debtor first bringing a turnover action. 11 U.S.C.A. §§ 362(a)(3), 542.

Cases that cite this headnote

[6] Bankruptcy

✉️ Repossession

Creditor that has repossessed debtor's motor vehicle prepetition is required to turn over such property of the estate following commencement of debtor's bankruptcy case, prior to a court determination establishing debtor's obligation to provide adequate protection for creditor's interest in vehicle. 11 U.S.C.A. §§ 362(a)(3), 542.

Cases that cite this headnote

[7] Bankruptcy

✉️ Collection and Recovery for Estate; Turnover

Turnover of estate property by creditor in possession thereof is compulsory. 11 U.S.C.A. § 542(a).

Cases that cite this headnote

[8] Bankruptcy

✉️ Acts excepted from stay

City which, prior to commencement of debtors' Chapter 13 cases, had impounded motor vehicles belonging to debtors based on their unpaid parking and moving tickets improperly exercised control over property of the estate, in violation of automatic stay, by refusing to return vehicles postpetition in order to avoid losing its posessory lien interests in vehicles; while city argued that its passive retention of motor vehicles that it had lawfully impounded was not an “act” to exercise control over property of the stay, of kind barred by automatic stay, city's argument ignored fundamental purpose of bankruptcy, to allow debtors to regain their financial foothold and repay their creditors, something for which motor vehicle was necessary. 11 U.S.C.A. § 362(a)(3).

Cases that cite this headnote

[9] Bankruptcy

✉️ Collection and Recovery for Estate; Turnover

Turnover statute compels the return of estate property, including property in which debtor did not have a possessory interest at the time the bankruptcy proceedings commenced. 11 U.S.C.A. § 542(a).

Cases that cite this headnote

[10] Bankruptcy

✉️ Adequate Protection

It is obligation of creditor with possessory lien interest in debtor's property to come to court and ask for adequate protection of its interest, not the debtor’s obligation to file adversary proceeding against every creditor holding her property at the time that she files for bankruptcy.

Cases that cite this headnote


✉️ Construction and Operation

Courts construe the Bankruptcy Code liberally in favor of debtors and strictly against creditors. 11 U.S.C.A. § 101 et seq.

Cases that cite this headnote

[12] Bankruptcy

✉️ Automatic Stay

Automatic stay is one of the fundamental debtor protections provided by bankruptcy laws, and courts therefore narrowly construe exceptions to
the stay in order to give the stay its intended broad application. 11 U.S.C.A. § 362(a).

Cases that cite this headnote

[13] Bankruptcy
Acts excepted from stay
Stay exception for “any act to perfect, or to maintain or continue the perfection of, an interest in property” did not permit city to continue to retain possession of motor vehicles that it had impounded prepetition for Chapter 13 debtors' unpaid parking and moving tickets; involuntary turnover of vehicles by city solely to comply with its obligations under the Bankruptcy Code would not result in loss of its possessory lien interest in vehicles. 11 U.S.C.A. § 362(b)(3).

Cases that cite this headnote

[14] Bankruptcy
Acts excepted from stay
By enacting stay exception for “any act to perfect, or to maintain or continue the perfection of, an interest in property,” and by limiting trustee’s power to avoid an unperfected lien by making that power subject to any nonbankruptcy law that permits perfection to relate back, Congress sought to prevent a trustee from avoiding the lien of creditor when only the intervening bankruptcy stopped creditor from perfecting or continuing perfection of its lien; purpose of these provisions is to prevent creditors from losing their lien rights due to debtor's bankruptcy filing, not to permit creditors to retain possession of debtors’ property. 11 U.S.C.A. §§ 362(b)(3), 546(b).

Cases that cite this headnote

[15] Bankruptcy
Administrative Proceedings and Governmental Action
“Police or regulatory power” exception to automatic stay is narrowly construed to apply to the enforcement of state laws affecting health, welfare, morals and safety, but not to regulatory laws that directly conflict with control of the res or property by bankruptcy court. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

[16] Bankruptcy
Administrative Proceedings and Governmental Action
City's retention of possession of motor vehicles which it had impounded prepetition for unpaid parking tickets and other monetary penalties assessed against Chapter 13 debtors, the vehicles' owners, and not against offending drivers, until such time as tickets and penalties were paid in full, was focused on debtors' financial obligations, not on public safety matters, and did not come within “police or regulatory power” exception to automatic stay. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

[17] Bankruptcy
Administrative Proceedings and Governmental Action
Courts apply two tests to determine whether a state’s actions fall within the “police or regulatory power” exception to automatic stay, the “pecuniary purpose” test and the “public policy” test, and the satisfaction of either test is sufficient for the stay exception to apply. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

[18] Bankruptcy
Administrative Proceedings and Governmental Action
“Pecuniary purpose” test for whether an action comes within the “police or regulatory power” exception to automatic stay requires court to look to what specific acts the government wishes to carry out and determine if such execution will result in an economic advantage over third parties in relation to debtor’s estate. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote
Bankruptcy

If focus of the State's alleged exercise of its police power is directed at debtor’s financial obligations, rather than at the State's health and safety concerns, then automatic stay is applicable. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

Bankruptcy

“Public policy” test for whether an action comes within the “police or regulatory power” exception to automatic stay considers whether the State's action is principally to effectuate public policy or to adjudicate private rights. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

Bankruptcy

Even if court assumed that city's adjudication of parking and minor moving violations against Chapter 13 debtors was result of city’s exercise of its police and regulatory powers, city could not enforce these final determinations of liability, which were in nature of money judgments, by retaining possession of debtors' vehicles until it was paid in full, without violating automatic stay; city had to seek satisfaction of any prepetition debts owed to it by debtors through bankruptcy process, just like any other creditor. 11 U.S.C.A. § 362(b)(4).

Cases that cite this headnote

*919 Appeal from the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division. No. 17-25141—Jacqueline P. Cox, Bankruptcy Judge.

Appeal from the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division. No. 18-16544—Deborah Lee Thorne, Bankruptcy Judge.

Appeal from the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division. No. 18-04116—Carol A. Doyle, Chief Bankruptcy Judge.

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In re Fulton, 926 F.3d 916 (2019)

Opinion

Flaum, Circuit Judge.

*920 In this consolidated appeal of four Chapter 13 bankruptcies, we consider whether the City of Chicago may ignore the Bankruptcy Code’s automatic stay and continue to hold a debtor’s vehicle until the debtor pays her outstanding parking tickets. Prior to the debtors’ filing for bankruptcy, the City impounded each of their vehicles for failure to pay multiple traffic fines. After the debtors filed their Chapter 13 petitions, the City refused to return their vehicles, claiming it needed to maintain possession to continue perfection of its possessory liens on the vehicles and that it would only return the vehicles when the debtors paid in full their outstanding fines. The bankruptcy courts each held that the City violated the automatic stay by “exercising control” over property of the bankruptcy estate and that none of the exceptions to the stay applied. The courts ordered the City to return debtors’ vehicles and imposed sanctions on the City for violating the stay.

This is not our first time addressing this issue: in Thompson v. General Motors Acceptance Corp., 566 F.3d 699 (7th Cir. 2009), we held that a creditor must comply with the automatic stay and return a debtor’s vehicle upon her filing of a bankruptcy petition. We decline the City’s request to overrule Thompson. We therefore affirm the bankruptcy courts’ judgments relying on Thompson, and we also agree with the bankruptcy courts that none of the exceptions to the stay apply.

I. Background

The Chicago Municipal Code permits creditor-appellant the City of Chicago to immobilize and then impound a vehicle if its owner has three or more “final determinations of liability,” or two final determinations that are over a year old, “for parking, standing, compliance, automated traffic law enforcement system, or automated speed enforcement system violation[s].” Municipal Code of Chicago (“M.C.C.”) § 9-100-120(b); see also id. § 9-80-240(a) (providing for impoundment of vehicles “operated by a person with a suspended or revoked driver’s license”). The fines for violations of the City’s Traffic Code range from § 25 (e.g., parallel parking violation) to $ 500 (e.g., parking on a public street without displaying a wheel tax license emblem). Id. § 9-100-020(b)–(c). Failure to pay the fine within twenty-five days automatically doubles the penalty. Id. § 9-100-050(e). After a vehicle is impounded, the owner is further subjected to towing and storage fees, see id. § 9-64-250(c), and to the City’s costs and attorney’s fees for collection activity. Id. §§ 1-19-020, 2-14-132(c)(1)(A). To retrieve her vehicle, an owner may either pay the fines, towing and storage fees, and collection costs and fees in full, id. § 2-14-132(c)(1)(A), or pay the full amount via an installment plan over a period of up to thirty-six months, provided she makes an initial payment of half the fines and penalties plus all of the impoundment, towing, and storage charges. Id. § 9-100-101(a)(2)–(3).

In 2016, the City amended the Code to include: “Any vehicle impounded by the City or its designee shall be subject to a possessory lien in favor of the City in the amount required to obtain release of the vehicle.” Id. § 9-92-080(f). Based on this provision, the City began refusing to release impounded vehicles to debtors who had filed Chapter 13 petitions. That is just what occurred in these four cases.

A. In re Fulton

Debtor-appellee Robbin Fulton uses a vehicle to commute to work, transport her young daughter to day care, and care for her elderly parents on weekends. On December 24, 2017, three weeks after she purchased a 2015 Kia Soul, the City towed and impounded the vehicle for a prior citation of driving on a suspended license. Fulton filed a Chapter 13 bankruptcy petition on January 31, 2018 and filed a plan on February 5, treating the City as a general unsecured creditor. The City filed a general unsecured proof of claim on February 23 for $ 9,391.20. After the court confirmed Fulton’s plan on March 21, she requested the City turn over her vehicle. The City then amended its proof of claim to add impound fees, for a total of $ 11,831.20, and to assert its status as a secured creditor; it did not return Fulton’s vehicle.

On May 2, Fulton filed a motion for sanctions arguing the City was required to turn over her vehicle pursuant to Thompson and that its failure to do so was sanctionable conduct. The City countered that Fulton must seek turnover through an adversary proceeding. It asserted it was retaining possession
to perfect its possessory lien and was thus excepted from the automatic stay pursuant to 11 U.S.C. § 362(b)(3).

On May 25, the bankruptcy court held that the City was required to return Fulton’s vehicle under Thompson and that the City was not excepted from the stay under § 362(b)(3). The court ordered the City to turn over Fulton’s vehicle no later than May 29, imposed a sanction of $100 for every day the City failed to comply, and sustained Fulton’s objection to the City’s claim as a secured creditor. The City moved to stay the order in the district court pending appeal; the district court denied the stay request on September 10. Eventually, the City returned Fulton’s vehicle. At no point did the City initiate proceedings to protect its rights under § 363(e).

**B. In re Shannon**

The City impounded debtor-appellee Timothy Shannon’s 1997 Buick Park Avenue on January 8, 2018 for unpaid parking tickets. Shannon filed a Chapter 13 petition on February 15. On February 27, the City filed an unsecured proof of claim for $3,160 in fines dating back to 1999. Shannon, in turn, filed a proposed plan that did not include the City as a secured creditor, to which the City did not object, and the court confirmed the plan on May 1. When Shannon sought the return of his vehicle, the City amended its proof of claim, adding fines, storage, and towing fees for a total of $5,600, and stated the claim was secured by its possession of Shannon’s vehicle.

Shannon filed a motion for sanctions on June 12, asserting the stay required the City to turn over his vehicle. The court granted his motion on September 7; it held the City’s claim was unsecured because it did not object to the plan that characterized the debt as such. It also determined the City violated the stay by failing to return Shannon’s vehicle, that the §§ 362(b)(3) and (b)(4) exceptions to the stay did not apply, and that the City further violated § 362(a)(4) and (a)(6) by retaining the vehicle. The court noted the City was free to file a motion seeking adequate protection of its lien. The City returned Shannon’s car and did not file any such motion.

**C. In re Peake**

Debtor-appellee George Peake relies on his car to travel approximately forty-five miles from his home to work. The City impounded his 2007 Lincoln MKZ for unpaid fines on June 1, 2018. Peake filed a Chapter 13 petition on June 9. In response, the City filed a secured proof of claim for $5,393.27 and asserted a possessory lien on his vehicle. After the City refused Peake’s request to return his vehicle, he filed a motion for sanctions and for turnover. On August 15, the bankruptcy court granted the motion; it held that neither § 362(b)(3) nor (b)(4) applied, so the City’s retention of Peake’s vehicle violated the stay, and it ordered the City to release his vehicle immediately. The City filed a motion to stay the order pending appeal, which the court denied on August 22. The same day, Peake filed a motion for civil contempt based on the City’s refusal to release his vehicle. The court granted the motion and entered an order requiring the City to pay monetary sanctions—$100 per day from August 17 through August 22 and $500 per day thereafter until the City returned his vehicle. The City filed an emergency motion for a stay pending appeal in our Court, which we denied. Finally, the City released Peake’s vehicle. At no point did the City file a motion to protect its interest in the vehicle.

**D. In re Howard**

The City immobilized debtor-appellee Jason Howard’s vehicle on August 9, 2017 and impounded it soon after. Howard filed a Chapter 13 petition on August 22. The City filed a secured proof of claim on August 23 for $17,110.80. The court confirmed Howard’s plan on October 16, which included a nonpriority unsecured debt of $13,000 owed to the City for parking tickets. Though the Code did not impose an automatic stay when Howard filed his petition due to his prior dismissed bankruptcy petitions, see 11 U.S.C. § 362(c)(4)(A), the court granted Howard’s motion to impose a stay when it confirmed his plan on October 16. The City did not object to its treatment as unsecured under the plan and did not appeal the confirmation order; rather, it simply refused to release Howard’s vehicle unless he paid 100% of its claim.

On January 22, 2018, the court issued a rule to show cause to the City why it should not be sanctioned for refusing to release Howard’s vehicle in accordance with Thompson. The court rejected the City’s argument that it was excepted from the stay under § 362(b)(3) and, on April 16, 2018, ordered sanctions of $50 per day beginning August 22, 2017 for the City’s violation of the stay.

[1] [2] After the City filed its opening appellate brief, Howard filed notice of his intention not to participate in the appeal. His counsel explained Howard’s bankruptcy case had been dismissed and the City disposed of his vehicle. He has since filed a new bankruptcy case to address his parking tickets but has abandoned interest in the vehicle that was the subject of the relevant Chapter 13 petition in the bankruptcy court below. However, “issues related to an alleged violation
of the **automatic stay** are not mooted by dismissal of a bankruptcy petition, *Denby-Peterson v. Nu2u Auto World*, 595 B.R. 184, 188 (D.N.J. 2018); a court “must have the power to compensate victims of violations of the **automatic stay** and punish the violators, even after the conclusion of the underlying bankruptcy case.” *In re Johnson*, 575 F.3d 1079, 1083 (10th Cir. 2009) (citing *In re Davis*, 177 B.R. 907, 911–12 (B.A.P. 9th Cir. 1995)).

* * *

In each of these four cases, the City appealed the bankruptcy courts’ orders finding the City violated the stay. These cases have been consolidated for appeal.

II. Discussion

[3] The main question before us is whether the City is obligated to return a debtor’s vehicle upon her filing of a Chapter 13 bankruptcy petition, or whether the City is entitled to hold the debtor’s vehicle until she pays the fines and costs or until she obtains a court order requiring the City to turn over the vehicle. We review a “923 bankruptcy court’s factual findings for clear error and conclusions of law de novo. *In re Jepson*, 816 F.3d 942, 945 (7th Cir. 2016).

A. The Automatic Stay

Section 362(a)(3) of the Bankruptcy Code provides that a Chapter 13 bankruptcy petition “operates as a stay, applicable to all entities, of ... any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.” 11 U.S.C. § 362(a)(3) (emphasis added). We applied this provision to a very similar factual situation in *Thompson v. General Motors Acceptance Corp.* There, a creditor seized a debtor’s car after he defaulted on payments. 566 F.3d at 700. The debtor filed a Chapter 13 petition and attempted to retrieve his car, but the creditor refused. *Id.* We considered two issues relating to § 362(a)(3): whether the creditor “exercised control” of property of the bankruptcy estate by failing to return the vehicle after the debtor filed for bankruptcy, and whether the creditor was required to return the vehicle prior to a court determination establishing the debtor could provide adequate protection for the creditor’s interest in the vehicle. *Id.* at 701.

I. “Exercise Control”

[4] First, we observed in *Thompson* there was no debate the debtor has an equitable interest in his vehicle, and “as such, it is property of his bankruptcy estate.” 566 F.3d at 701 (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983)); see 5 Collier on Bankruptcy ¶ 541.01 (16th ed. 2019) (“Congress’s intent to define property of the estate in the broadest possible sense is evident from the language of the statute which, in section 541(a)(1), initially defines the scope of estate property to be all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held.”). We then rejected the creditor’s argument that passively holding the asset did not satisfy the Code’s definition of exercising control: “Holding onto an asset, refusing to return it, and otherwise prohibiting a debtor’s beneficial use of an asset all fit within th[e] definition, as well as within the commonsense meaning of the word.” *Thompson*, 566 F.3d at 702. As we explained, limiting the reach of “exercising control” to “selling or otherwise destroying the asset,” as the creditor proposed, did not fit with bankruptcy’s purpose: “The primary goal of reorganization bankruptcy is to group all of the debtor’s property together in his estate such that he may rehabilitate his credit and pay off his debts; this necessarily extends to all property, even property lawfully seized pre-petition.” *Id.* (citing *Whiting Pools*, 462 U.S. at 203–04, 103 S.Ct. 2309).

Additionally, Congress amended § 362(a)(3) in 1984 to prohibit conduct that “exercise[d] control” over estate assets. We determined this addition suggested congressional intent to make the stay more inclusive by including conduct of “creditors who seized an asset pre-petition.” *Id.*; see *In re Javens*, 107 F.3d 359, 368 (6th Cir. 1997) (“The fact that ‘to obtain possession’ was amended to ‘to obtain possession ... or to exercise control’ hints [...] that this kind of ‘control’ might be a broadening of the concept of possession ... It could also have been intended to make clear that [§ 362](a)(3) applied to property of the estate that was not in the possession of the debtor.”) (first alteration in original)); *In re Del Mission Ltd.*, 98 F.3d 1147, 1151 (9th Cir. 1996) (The 1984 amendment “broaden[ed] the scope of § 362(a)(3) to proscribe the mere knowing retention of estate property.”). We therefore held that in retaining possession of the car, the creditor violated the **automatic stay** in § 362(a)(3). *Thompson*, 566 F.3d at 703.
2. Compulsory Turnover

[5] Next, we concluded § 362(a)(3) becomes effective immediately upon filing the petition and is not dependent on the debtor first bringing a turnover action. Id. at 707–08. In so concluding, we relied on a plain reading of §§ 363(e) and 542(a) and the Supreme Court’s decision in *Whiting Pools*.

[6] Section 363(e) provides:

> [O]n 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.

¹¹ U.S.C. § 363(e). The creditor acknowledged, and we agreed, that it has the burden of requesting protection of its interest in the asset under § 363(e). “However, if a creditor is allowed to retain possession, then this burden is rendered meaningless—a creditor has no incentive to seek protection of an asset of which it already has possession.” *Thompson*, 566 F.3d at 704. For § 363(e) to have meaning then, the asset must be returned to the estate prior to the creditor seeking protection of its interest. Id.; cf. *In re Sharon*, 234 B.R. 676, 684 (B.A.P. 6th Cir. 1999) (“[T]he Bankruptcy Code does not elevate [the creditor’s] adequate protection right above the Chapter 13 debtor’s right to possession and use of a car.”).

[7] Moreover, § 542(a) “indicates that turnover of a seized asset is compulsory.” *Thompson*, 566 F.3d at 704. Section 542(a) requires that a creditor in possession of property of the estate “shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.” ¹¹ U.S.C. § 542(a) (emphasis added). We observed that a majority of courts had found § 542(a) worked in conjunction with § 362(a) “to draw back into the estate a right of possession that is claimed by a lien creditor pursuant to a pre-petition seizure; the Code then substitutes ‘adequate protection’ for possession as one of the lien creditor’s rights in the bankruptcy case.” *Thompson*, 566 F.3d at 704 (quoting *Sharon*, 234 B.R. at 683). Because “[t]he right of possession is incident to the

automatic stay,” id., the creditor must first return the asset to the bankruptcy estate. Only then is “the bankruptcy court [ ] empowered to condition the right of the estate to keep possession of the asset on the provision of certain specified adequate protections to the creditor.” Id.; see also ¹¹ U.S.C. § 362(d)(1) (“On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under [§ 362(a)] ... for cause, including the lack of adequate protection of an interest in property ....”). The Supreme Court indicated as much in *Whiting Pools* when it explained that a “creditor with a secured interest in property included in the estate must look to [§ 363(e)] for protection, rather than to the nonbankruptcy remedy of possession.” ⁴⁶² U.S. at 204, 103 S.Ct. 2309 (emphasis added).

3. *Thompson* Controls

[8] Applying *Thompson* to the facts before us, we conclude, as each bankruptcy court did, that the City violated the automatic stay pursuant to § 362(a)(3) by retaining possession of the debtors’ vehicles after they declared bankruptcy. See *In re Shannon*, ⁵⁹⁰ B.R. ⁴⁶⁷, ⁴⁷⁷ (Bankr. N.D. Ill. 2018), ECF No. ⁶⁴ (“*Thompson* [ ] requires any secured creditor in possession of a debtor’s vehicle to return it immediately and seek adequate protection ....”); *In re Peake*, ⁵⁸⁸ B.R. ⁸¹¹, ⁸¹⁶ (Bankr. N.D. Ill. 2018), ECF No. ⁴⁰ (“[T]he City’s conduct in retaining possession of the vehicle violates [§] 362(a)(3) as that section *⁹⁲⁵* has been interpreted ... in *Thompson* ....”); *In re Fulton*, ¹⁸-bk-⁰⁴⁷⁶⁰, Mem. Op. at ², ²⁰¹⁸ WL ²³⁹²⁸⁵⁴ (Bankr. N.D. Ill. May ²⁵, ²⁰¹⁸), ECF No. ³⁹ (“[T]he City is circumventing entirely the procedural burden imposed on it by *Thompson* and the protections provided to debtors by the automatic stay.”); *In re Howard*, ¹⁷-bk-²⁵²²¹, Mem. Op. at ¹⁰, ²⁰¹⁸ WL ¹⁸³⁰⁹¹⁰ (Bankr. N.D. Ill. Apr. ¹⁶, ²⁰¹⁸), ECF No. ⁶³ (“[Section 362(a)] does not authorize continued possession of impounded vehicles in contravention of the *Thompson* ruling.”). The City was required to return debtors’ vehicles and seek protection within the framework of the Bankruptcy Code rather than through “the nonbankruptcy remedy of possession.” *Whiting Pools*, ⁴⁶² U.S. at ²⁰⁴, ¹⁰³ S.Ct. ²³⁰⁹.

The City acknowledges *Thompson* controls but asks us to overrule *Thompson* for three reasons: (1) property impounded prior to bankruptcy is not property of the bankruptcy estate because the debtors did not have a possessory interest in their vehicles at the time of filing; (2) the stay requires creditors to maintain the status quo and not take any action, such as
returning property to the debtor, so the onus is on the debtor to move for a turnover action to retrieve her vehicle; and (3) the plain language of § 362(a)(3) requires an “act” to exercise control, and passive retention of the vehicle is not an “act.”

[9] We decline the City’s request; Thompson considered and rejected these arguments. More fundamentally, the City’s arguments ignore the purpose of bankruptcy—“to allow the debtor to regain his financial foothold and repay his creditors.” Thompson, 566 F.3d at 706; see also 5 Collier on Bankruptcy ¶ 541.01 (“[T]he central aggregation and protection of property [ ] promote[s] the fundamental purposes of the Bankruptcy Code: the breathing room given to a debtor that attempts to make a fresh start, and the equality of distribution of assets among similarly situated creditors according to the priorities set forth within the Code.”). To effectively do so, a debtor must be able to use his assets “while the court works with both debtor and creditors to establish a rehabilitation and repayment plan.” Thompson, 566 F.3d at 707; see also Whiting Pools, 462 U.S. at 203, 103 S.Ct. 2309 (“[T]o facilitate the rehabilitation of the debtor’s business, all the debtor’s property must be included in the reorganization estate.”). This is why § 542 compels the return of property to the estate, including “property in which the debtor did not have a possessory interest at the time the bankruptcy proceedings commenced.” Whiting Pools, 462 U.S. at 205, 103 S.Ct. 2309; see In re Weber, 719 F.3d 72, 79 (2d Cir. 2013) (“Whiting Pools teaches that the filing of a petition will generally transform a debtor’s equitable interest into a bankruptcy estate’s possessory right in the vehicle.”). Thus, contrary to the City’s argument, the status quo in bankruptcy is the return of the debtor’s property to the estate. In refusing to return the vehicles to their respective estates, the City was not passively abiding by the bankruptcy rules but actively resisting § 542(a) to exercise control over debtors’ vehicles.

What’s more, the position we took in Thompson brought our Circuit in line with the majority rule, held by the Second, Eighth, and Ninth Circuits. See Weber, 719 F.3d 72; Del Mission 98 F.3d 1147; In re Knaus, 889 F.2d 773 (8th Cir. 1989). Although the Tenth Circuit recently adopted the City’s view, see In re Cowen, 849 F.3d 943 (10th Cir. 2017), that position is still the minority rule. Our reasoning in Thompson continues to reflect the majority position and we believe it is the appropriate reading of the bankruptcy statutes. At bottom, the City wants to maintain possession of the vehicles not because it wants the vehicles but to put pressure on the debtors to pay their tickets. That is precisely what the stay is intended to prevent. 1

The City, though, pleads necessity; it claims that, without retaining possession, it is helpless to prevent the loss or destruction of the vehicles. It did not attempt in any of these cases, however, to seek adequate protection of its interests through the methods available under the Bankruptcy Code, and at oral argument, the City asserted it did not have “the opportunity” to request such protection before the bankruptcy courts ordered it to return the vehicles. The record belies this statement. In each case, the parties engaged in motion practice, often over the course of months, before the courts held the City to be in violation of the stay. At any point the City could have sought adequate protection of its interests, but it chose not to avail itself of the Code’s available procedures. See, e.g., 11 U.S.C. § 362(d)(1) (court may relieve creditor from the stay if debtor cannot adequately protect creditor’s interest in the property); id. § 362(f) (court may relieve creditor from stay “as is necessary to prevent irreparable damage to the interest of an entity in property”); id. § 363(e) (creditor may request court to place limits or conditions on trustee’s power to use, sell, or lease property to protect creditor’s interest).

[10] We recognize that once the City complies with the automatic stay and immediately turns over vehicles, it will need to seek protection on an expedited basis. Though we leave it to the City and the bankruptcy courts to fashion the precise procedure for doing so, we note the following: The City will have notice of the bankruptcy petition when the debtor requests her vehicle, if not sooner. At that time, the City may immediately file an emergency motion for adequate protection of its interest in a debtor’s vehicle, which may be heard within a day or so, and the City can even file such motions ex parte if necessary. See id. § 363(e); Fed. R. Bankr. P. 4001(a)(2); see also 11 U.S.C. § 362(d)(1), (f); Bankr. N.D. Ill. R. 9013-9(B)(9)(d) (motion for relief from stay under § 362 where movant alleges security interest in vehicle “ordinarily [ ] granted without hearing”). It will be the rare occasion where a single day’s delay will have lost the City the value of its security. Regardless, the Code is clear that it is the creditor’s obligation to come to court and ask for protection, not, as the City advocates, the debtor’s obligation to file an adversary proceeding against every creditor holding her property at the time she files for bankruptcy. Cf. In re Lisse, 921 F.3d 629, 639 (7th Cir. 2019) (“The basic premise [of Chapter 13] is to facilitate the debtor’s ability to pay his creditors ....”).
The City’s argument that it will be overburdened with responding to Chapter 13 petitions is ultimately unavailing; any burden is a consequence of the Bankruptcy Code’s focus on protecting debtors and on preserving property of the estate for the benefit of all creditors. It perhaps also reflects the importance of vehicles to residents’ everyday lives, particularly where residents need their vehicles to commute to work and earn an income in order to eventually pay off their fines and other debts. It is not a reason to permit the City to ignore the automatic stay and hold captive property of the estate, in contravention of the Bankruptcy Code.

Furthermore, if a debtor files a bankruptcy petition in bad faith and immediately dismisses her case, as the City claims many debtors do solely to retrieve their impounded vehicles, the City has recourse: it may file a bad faith motion against the debtor. If the court finds bad faith, it may immediately dismiss the case and may even sanction the debtor. 11 U.S.C. § 1307(c); see, e.g., Lisse, 921 F.3d at 639–41 (affirming sanctions and dismissal of Chapter 13 petition filed in bad faith to collaterally attack state court judgment); In re Bell, 125 F. App’x 54, 57 (7th Cir. 2005) (affirming dismissal of Chapter 13 petition with prejudice where debtors filed multiple petitions “solely to impede the foreclosure sale” of their home).

B. Exceptions to the Stay

[11] [12] The City next argues that even if the stay applies, it is excepted under § 362(b)(3) and (b)(4). “We construe the Bankruptcy Code ‘liberally in favor of the debtor and strictly against the creditor.’” Village of San Jose v. McWilliams, 284 F.3d 785, 790 (7th Cir. 2002) (quoting In re Brown, 108 F.3d 1290, 1292 (10th Cir. 1997)). The automatic stay is “one of the fundamental debtor protections provided by the bankruptcy laws.” Midlantic Nat’l Bank v. N.J. Dep’t of Envtl. Prot., 474 U.S. 494, 503, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) (quoting S. Rep. No. 95–989, at 54 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5840). We therefore narrowly construe exceptions “to give the automatic stay its intended broad application.” In re Grede Foundries, Inc., 651 F.3d 786, 790 (7th Cir. 2011); see In re Stringer, 847 F.2d 549, 552 (9th Cir. 1988) (“Congress clearly intended the automatic stay to be quite broad. Exemptions to the stay, on the other hand, should be read narrowly to secure the broad grant of relief to the debtor.” (footnotes omitted)).

1. Section 362(b)(3)

[13] Section 362(b)(3) provides that a Chapter 13 bankruptcy petition does not operate as a § 362(a) automatic stay of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee’s rights and powers are subject to such perfection under section 546(b) of [the Bankruptcy Code] or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of [the Bankruptcy Code].

11 U.S.C. § 362(b)(3). Section 546(b) limits a trustee’s power to avoid a nonperfected lien by making that power subject to any nonbankruptcy law that “permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection,” or “provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.” 11 U.S.C. § 546(b)(1). The classic example of this exception is for a creditor who has a grace period for perfecting its interest, such as under the Uniform Commercial Code. See 3 Collier on Bankruptcy ¶ 362.05 (explaining § 362(b)(3) permits a purchase-money secured creditor to retroactively perfect under the twenty-day grace period provided in Article 9 of the U.C.C. and permits the filing of continuations of financing statements under U.C.C. § 9-515).

[14] As the In re Shannon court explained, through §§ 362(b)(3) and 546(b), “Congress sought only to prevent a trustee from avoiding the lien of a creditor when only the intervening bankruptcy stopped the creditor from perfecting or continuing perfection of its lien.” Thus, the purpose of these sections is to prevent creditors from losing their lien rights because of the bankruptcy; they do not permit creditors to retain possession of debtors’ property. Indeed, if the nonbankruptcy law requires a creditor to seize property after the filing of a bankruptcy petition to perfect or maintain the perfection of a lien, § 546(b)(2) replaces the seizure requirement with the
giving of notice. See 3 Collier on Bankruptcy ¶ 362.05. “This assures that the trustee’s right to maintain possession of the property will be unaffected by the creditor’s right to perfect its interest.” Id. And the (b)(3) exception permits a creditor to give notice under § 546(b)(2) without violating the automatic stay.

Here, the City argues the Chicago Municipal Code (a nonbankruptcy law) gives it the right to retain possession of a debtor’s vehicle until the debt is paid, thereby creating a possessory lien on the vehicle. See, e.g., M.C.C. §§ 9-92-080(f), 9-100-120(b)–(c). It further asserts it must retain the vehicle to maintain perfection of its lien.

First, as to perfection, it is commonly understood that an interest in property is perfected when it is valid against other creditors who have an interest in the same property. See Perfection, Black’s Law Dictionary (11th ed. 2019). The City’s continued possession of a debtor’s vehicle is one way to perfect its lien because it can demand the amount owed to it from any holder of an interest in the vehicle before it gives up possession, be that the debtor or another lienholder asserting its right to possession of the vehicle. See M.C.C. § 9-92-080(a), (c). However, possession is not the only way to perfect; the City can also perfect its lien by filing notice of its interest in the vehicle, such as with the Secretary of State or the Recorder of Deeds. And the Chapter 13 plan, itself, provides a public record of secured liens. See 11 U.S.C. § 1325(a)(5) (regarding the rights of secured creditors related to confirmation of the plan). Thus, the City does not need to retain possession of the vehicle to maintain perfection of its lien.

Second, despite its arguments to the contrary, the City’s possessory lien is not destroyed by its involuntary loss of possession due to forced compliance with the Bankruptcy Code’s automatic stay. The City did not indicate any intent to abandon or release its lien, so its possessory lien survives its loss of possession to the bankruptcy estate. See In re Estate of Miller, 197 Ill.App.3d 67, 144 Ill.Dec. 890, 556 N.E.2d 568, 572 (1990) (“The law respecting common law retaining liens is that the involuntary relinquishment of retained property pursuant to a court order does not result in the loss of the lien.”); see also #929 In re Borden, 361 B.R. 489, 495 (B.A.P. 8th Cir. 2007) (“[I]nvoluntary loss of possession does not defeat the [ ] lien.”); Restatement (First) of Security § 80 cmt. c (1941) (“The lien is a legal interest dependent upon possession. Where the lienor voluntarily gives up the possession, his lien, at least so far as it is a legal interest, is gone. The lienor ... does not lose his legal interest if he is deprived without his consent of his possession.”). 3

Because the City does not lose its perfected lien via the involuntary loss of possession of the debtors’ vehicles to the bankruptcy estates, § 362(b)(3) does not apply to except it from the stay. To the extent the City has any doubt about the continuation of its lien, when it requests relief from the automatic stay and adequate protection, it could also ask the bankruptcy court to include in its order a notation of the City’s continuing lien on the property.

2. Section 362(b)(4)

[15] [16] Alternatively, the City looks to § 362(b)(4) to except it from the stay. That section provides that a Chapter 13 bankruptcy petition does not operate as a § 362(a) automatic stay: of the commencement or continuation of an action or proceeding by a governmental unit ... to enforce such governmental unit’s or organization’s police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit’s ... police or regulatory power.

11 U.S.C. § 362(b)(4). “This exception has been narrowly construed to apply to the enforcement of state laws affecting health, welfare, morals and safety, but not to ‘regulatory laws that directly conflict with the control of the res or property by the bankruptcy court.’ ” In re Missouri, 647 F.2d 768, 776 (8th Cir. 1981). The City asserts its impoundment of vehicles is an exercise of its police power to enforce traffic regulations as a matter of public safety. The debtors respond that the impoundment of vehicles enhances the City’s revenue collection rather than protects public safety, and it is therefore an enforcement of a money judgment which § 362(b)(4) does not permit.

[18] The pecuniary purpose test requires the court to “look to what specific acts the government wishes to carry out and determine if such execution would result in an economic advantage over third parties in relation to the debtor’s estate.” Solis v. Caro, No. 11-cv-6884, 2012 WL 1230824, at *5 (N.D. Ill. Apr. 12, 2012) (quoting *930 In re Emerald Casino, Inc., No. 03-cv-05457, 2003 WL 23147946, at *8 (N.D. Ill. Dec. 24, 2003)). “[I]f the focus of the police power is directed at the debtor’s financial obligations rather than the [government’s] health and safety concerns, the \textit{automatic stay} is applicable.” In re Ellis, 66 B.R. 821, 825 (N.D. Ill. 1986) (quoting In re Sampson, 17 B.R. 528, 530 (Bankr. D. Conn. 1982)). Though the City says its impoundment laws are “designed to further the safety and welfare of Chicago residents” with just an “ancillary pecuniary benefit,” we disagree. In retaining possession of the vehicles until it is paid in full, the City is “attempting to satisfy a debt outside the bankruptcy process,” which would give it an advantage over other parties interested in the debtors’ estates. Emerald Casino, 2003 WL 23147946, at *9. The City’s act is focused on the debtor’s financial obligation, not its safety concerns, and thus fails the pecuniary purpose test.

[20] Alternatively, the public policy test considers whether the state action is principally to effectuate public policy or to adjudicate private rights. Hosp. Staffing Servs., 270 F.3d at 385–86; Caro, 2012 WL 1230824, at *4. The public policy the City highlights is enforcing its traffic ordinances against repeat offenders “for the safety and convenience of the public.” It explains the traffic ordinance system gradually escalates, beginning with the issuance of fines then intensifying to immobilization and impoundment only after an individual ignores repeat citations. Without impoundment as a general deterrence, the City argues, it cannot enforce its traffic regulations. See Emerald Casino, 2003 WL 23147946, at *6.

The debtors argue the balance between revenue collection and public safety weighs heavily toward the former. Additionally, prior to the 2016 Municipal Code amendment imposing a possessoriy lien on impounded vehicles, the City released impounded vehicles to Chapter 13 debtors. When the City recently amended the Code, it did not mention public safety concerns but rather stated the amendment was “in response to a growing practice of individuals attempting to escape financial liability for their immobilized or impounded vehicles.” Chi., Ill., Ordinance, Amendment of M.C.C. § 9-100-120 (July 6, 2017).

We are persuaded that, on balance, this is an exercise of revenue collection more so than police power. As debtors observe, a not insignificant portion of the City’s annual operating fund comes from its collection of parking and traffic tickets. See City of Chicago, 2019 Budget Overview 29, 192 (2018), https://chicago.legistar.com/View.ashx?M=F&ID=6683992&GUID=CAEFBC7F-7C1A-4B2E-9F8B-0CB931B3EE88 (fines, forfeitures, and penalties—primarily from parking tickets—constitute approximately nine percent of the 2019 fund). Moreover, the kind of violations the City enforces are not traditional police power regulations; these fines are for parking tickets, failure to display a City tax sticker, and minor moving violations. Even tickets for a suspended license, a seemingly more serious offense, are often the result of unpaid parking tickets and are thus not related to public safety. And the City impounds vehicles regardless of what violations the owner has accrued, without distinguishing between more serious violations that could affect public safety versus the mere failure to pay for parking. Most notably, the City imposes the monetary penalty on the owner of the vehicle, not the driver, which signals a seeming disconnect if the City actually has safety concerns about the offending driver. As the ordinance amending M.C.C. § 9-100-120 demonstrates, the City’s focus is on the financial liability of vehicle owners, not on public safety.

[21] But even if we assume that the adjudication of these violations is the result *931 of the City’s exercise of police and regulatory power, the City cannot enforce these final determinations of liability if they are “money judgment[s]” as the term is used in § 362(b)(4). See S. Rep. No. 95-989, at 52 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5838 (“Since the assets of the debtor are in the possession and control of the bankruptcy court, and ... constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors.”). A judgment is a “money judgment” that cannot be enforced without violating the \textit{automatic stay} if it requires payment. 3 Collier on Bankruptcy ¶ 362.05 (“[T]he governmental unit
still may commence or continue any police or regulatory action, including one seeking a money judgment, but it may enforce only those judgments and orders that do not require payment.” (emphasis added)); First All. Mortg., 263 B.R. at 107 (same); see also 3 Collier on Bankruptcy ¶ 362.05 (“Although a governmental unit may obtain a liability determination, it may not collect on any monetary judgment received.”) (emphasis added)); SEC v. Brennan, 230 F.3d 65, 71 (2d. Cir. 2000) (“[Section] 362(b)(4) permits the entry of a money judgment against a debtor ... [but] anything beyond the mere entry of a money judgment against a debtor is prohibited by the automatic stay.”).

The City claims it did not have money judgments “because it did not pursue the additional steps required to turn the citations into money judgments in the circuit court.” We disagree. A “money judgment” is simply an order that identifies “the parties for and against whom judgment is being entered” and “a definite and certain designation of the amount ... owed.” Penn Terra Ltd. v. Dep’t of Envtl. Res., 733 F.2d 267, 275 (3d Cir. 1984). Prior to impounding a vehicle, the City must administratively adjudicate the debtor’s violations, see M.C.C. § 9-100-010, and those adjudications result in a determination of final liability—i.e., a judgment. Only after a debtor has two or three judgments against it does the Municipal Code authorize the City to impound the vehicle until the debtor pays the judgments and related costs and fees. See id. §§ 2-14-132(c)(1)(A), 9-92-080, 9-100-120(b). So, without any additional steps, the City had final determinations of liability requiring these particular debtors to pay it specific sums.

The City does not contest that it conditioned the release of the debtors’ vehicles on payment of the amount specified in the final determinations of liability. Cf. id. § 9-100-100(b) (“Any fine and penalty ... remaining unpaid after the notice of final determination of liability is sent shall constitute a debt due and owing the city ....”). The continued possession of the vehicles is the City’s attempt to short-circuit the state court collection process and to enforce final judgments requiring monetary payment from the debtors. As such, the City is not excepted from the stay under § 362(b)(4). That the City is not excepted under § 362(b)(4) does not “permit[ ] debtors to park for free wherever they like, or to drive without a risk of fines for moving violations ....” In re Steenes, 918 F.3d 554, 558 (7th Cir. 2019). This just means the City needs to satisfy the debts owed to it through the bankruptcy process, as do all other creditors.

III. Conclusion

For the foregoing reasons, we AFFIRM the judgments of the bankruptcy courts.

All Citations

926 F.3d 916, 67 Bankr.Ct.Dec. 100

Footnotes

1. The In re Shannon court further found that § 362(a)(4) and (a)(6) also prohibit the City’s continued retention of debtors’ vehicles. Because the City is bound by the stay under § 362(a)(3), we do not reach the applicability of the additional stay provisions.

2. We additionally note that the “flood” of Chapter 13 filings is evidence of the disproportionate effect of the City’s traffic fines and fees on its low-income residents, an issue that is not unique to Chicago. See, e.g., Maura Ewing, Should States Charge Low-Income Residents Less for Traffic Tickets?, The Atlantic (May 13, 2017), https://www.theatlantic.com/politics/archive/2017/05/traffic-debt-california-brown/526491/ (California); Sam Sanders, Study Finds The Poor Subject To Unfair Fines, Driver’s License Suspensions, NPR: The Two-Way (Apr. 9, 2015), https://www.npr.org/sections/thetwo-way/2015/04/09/398576196/study-find-the-poor-subject-to-unfair-fines-drivers-license-suspensions (Missouri and California); Melissa Sanchez & Sandhya Kambhampati, How Chicago Ticket Debt Sends Black Motorists Into Bankruptcy, ProPublica Illinois (Feb. 27, 2018), https://features.propublica.org/driven-into-debt/chicago-ticket-debt-bankruptcy/ (“[African-American] neighborhoods account for 40 percent of all debt, though they account for only 22 percent of all the tickets issued in the city over the past decade—suggesting how the debt burdens the poor.”); see also Torie Atkinson, Note, A Fine Scheme: How Municipal Fines Become Crushing Debt in the Shadow of the New Debtors’ Prisons, 51 Harv. C.R.-C.L. L. Rev. 189, 217–22 (2016) (“The consequences of fines and fees can be dramatic and unforgiving: unemployment, loss of transportation, homelessness, loss of government or community services, and poor credit. And without the ability to accumulate wealth or capture even the smallest windfall for themselves, the poor become poorer, unable to climb out of an economic chasm.”).
The City’s attempt to distinguish between loss of possession due to compliance with a court order versus compliance with the automatic stay is in vain. Section 362 provides for the imposition of punitive damages for willful violations of the automatic stay. See 11 U.S.C. § 362(k)(1). This demonstrates that failure to comply with the stay may be punished even more severely than failure to comply with a court order and, correspondingly, there is no question the stay compels the City to return the vehicles.
UP ON BLOCKS—Tales of Rigs and Redemption

By Ford Elsaesser
Darrell, the Debtor

Now Darrell, the debtor, whose prospects were poor,
Had one joy in life—his Ford 4x4,
Jacked up to the hilt,
With chrome all around,
And Toby Keith blaring from 12-speaker sound,
With NSFW mudflaps,
and an overdrive kit,
And a bumper sticker reading,
*If you don’t like my driving, call 1-800-eat-(whatever).*

But Darrell was down-sized,
His job left our shores,
He was living on Twinkies, Dorritos, and Coors,
Once evicted, he had far and wide to roam,
His prized “high rise pickup”
Soon became his home.

He went to his lawyer,
Who said, “Son, you’re in luck.
We can use Chapter 13 to keep your fine truck!
Just ding the body up a bit,
and pretend it burns oil,
Represent that you’ve patched major problems
in the engine with tinfoil.

“Then we’ll cram down the value
To half what Darrell owes,
And stretch out the payments until,
well, God knows;
And when the inevitable DUI and rollover occurs,
We’ll call up the bank, and say, ‘Guys, it’s all yours.’”

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UP ON BLOCKS—Tales of Rigs and Redemption

By Ford Elsaesser

As we approach the 15th anniversary of BAPCPA, valuation, redemption, plan treatment, and the bankruptcy treatment of cars, continues to generate strategies, cases, and disputes. With even reliable used vehicles well over the 15,000 to $20,000 range, solving the “car issue” remains an area in, to put it charitably, “flux.”

Creative consumer bankruptcy counsel and thoughtful bankruptcy courts and appellate courts have kept issues regarding valuation and Plan treatment very much alive, even after the Rash case and § 506 was to clarify vehicle treatment “for all time,” particularly with the addition of the 910-day rule and prohibition of any sort of “ride through.” From the perspective of nearly 40 years as a Chapter 7 trustee, and witnessing a lot of creative Chapter 13 action over those years, even post-BACCPA, I think there are always strategies that bankruptcy practitioners could utilize when dealing with what is either the most or second-most important asset to virtually every consumer.

The “Darrell the Debtor” saga lives on!

The 910-day rule notwithstanding, we now know what happens if Darrell’s 4x4 is treated in a Plan because whether Darrell’s 4x4 was late-model under the 910-day rule or a classic cramdown, the Chapter 13 Plan can always be modified. See In re: Scarver, a summary of which is attached.

If Darrell’s 4x4 is late model, under Scarver, a surrender will not leave him hanging out on paying for his rig when there is no “there” there.

Yes, Virginia, there is redemption under § 722.

Bankruptcy Courts in Virginia, and other southeastern states, appear to have a higher level of redemption than other parts of the country, where redemption seems rather nonexistent. It is an underutilized remedy, particularly when reaffirmation is not feasible.

Another good discussion of § 722 is in the attached In re Steven M. Perales case from the Bankruptcy Appellate Panel of the Sixth Circuit. While the secured creditor here dropped the ball, what I believe the case points out is that for older, lower-end vehicles, with high balances
and an overpriced reaffirmation, redemption, perhaps with help from family and friends, presents a “cleaner option” with a rarely seen valuation issue in a Chapter 7, which as in this case, perhaps will find the secured creditor not well prepared in the circumstances. See attached.

With new online lenders appearing all the time, streamlined § 722 options could become a viable business model for lenders and debtors alike. With the value of used vehicle increasing at a faster rate sometimes than new vehicles, § 722 financing options with creative lenders and creative debtors’ counsel should grow as a Chapter 7 option.

The cram-down values under § 506(a)(2) ain’t over ‘til they’re over.

The Internet smart phones have turned valuation of vehicles on its head. With Edmunds, Cars.com, Craigslist, and eBay, the scope of retail valuations of a car in virtually any condition is a broader universe almost daily. The message here to Chapter 13 debtors’ counsel is “don’t give up on cramdown.” Despite the provisions of § 506 and Rash, courts continue to wrestle with replacement value, and certainly the days of NADA and Bluebook retail being a guide to replacement value is certainly suspect with so many other options of “real cars in real time” now available.

The best discussion, in my view, comes from Bankruptcy Judge Tony M. Davis, of Austin, Texas. A summary of his decision is attached. The case In re Solis provides a handy guide as to the various burdens of proof by the parties, as well as the realities that are now available, such as Edmunds, for courts to use as a real-world guide, even with replacement value as the standard.

Whither, Uber and Lyft

The 910-day rule can create a real disparity between true replacement value and the anti-cramdown provisions of § 1325. Will working for Uber and Lyft for more miles than household use provide relief from the 910-day rule for a newer car with a $30,000 balance, but only worth $20,000? If the car is regularly being used for “business,” that is, independent contracting for Uber and Lyft, how far back do you measure the business use—three months? six months? maybe only one month? Is there an argument to be made that in the last six months, the debtor drove 3,000 Uber miles and 2,500 consumer miles, does the business use provide real flexibility for valuation purposes? Stay tuned…
Summary

Valuation fights and flexible “negative estate planning” in Chapter 13 survive, despite BAPCPA, and despite the limitations of § 506 and § 1325. With new vehicle prices having approximately doubled since BAPCPA and used car prices following along, creative lawyering and creative lending are, indeed, catching up.
IN RE SCARVER

Ruling:
Debtor could modify plan after motor vehicle was damaged in an accident. (Bankr. M.D. Ala.) 11 U.S.C. § 1329 (taxonomy/term/422)

Issue:
Whether a Chapter 13 debtor acting in good faith may modify her confirmed plan to surrender collateral and reclassify any deficiency balance as an unsecured claim?

Holdings:
[1] A Chapter 13 debtor who obtained confirmation of a plan that allowed her to keep a vehicle she owned and pay the full amount of a debt she owed a creditor that held a purchase-money security interest in the vehicle under Ala. Code §7-9A-103 was not precluded from modifying her plan pursuant to 11 U.S.C.S. § 1329 (https://law.abi.org/title11/1329), (https://law.abi.org/title11/1329) after the vehicle was damaged in an accident and declared to be a total loss, to treat the amount she received from her insurance company as the amount of the creditor’s secured interest and the balance she owed on the debt as an unsecured claim; [2] The majority view allowed Chapter 13 debtors to surrender collateral and reclassify any resulting deficiency balance from a secured debt to an unsecured debt, pursuant to 11 U.S.C.S. § 506, if a debtor was acting in good faith.

Court: Middle District of Alabama (11th-circuit/alabama) (Sawyer (11th-circuit/alabama/middle-district/judge-sawyer)) [{Bankruptcy Court (/courts/bankruptcy-court)}]

Consumer (/taxonomy/term/1) case opinion summary, case decided on August 23, 2016, LexisNexis #0916-065
By order of the Bankruptcy Appellate Panel, the precedential effect of this decision is limited to the case and parties pursuant to 6th Ctr. BAP LBR 8013-1(b). See also 6th Ctr. BAP LBR 8010-1(c).

File Name: 12b0002n.06

BANKRUPTCY APPELLATE PANEL OF THE SIXTH CIRCUIT

In re: STEVEN M. PERALES, )
) )
Debtor. ) No. 11-8045 )

Appeal from the United States Bankruptcy Court
for the Northern District of Ohio, Eastern Division at Canton.
Bankruptcy Case No. 11-60366.

Decided and Filed: March 12, 2012

Before: EMERSON, McIVOR, and PRESTON, Bankruptcy Appellate Panel Judges.

COUNSEL

ON BRIEF: Thomas C. Loepp, MAISTROS & LOEPP, LTD., Stow, Ohio, for Appellant. Douglas L. Thrush, THRUSH & ROHR, LLC, Canton, Ohio, for Appellee.

OPINION

GEORGE W. EMERSON, JR., Bankruptcy Appellate Panel Judge. CNAC Motor Car Credit Co. appeals an order of the bankruptcy court granting Steven M. Perales’ motion to redeem his 2002 Dodge Neon for a lump sum of $1,400. For the reasons that follow, we affirm the bankruptcy court’s order.
I. ISSUE ON APPEAL

The issue presented by this appeal is whether the bankruptcy court erred in granting the Debtor’s motion to redeem his personal use vehicle for the lump sum of $1,400.

II. JURISDICTION AND STANDARD OF REVIEW

The Bankruptcy Appellate Panel of the Sixth Circuit has jurisdiction to decide this appeal. The United States District Court for the Northern District of Ohio has authorized appeals to the Panel and neither party has timely elected to have this appeal heard by the district court. 28 U.S.C. § 158(b)(6), (c)(1). A final order of the bankruptcy court may be appealed as of right pursuant to 28 U.S.C. § 158(a)(1). An order granting a motion to redeem is a final order. *Weber v. Wells Fargo Auto Fin., Inc.* (In re Weber), 332 B.R. 432 (B.A.P. 10th Cir. 2005).

The court’s findings of fact are reviewed under the clearly erroneous standard. *Riverview Trenton R.R. Co. v. DSC, Ltd.* (In re DSC, Ltd.), 486 F.3d 940, 944 (6th Cir. 2007). “A finding of fact is clearly erroneous ‘when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.’” *Id.* (quoting *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573, 105 S. Ct. 1504 (1985)).


III. FACTS

On February 11, 2011, Steven M. Perales (“Debtor”) filed a voluntary petition for relief under chapter 7 of the Bankruptcy Code. Listed on Schedule B was a debt owing CNAC Motor Car Credit Co. (“CNAC”) in the amount of $10,014. The debt to CNAC is secured by a 2002 Dodge Neon.

On April 25, 2011, the Debtor filed a motion to redeem the 2002 Dodge Neon for the lump sum of $1,132 pursuant to 11 U.S.C. § 722 and Federal Rule of Bankruptcy Procedure 6008. Attached to the Debtor’s motion was a printout from Edmonds.com showing that the trade-in value of the vehicle was $792, the private party sale value was $1,132, and the dealer retail was $1,586.
The Debtor’s motion also included a “Notice of Motion to Redeem” which indicated that any party opposing the requested relief must file a written response with the bankruptcy court by May 25, 2011. CNAC received notice of the Debtor’s motion.

CNAC filed a Motion in Opposition to the Debtor’s Motion to Redeem on April 28, 2011. In its opposition, CNAC asserted that the vehicle was not exempt, was not abandoned, and that the debt thereon was not dischargeable.¹ CNAC further asserted that the Kelley Blue Book value of the vehicle was $3,570, and that, as of the time of the opposition, the outstanding balance of the note was $10,013.54. CNAC did not attach to its opposition a copy of the Kelley Blue Book page or a printout from the Kelley Blue Book website to support their claim that the Kelley Blue Book value was $3,570. Finally, CNAC stated that the Debtor had failed to make periodic payments on the note from January to April 2011.

CNAC filed a notice of the hearing on its opposition to the Debtor’s motion to redeem on April 29, 2011.² The notice indicated that the bankruptcy court would hold a hearing on CNAC’s opposition to the Debtor’s redemption motion on June 6, 2011.

At the hearing on June 6, 2011, counsel for the Debtor asserted that the Edmunds.com values listed in the Debtor’s motion to redeem were accurate for purposes of redemption. Debtor’s counsel also advised the court that she had looked at the results of a local auctioneer, Skipeo, on similar cars. Those values, she stated, ranged from $250 to $2,700. Debtor’s counsel then requested that the bankruptcy court either rule on the redemption motion or set an evidentiary hearing regarding the value of the vehicle. Counsel for CNAC argued that because there was a retail installment contract which had not been paid in full, the Debtor must either return the vehicle or pay the entire outstanding balance of $10,014 to redeem it. Again, CNAC provided no evidence to the court regarding the value of the vehicle. Although CNAC originally stated in its opposition to the Debtor’s motion to redeem that the vehicle was not subject to redemption, it did not make such assertions before the bankruptcy court at the June 6, 2011 hearing. CNAC also failed to make those

¹At both the hearing before the bankruptcy court on the Debtor’s motion and on appeal, CNAC argues only that the valuation was improper.

²The notice also indicated that the bankruptcy court would conduct a hearing on CNAC’s motion for relief from the automatic stay at the same time.
assertions in this appeal. Therefore, the only dispute before the bankruptcy court, and now before the Panel, concerns the amount the Debtor must pay CNAC to redeem the vehicle.

At the conclusion of the hearing, the bankruptcy court ruled from the bench that the Debtor had the right to redeem the Dodge Neon. The court further found that, after looking at several sources on its own, it had arrived at a value of $1,400, which was only slightly more than the Debtor’s proposed value of $1,132. On June 13, 2011, the bankruptcy court entered a written order granting the Debtor’s motion to redeem which directed the Debtor to pay CNAC a lump sum of $1,400 within 30 days of entry of the order. CNAC’s timely notice of appeal followed on June 22, 2011.

IV. DISCUSSION

Pursuant to 11 U.S.C. § 722, an individual debtor may redeem consumer goods from a lien securing a dischargeable consumer debt, if the property is exempt under 11 U.S.C. § 522 or has been abandoned under § 544, by paying the lienholder in full, at the time of redemption, the amount of the “allowed secured claim” that is secured by the collateral. 11 U.S.C. § 722.

The term “allowed secured claim” is not defined in the Bankruptcy Code. See, 11 U.S.C. § 101. However, 11 U.S.C. § 506 describes how to determine a creditor’s secured claim, and, thus, what amount a debtor must pay pursuant to § 722 in order to redeem property:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property . . . and is an unsecured claim to the extent that the value of such creditor’s interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.

Section 506(a)(2) further describes in more detail the method of valuing a secured claim if the debtor is an individual in chapter 7 or 13. It states:

If the debtor is an individual in a case under chapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs
of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

Section 506(a)(2) was added to the Bankruptcy Code in 2005 when Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Unfortunately, “no consensus has emerged in the case law interpreting § 506(a)(2) as to how replacement value for motor vehicles should be determined.” *In re Pearsall*, 441 B.R. 267, 270 (Bankr. N.D. Ohio 2010) (collecting cases detailing vehicle valuation). As the *Pearsall* court explained, “[t]he results reached ultimately seem to depend, not entirely surprisingly, on the overall record a court is presented with in a particular case.” *Id.* Courts have employed a variety of vehicle valuation methods under § 506(a)(2) ranging from use of the Kelley Blue Book or N.A.D.A. Guide retail values of a like vehicle to the opinion testimony of a car salesperson as to what he would sell a vehicle for on the lot. *Id.* at 270–71. The Sixth Circuit has not established a uniform method.

As the party seeking redemption, the Debtor “bear[s] the burden of proving the appropriate redemption value by a preponderance of the evidence.” *In re Herrera*, 454 B.R. 559, 561 (Bankr. E.D.N.Y. 2011) (citations omitted) (collecting cases holding debtor bears burden of proving value by preponderance of evidence for redemption purposes under § 722). Therefore, the Debtor here bore the evidentiary burden of proving that the replacement value of his vehicle was, more likely than not, $1,132, the amount he proposed to pay.

In this appeal, CNAC does not argue that the bankruptcy court used an improper method of valuing the Debtor’s vehicle. Instead, CNAC asserts that the bankruptcy court erred by failing to hold an evidentiary hearing regarding the value of its collateral and by failing to specifically state the basis for its valuation either at the redemption hearing or in its written judgment. In support of its position, CNAC cites to Federal Rule of Bankruptcy Procedure 3012 and the Eleventh Circuit case of *Green Tree Acceptance, Inc. v. Calvert (In re Calvert)*, 907 F.2d 1069 (11th Cir. 1990).

Bankruptcy Rule 3012 provides that “[t]he court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct.”

In the case of *Calvert*, the Eleventh Circuit Court of Appeals held that Rule 3012 mandates that a bankruptcy court give "specific notice" to the holder of a secured claim that it will determine "the extent to which the claim is secured" at a particular hearing. *Calvert*, 907 F.2d at 1072. In *Calvert*, the bankruptcy court determined the value of the secured creditor’s claim at a hearing on the debtors’ motion to reconsider their bankruptcy plan. Although the secured creditor received notice of the hearing on the motion to reconsider, that notice did not include a “specific notice to . . . the holder of the secured claim, that [the bankruptcy court] would take up the collateral valuation issue.” *Id.* The Eleventh Circuit concluded that this omission violated the requirements of Rule 3012.

CNAC’s reliance upon Rule 3012 and *Calvert* in support of its position here is misguided. Although Rule 3012 provides an avenue for security valuation, neither Rule 3012 nor the holding in *Calvert* contain any requirement that a court conduct a separate evidentiary hearing when setting the value of collateral under § 506(a). *See Calvert*, 907 F.2d at 1072 (“Section 506(a) approves of holding this hearing in conjunction with the confirmation plan, as was done here; there is no

³CNAC did not request a separate evidentiary hearing regarding the vehicle’s value or file a motion pursuant to Rule 3012 to initiate the process of determination of its secured status and value of its collateral. Having not raised the issue of a separate evidentiary hearing before the bankruptcy court or filed a motion for independent determination of the value of the vehicle, CNAC cannot now raise the issue on appeal. *See Dealer Computer Servs., Inc. v. Dub Herring Ford*, 623 F.3d 348, 357 (6th Cir. 2010) ("It is well-settled that this court will not consider arguments raised for the first time on appeal unless our failure to consider the issue will result in a plain miscarriage of justice.") (quoting *Hood v. Tenn. Student Assistance Corp. (In re Hood)*, 319 F.3d 755, 760 (6th Cir. 2003)); *White v. Anchor Motor Freight, Inc.*, 899 F.2d 555, 559 (6th Cir. 1990)).
requirement of a separate hearing."). Instead, what is required is that the lienholder receive specific notice that the value of its claim is being determined at the relevant hearing.

The bankruptcy court in this case currently on appeal conducted a hearing on the Debtor's motion to redeem and CNAC's objection thereto in accordance with Federal Rule of Bankruptcy Procedure 6008. As is evidenced by both the certificate of service in the Debtor's redemption motion and the fact that CNAC filed an objection to that motion, CNAC received notice of the Debtor's motion to redeem the property. Implicit in a motion to redeem is the debtor's proposed valuation of the collateral. CNAC's objection to the Debtor's motion included an objection to the Debtor's proposed value of the vehicle. By virtue of the fact that CNAC filed the notice of hearing on April 29, 2011, and stated therein that a hearing on the Debtor's redemption motion would be held on June 6, 2011, it is abundantly clear that CNAC had adequate notice that the value of its claim and its collateral was to be determined at that hearing.

In its objection to the Debtor's redemption motion, CNAC did not object to the Debtor's Edmonds.com attachment nor did it provide any evidence of the value of the vehicle. Instead, CNAC simply insisted that the vehicle should be redeemed for the full amount owed on the debt. At the June 6, 2011 hearing, at which counsel for CNAC appeared, it again did not present any evidence regarding the value of the vehicle, but rather stated that the redemption amount should be the same as the outstanding loan.

The Debtor in this case submitted evidence as to the value of the vehicle with his motion to redeem. Although the bankruptcy court did not specify the exact sources it relied on in establishing the redemption value for the Dodge Neon, the bankruptcy court explained that it had reviewed the Debtor's Edmonds.com attachment as well as additional sources on its own and determined a value nearly identical to the number the Debtor proposed to pay, albeit slightly higher. CNAC presented no evidence of value nor did it object to the evidence submitted by the Debtor. Rather, it simply stated that the redemption value should be identical to the outstanding balance on the debt which is simply not the standard set forth under § 506(a)(2). The only evidence submitted by the parties came from the Debtor. Therefore, the Debtor met his burden of proof.

CNAC has failed to demonstrate how the bankruptcy court's failure to specifically detail the sources it looked to for valuation constitutes reversible error. A court's determination of value

An abuse of discretion occurs only when the [trial] court relies upon clearly erroneous findings of fact or when it improperly applies the law or uses an erroneous legal standard. A finding of fact is clearly erroneous when although there is evidence to support it, the reviewing court, on the entire evidence, is left with the definite and firm conviction that a mistake has been committed. An abuse of discretion is defined as a definite and firm conviction that the [court below] committed a clear error of judgment. The question is not how the reviewing court would have ruled, but rather whether a reasonable person could agree with the bankruptcy court’s decision; if reasonable persons could differ as to the issue, then there is no abuse of discretion.

*Id.* at 685 (internal citations and quotation marks omitted); *First Merit N.A. v. Getz* (In re Getz), 242 B.R. 916, 920 (B.A.P. 6th Cir. 2000).

Pursuant to the Bankruptcy Rules, the filing of the motion to redeem is a contested matter under Federal Rule of Bankruptcy Procedure 9014. As a result, the court was required to make findings of fact and conclusions of law pursuant to Federal Rule of Civil Procedure 52(a), made applicable to contested matters by Federal Rules of Bankruptcy Procedure 7052 and 9014. These findings and conclusions can be written or oral. The main requirement for these findings is that they “must be sufficient to enable a reviewing court to determine the factual basis for the court’s ruling.” *Veal v. Am. Home Mortgage Serv., Inc.* (In re Veal), 450 B.R. 897, 919 (B.A.P. 9th Cir. 2011). “This same standard applies in this Circuit even when the findings are based on documentary, rather than testimonial, evidence.” *Brown v. UAW*, 689 F.2d 69, 71 (6th Cir. 1982).

In the case of *Corzin v. Fordu* (In re Fordu), 201 F.3d 693 (6th Cir. 1999), the Sixth Circuit Court of Appeals stated the standard used in reviewing a decision under Federal Rule of Civil Procedure 52:

We have not interpreted [Rule] 52 to require trial courts to explicitly treat each issue raised. Rather, findings are to be liberally construed in support of a judgment, even if the findings are not as explicit or
detailed as might be desired. However, there must be findings, in such detail and exactness as the nature of the case permits, of subsidiary facts on which an ultimate conclusion can rationally be predicated. And there must be sufficient findings of fact and conclusions of law to give an appellate court a clear understanding of the basis of the trial court's decision and enable it to determine the grounds on which the trial court reached its decision.

Id. at 710 (internal citations and quotation marks omitted). The Sixth Circuit further explained that:

The reviewing court oversteps the bounds of its duties under Rule 52 if it undertakes to duplicate the role of the lower court.... If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. Where there are two permissible views of the evidence, the fact finder's choice between them cannot be clearly erroneous.


In the case presently before the panel, the bankruptcy court stated that it had reviewed the figures submitted by the debtor and had investigated several sources on its own to arrive at the value of $1,400. This value was slightly higher than the Debtor's proposed redemption value of $1,132 which, according to the Edmonds.com printout presented by the Debtor, represented the private party sale value of the Neon. According to the Edmonds.com figures, dealer retail for the vehicle was $1,586. Although the bankruptcy court did not specify what other sources to which it looked to arrive at the $1,400 figure, it is clear from the record that it used its discretion to arrive at an approximate replacement value for the vehicle based on the exhibit submitted by the Debtor.

The only figures submitted by CNAC were statements by counsel that the debtor should be required to pay the entire amount due on the note, which is not warranted under § 506(a)(2), and that the Kelley Blue Book value was $3,570. However, CNAC did not submit any evidence of this purported Kelley Blue Book value. As a result, the record does not demonstrate that the court abused its discretion in determining the redemption value was $1,400. And, pursuant to Civil Rule 52(a), the bankruptcy court's determination of value is clearly based on the record presented to it by the
parties. There was no requirement for the bankruptcy court to state with any additional particularity the basis for its valuation determination.

V. CONCLUSION

For the foregoing reasons, the Panel affirms the order of the bankruptcy court granting the Debtor’s motion to redeem the vehicle for $1,400.
April 20, 2016

**Austin Judge Writes Treatise on Valuation of Personal Property**

Lender needs more than Blue Book value to win a valuation trial.

**Analysis:**

Bankruptcy Judge Tony M. Davis of Austin, Texas, wrote a practice manual with everything you need to know about valuing an auto under Section 506(a).

The chapter 13 debtor owned an SUV encumbered with a $12,800 lien. In his schedules, the debtor valued the SUV at $6,700. The lender filed a claim for the same amount but alleged that the value was almost $10,000.

Confirmation of the chapter 13 plan depended on having Judge Davis decide that the auto was worth much more than the debtor’s claimed value of $6,700.

Judge Davis’ April 15 opinion synthesizes the law on burden of proof and persuasion. It also explains the hearsay exception allowing the court to take price reports into evidence without accompanying expert testimony attesting to the accuracy of the reports. Of most significance, the opinion pinpoints evidence that debtors and lenders must produce to prevail.

Because the lender had some evidence, but none on the pivotal issue, the debtor won.

Since the lender attached no exhibits to its claim justifying the claimed value of the SUV, Judge Davis said that the lender assumed the “ultimate burden” of proving its claim by “the preponderance of the evidence” because the debtor’s objection to the claim proffered the Edmunds dealer retail value for average condition at $5,900.

Because the lender had the burden of proving the amount of the claim, Judge Davis said it also had the burden of proving the value of the collateral. Since the debtor had produced the Edmunds report showing a lower value, the judge said the burden shifted to the lender to show a higher value.

Judge Davis interpreted Sections 502(a)(1)-(2) as requiring evidence of “the price for which a retail car dealer would agree to sell” the SUV on the filing date.
At trial, the lender introduced an NADA (National Automobile Dealers Association) report into evidence showing a clean retail value of about $9,700. The debtor testified at trial that the SUV was in good mechanical condition but had deep scratches and light damage to the fenders.

Relying on decisions by other courts, Judge Davis said that the NADA report "typically overstates the replacement value" and is an "idealized standard that is rarely met." He said courts often use an NADA report as the "starting point before deducting the costs of repairs to determine value."

Since the Edmunds report might understate replacement value, Judge Davis said the value would be somewhere between the NADA and Edmunds prices.

The lender came up short, Judge Davis said, because it introduced no evidence about the cost of reconditioning to justify reliance on the NADA price report. The debtor, in contrast, testified about scratches and fender damage, and his schedules swore to a value of $6,700. The meager evidence produced or not produced governed how Judge Davis would rule.

On the one hand, the lender had no evidence to carry its burden of proof showing the proper reduction from the NADA’s reported value. On the other hand, the debtor’s schedules and testimony about minor damage were consistent with the idea that the SUV was “worth a little more” than the Edmunds value of $5,900.

Although the debtor’s evidence was "weak" and got "weaker" on cross examination, Judge Davis said it was the “only basis” on which to pick a final value between the two reports. Consequently, the judge pegged the SUV’s value at $6,700, the amount proffered by the debtor.

Judge Davis was not critical of the lack of expert testimony, saying that "the expense of expert testimony will rarely (if ever) be justified to establish the value of a debtor’s personal vehicle under Section 506(a)."

**Case Details**

**Judge Name**

Tony M. Davis

**Case Citation**

In re Solis, 15-11181 (Bankr. W.D. Tex. April 15, 2016)

**Case Name**

In re Solis