

1998 BANKRUPTCY LAW UPDATE FOR SEVENTH CIRCUIT PRACTITIONERS

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INTRODUCTION

The Seventh Circuit Court of Appeals wrote a number of interesting, and in some cases entertaining, decisions in the area of bankruptcy law. This Article examines some of those decisions.

I. EQUITABLE SUBORDINATION OF CLAIMS

*In re Lifschultz Fast Freight*¹ involved a request by the bankruptcy trustee to equitably subordinate a creditor's secured claim.² The bankruptcy court denied this request, but the district court reversed and remanded.³ The issue on appeal was whether the bankruptcy court could exercise its power of equitable subordination based on the debtor's purported undercapitalization.⁴ In this case, Lifschultz Fast Freight Corporation (the "debtor"), developed from another company, Lifschultz Fast Freight, Inc. ("LFFI"), which had operated in the shipping industry since the beginning of the century.⁵ LFFI suffered tremendous losses in the late 1980s (which approached \$5.5 million in 1989). In an effort to save the business, the owners established the company that would become the debtor. Five individuals (the "insiders") held eighty percent of the debtor's stock, and LFFI held the remaining twenty percent.⁶

From the outset, the debtor was cash poor. Thus, just weeks after its inception, one of the insiders' affiliated companies, Salson Express, entered into a secured loan agreement with the debtor. Essentially, three of the insiders offered personal guarantees for money they borrowed from First Fidelity Bank. They then lent that money to Salson Express, which in turn lent the money to the debtor. Within one month, the debtor had borrowed more than \$862,000 from Salson Express.⁷ Significantly, the debtor also obtained another \$1 million

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1. 132 F.3d 339 (7th Cir. 1997).

2. "Equitable subordination of a claim moves the creditor down in the order of payment out of the assets in the bankruptcy estate, generally reducing (or eliminating) the amount the creditor can recover." *Id.* at 341. After notice and a hearing, the court may "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 . . ." 11 U.S.C. § 510(c)(1) (1994).

3. *In re Lifschultz*, 132 F.3d at 341.

4. *See id.* at 343.

5. *See id.* at 342.

6. *See id.*

7. *See id.*

through a factoring agreement with Ambassador Factors.⁸ This new money permitted the debtor to pay off all but \$300,000 of the insiders' secured loan.⁹ The insiders filed a claim in bankruptcy for the \$300,000, and the trustee argued that the secured interest should be equitably subordinated.¹⁰

The bankruptcy court concluded that the debtor had not been undercapitalized and that even if it had, equitable subordination required some other inequitable conduct.¹¹ The district court, however, decided that undercapitalization alone was sufficient to justify invoking the doctrine of equitable subordination and concluded that the debtor was "patently undercapitalized."¹²

The court of appeals noted that one important theme of bankruptcy law is maintaining claimants' state law rights and the order of their claims relative to one another.¹³ The potential always exists for an equity holder, who comes last on the priority list, to "dress[] up a claim she has on the firm as something else of higher priority."¹⁴ However, it may be even more likely in bankruptcy cases involving closely held corporations because the players' roles may be less distinct: "[T]he same person can be an owner of a company, its creditor and, as in the instant case, its employee as well."¹⁵ Nevertheless, insiders must remain true to their fiduciary obligations to the company.¹⁶ If they breach those duties through a bad faith or unfair characterization of an equity infusion as debt, the court may send the insiders to the end of the line.¹⁷

The court in *Lifschultz* relied on the framework provided by the U.S. Court of Appeals for the Fifth Circuit in *In re Mobile Steel Co.*¹⁸ The first step under that framework is to search for inequitable conduct, and if there is none, the bankruptcy court may not subordinate the claim.¹⁹ The court proceeded through a detailed discussion of undercapitalization and whether the fact of undercapitalization alone would constitute such misconduct. While recognizing that some courts have adopted this position,²⁰ this court chose not to do so.

8. The agreement with Ambassador Factors required that its interest be superior to the insiders' interest under the secured loan agreement, and Ambassador also received personal guarantees from the insiders. *See id.*

9. The court referred to Salson Express and the insiders interchangeably. *See id.* at 343.

10. *See id.*

11. *Id.*

12. *Id.* The debtor was set up with \$1000 in cash, and the insiders also transferred to the debtor all of LFFI's operations outside New York, including its customer list, a valuable lease to a California shipping terminal, and Los Angeles Dodgers season tickets. *See id.* at 342.

13. *Id.* at 343.

14. *Id.*

15. *Id.* at 344.

16. *See id.*

17. *See id.*

18. 563 F.2d 692 (5th Cir. 1977).

19. *See In re Lifschultz*, 132 F.3d at 344.

20. *Id.* at 345 (citing, e.g., *In re Fabricators*, 926 F.2d 1458, 1470 (5th Cir. 1991)).

“Because mere undercapitalization does not, and should not, justify equitable subordination, we think the better view is that, while undercapitalization may indicate inequitable conduct, undercapitalization is not in itself inequitable conduct.”²¹

This was not a case where the insiders attempted to convert already existing equity into debt. They contributed fresh capital, and if no deception existed, there was no reason to treat an insider’s loan more harshly than a third party’s loan.²² The court summarized its position as follows: “[U]ndercapitalization alone, without evidence of deception about the debtor’s financial condition or other misconduct, cannot justify equitable subordination of an insider’s debt claim. Extraordinary circumstances might provide an exception . . . but we believe that almost any such exception would arguably also involve other misconduct of some sort.”²³

The court also addressed the debtor’s purported undercapitalization itself and concluded that under *Mobile Steel*, undercapitalization would have existed at the time the debtor received the loan from the insiders if an informed outside source would not also have loaned the debtor a similar amount of money.²⁴ “In this case, we need not speculate about what might have happened. We know what *did* happen. The debtor not only could have gotten a third-party loan, it actually did—from Ambassador Factors.”²⁵ Furthermore, that Ambassador Factors required personal guarantees from several insiders did not prove undercapitalization.²⁶ Thus, the court found no clear error in the bankruptcy court’s factual conclusion.²⁷

Interestingly, however, the court still remanded the case.²⁸ The trustee had also argued, among other things, that the insiders had inflated their salaries in the spring and summer before the bankruptcy petition was filed. The court noted that a “classic form of creditor misconduct is boosting the owner-employee’s salary as the firm is drifting into financial collapse.”²⁹ If an insider did commit such misconduct, it could justify equitable subordination of the Salson Express claim.³⁰ The court remanded the case so that the bankruptcy court could determine whether the insiders could meet their burden of showing that the transactions were inherently fair and were undertaken in good faith.³¹

21. *Id.* “Most often undercapitalization signifies nothing more than business failure, poor access to capital, or both.” *Id.*

22. *Id.* at 347.

23. *Id.* at 349 (citations omitted).

24. *Id.* at 351 (citing *In re Mobile Steel Co.*, 563 F.2d 692, 703 (5th Cir. 1997)).

25. *Id.* at 353.

26. *See id.*

27. *Id.*

28. *Id.* at 355.

29. *Id.* at 354.

30. *See id.*

31. *Id.* at 354-55.

II. CASES INVOLVING THE GERACI FIRM

A. *Unjustified High Fees*

Attorney Peter Francis Geraci and the associates in his firm (the “Geraci firm”) file thousands of bankruptcy cases each year in the Seventh Circuit,³² and the firm’s practices provide the judges on the court of appeals with a number of opportunities to earn their salaries. *In re Geraci*³³ dealt with twelve consumer bankruptcy cases in which the Geraci firm had represented the debtors. The cases were relatively straightforward and required little attorney time. In fact, the attorneys spent an average of only thirty-six minutes preparing each petition,³⁴ yet the Geraci firm charged a flat fee ranging from \$1095 to \$1900 in each.³⁵ “Believing that those fees were unreasonably high in light of the uncomplicated nature of the cases at issue, the United States Trustee invoked Bankruptcy Rule 2017 to challenge the fees charged”³⁶

Bankruptcy Judge Fines analyzed the criteria listed in 11 U.S.C. § 330 regarding compensation of professionals by considering the twelve factors set out in *Johnson v. Georgia Highway Express, Inc.*³⁷ The bankruptcy court found that the average fee charged in similar cases in that location was \$550 and that neither the Geraci firm’s experience and ability nor the results obtained justified significantly higher fees.³⁸ The bankruptcy court concluded that \$800 was presumptively reasonable and ordered Geraci to return to each of the twelve debtors the portion of each fee that exceeded \$800. The court also made the order applicable to all future cases filed by that law firm in that court, which meant that “Geraci either could accept a presumptively reasonable fee of \$800 in no-asset consumer bankruptcy cases under Chapter 7, or file a detailed fee itemization in support of a higher fee.”³⁹

32. See *In re Turner*, 156 F.3d 713, 715 (7th Cir. 1998).

33. 138 F.3d 314 (7th Cir. 1998).

34. See *id.* at 319.

35. See *id.* at 316.

36. *Id.* at 317.

37. 488 F.2d 714, 717-19 (5th Cir. 1974).

38. *In re Geraci*, 138 F.3d at 317. In fact, despite Geraci’s description of himself as the “foremost consumer bankruptcy practitioner in the country,” Judge Fines concluded that “[t]he work product of [the Geraci firm] is not extraordinary. It is not outstanding. It is not up to a level that this [c]ourt sees from the majority of practitioners who regularly appear before it.” *Id.* at 317-18.

39. *Id.* at 318. The trustee brought similar challenges in other bankruptcy courts throughout Illinois, and those challenges resulted in orders similar to the one at issue here. Geraci informed the court that “fee orders in 72 cases already have been appealed to this court and that approximately 400 more appeals are on their way.” *Id.* at 318 n.3. Later, in the case *In re Agnew*, 144 F.3d 1013 (7th Cir. 1998), other bankruptcy judges in the same district determined that \$575 and \$600 were presumptively reasonable fees, and the Seventh Circuit affirmed. *Id.* at 1014. The court stated that judges and trustees were pushed to take this approach to handling fees

Geraci made a number of arguments on appeal, but to no avail. Geraci argued that he was entitled to the market value of his services and that the market value was whatever he was able to negotiate with his clients. The court disagreed, stating that sections 329 and 330 of the Bankruptcy Code limit the market's role in establishing professional fees in bankruptcy cases.⁴⁰ There is no requirement that there be overreaching by debtor's counsel or that there be no arm's length transaction to check the reasonableness of the agreed-to fee in order for the bankruptcy court to exercise its power of review, as Geraci contended.⁴¹ "Rather, the bankruptcy court is authorized to act whenever it determines that the compensation the debtor has paid or agreed to pay his counsel exceeds the reasonable value of the services provided."⁴²

The court also found that the bankruptcy court did not arbitrarily cap Geraci's fees because Geraci maintained the right to demonstrate that the services provided justify a higher fee.⁴³ Moreover, even if Geraci had not waived his Equal Protection Clause argument by failing to raise it in the bankruptcy court, he would not have prevailed.⁴⁴ The record indicated that Judge Fines used the same presumption of a reasonable fee in all similar cases before him.⁴⁵ The Seventh Circuit therefore affirmed.⁴⁶

B. Unilateral Reaffirmation of Pre-Petition Debts

Another case involving the Geraci firm, *In re Turner*,⁴⁷ addressed the situation where the debtor unilaterally reaffirmed a pre-petition debt. The court of appeals agreed with the lower courts that such a reaffirmation did not

by a perception that Geraci conducts his practice in an abusive manner, taking advantage of debtors who are unaware that his promises of superior services at a premium rate are hot air (one bankruptcy judge found that 'Geraci's work is not on a par with that of other bankruptcy practitioners, that his motions practice leaves much to be desired, and that his abilities as a trial lawyer are substandard')

Id.

40. *In re Geraci*, 138 F.3d at 320 (referring to 11 U.S.C. §§ 229, 330 (1994)).

41. *See id.*

42. *Id.*

43. *Id.* at 321.

44. *See id.*

45. *See id.*

46. *Id.* Geraci was also involved in another appeal to the Seventh Circuit, *In re Bryson*, 131 F.3d 601 (7th Cir. 1997). There, Geraci's client fired the Geraci firm and sought to have unearned fees returned. The bankruptcy judge ordered Geraci to return to Bryson \$182.50. Geraci, of course, appealed. The district court found that Geraci filed a motion to reconsider in bad faith as a vehicle for extending the time available for appeal, and it granted Bryson's motion to dismiss. *Id.* at 602-03. The court of appeals reversed, opining that the court had more appropriate methods available for dealing with a bad faith motion to reconsider. *Id.* at 603.

47. 156 F.3d 713 (7th Cir. 1998).

constitute an "agreement" for purposes of 11 U.S.C. § 524(c).⁴⁸ In each of the six bankruptcy cases underlying the appeal, the Geraci firm had filed a document entitled "REAFFIRMATION AGREEMENT" or "AUTOMOBILE REAFFIRMATION AGREEMENT" whereby the debtor purportedly agreed to pay a pre-petition installment debt.⁴⁹ In each case, the debtor, but not the creditor, signed the reaffirmation.⁵⁰ The Geraci firm filed these "agreements" without even notifying the creditors of their execution.⁵¹

The bankruptcy court concluded that strict compliance with section 524 of the Bankruptcy Code was mandatory and that the creditor's signature was required in order to comply with that section.⁵² Bankruptcy Judge Fines further stated that "[r]eaffirmation agreements are unlike any other contractual agreement under the law, . . . and nowhere else is the requirement that both parties sign the agreement more critical."⁵³ The signature demonstrates not only that the creditor is aware of the reaffirmation, but also that there is agreement between the parties.⁵⁴

The appeals court noted that in canvassing the U.S. Trustees and their field offices, none saw these types of reaffirmation agreements outside this circuit's judicial districts, and within this circuit, the only such reaffirmations the trustees encountered were filed by the Geraci firm.⁵⁵ The court emphasized the statute's repeated reference to an "agreement" and noted that "[a]s unilateral statements of reaffirmation, filed without notice to the creditors, let alone their consent, the declarations at issue here cannot be understood as the mutual 'agreement' that the statute requires."⁵⁶ The court also recognized that even though section 524(c) does not expressly require the creditor's signature, the bankruptcy court's reasoning in requiring such was not assailable.⁵⁷ That signature provides concrete evidence of the creditor's awareness of and assent to the terms of the reaffirmation.⁵⁸

III. LETTERS OF CREDIT AND VOIDABLE PREFERENCES

*In re Bergner*⁵⁹ was a relatively complicated case where Bergner made payments (shortly before declaring bankruptcy) to Bank One in order to cover the

48. *Id.* at 721.

49. *See id.* at 715.

50. *See id.*

51. *See id.*

52. *See id.*

53. *See id.* (internal quotes omitted).

54. *See id.* at 720.

55. *Id.* at 716.

56. *Id.* at 719.

57. *Id.* at 720.

58. *See id.*

59. 140 F.3d 1111 (7th Cir. 1998).

bank's payments honoring certain letters of credit.⁶⁰ Bergner later sought to recover those payments as voidable preferences under 11 U.S.C. § 547(b). The Seventh Circuit affirmed the district court's determination that the payments were voidable preferences, but reversed on the issue of prejudgment interest.⁶¹ The denial of such interest was an abuse of discretion, and the case was remanded to determine the appropriate amount of interest due.⁶²

At Bergner's request, Bank One issued standby letters of credit to AMC, one of Bergner's suppliers, and to Liberty Mutual Insurance, an insurance provider.⁶³ As long as Bergner paid these creditors, the letters of credit did not come into play. However, the occurrence of certain events would entitle AMC and Liberty Mutual (the beneficiaries) to go straight to Bank One for payments on Bergner's promises without regard to Bergner's financial health.⁶⁴ One of those events was a decision by Bank One not to renew the letters of credit upon their expiration.⁶⁵

By mid-summer 1991, Bank One had issued letters of credit exceeding \$31.2 million to AMC and exceeding \$5.8 million to Liberty Mutual.⁶⁶ When Bank One informed Bergner and these two beneficiaries that it would not renew the letters of credit upon their expiration at the end of July, AMC notified Bergner that it intended to exercise its rights under the agreement and draw down the full amount of its credit. Bergner relied on a revolving line of credit (totaling approximately \$74 million) that it had with a Swiss bank group to fund AMC's draw from Bank One.⁶⁷

Bergner's financial position continued its downward spiral, however, and the Swiss bank group eventually pulled the remaining \$43 million line of credit.⁶⁸ Bank One exercised its rights under the Standby Letter of Credit Agreement and took control of funds in Bergner's account to satisfy future claims by Liberty Mutual under its letter of credit. That same day, Bergner filed a Chapter 11

60. *See id.* at 1114.

61. *Id.* at 1123.

62. *See id.*

63. *See id.* at 1114.

64. Bergner was paying Bank One approximately \$300,000 per year for this service. *See id.* at 1115. In addition, the Standby Letter of Credit Agreement between Bergner and Bank One, which established the terms of the agreement between these two parties, required Bergner to pay Bank One the amount of any draft presented by a beneficiary either before or at the time of presentation to Bank One for payment. *See id.*

65. It is important to note that the relationships in letter of credit arrangements are independent of one another. For example, if an event occurred that permitted a beneficiary to draw on the letter of credit, Bank One would be required to pay the beneficiary without regard to Bergner's obligations to Bank One. If Bergner breached his duty to pay Bank One under the Standby Letter of Credit Agreement, Bank One would have a valid contract action against Bergner, but it would be no less obligated to honor its contractual duty to the beneficiary. *See id.* at 1119, 1114.

66. *See id.* at 1115.

67. *See id.* at 1116.

68. *See id.*

petition for bankruptcy.⁶⁹

The central issue in this case was whether the lower courts concluded correctly that Bergner's payments to Bank One to cover the AMC and Liberty Mutual obligations were voidable preferences under section 547(b) of the Bankruptcy Code.⁷⁰ Bank One argued that it was only a collection agent for Bergner, that the money simply flowed through the bank, and therefore if Bergner were to recover these payments, it would receive a windfall.⁷¹ The problem was that "Bank One's position [did] not reflect the independent obligations that ran from the bank to the beneficiaries."⁷²

Thus, when AMC presented its draft with conforming documents to Bank One on July 19, 1991, Bank One was required to pay AMC the full \$31,207,000 that the letter of credit then provided, whether or not Bergner gave it a red cent. If Bergner did not comply with its own agreement with Bank One, under which it was required to give the bank the amount of the draw either before or at the time of the payment to the beneficiary, then Bank One would have had a perfectly good contract action against Bergner, but it would have had no defense against honoring the beneficiary's demand.

* * *

This means that at the moment AMC presented its draft, a debt arose between Bergner (as debtor) and Bank One (as creditor), in the amount of the requested draft.⁷³

The Seventh Circuit concluded that Bank One's arguments were simply unpersuasive attempts to recharacterize the transaction and to attack the independence principle.⁷⁴ The elements of section 547(b) were all present, and the transfers were thus voidable preferences.⁷⁵

IV. STATE CLAIM FOR SUPPORT OF DELINQUENT MINOR

*In re Platter*⁷⁶ involved a debtor whose delinquent son was placed in a residential treatment facility. Under Indiana Code section 31-6-4-18(b),⁷⁷ the

69. *See id.*

70. *Id.* at 1118.

71. *See id.* at 1118-19.

72. *Id.* at 1119.

73. *Id.* (citations omitted).

74. *Id.* at 1120.

75. *See id.* at 1119-20.

76. 140 F.3d 676 (7th Cir. 1998).

77. In 1997 Indiana lawmakers repealed this section and replaced it with Indiana Code section 31-40-1-2, which provides: "The child's parent or the guardian of the estate of a child shall reimburse the county for the costs paid under subsection (a) (or [Indiana Code section] 31-6-4-

mother was required to repay the \$65,565 cost incurred by the DeKalb County Division of Family and Children Services ("DFCS") in caring for her son.⁷⁸ When Platter declared bankruptcy, DFCS argued that this obligation was not dischargeable.⁷⁹ Despite the divided authority on this issue, the bankruptcy court held Platter's debt dischargeable, and the District Court for the Northern District of Indiana affirmed.⁸⁰

The first issue on appeal dealt with DFCS's purported immunity under the Eleventh Amendment.⁸¹ DFCS argued that the bankruptcy court had no authority to determine whether Platter's debt to the state agency was dischargeable.⁸² "For over a century, the Supreme Court has interpreted the Amendment to deny to the federal courts authority to entertain a suit brought by a private party against a state without its consent."⁸³ The court dealt with the issue summarily, however, concluding that "[b]ecause a state voluntarily chooses to enter a bankruptcy case when it initiates an adversary proceeding, we hold that a state removes itself from the Eleventh Amendment's protection by starting one."⁸⁴ A state cannot enter a federal forum voluntarily and then seek protection under the Eleventh Amendment just because it does not like the result.⁸⁵

The second issue in the *Platter* case dealt with discharge of the debt. DFCS relied upon section 523(a)(5) of the Bankruptcy Code.⁸⁶ This section provides that a discharge does not discharge the debtor from a debt

to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, . . . but not to the extent that . . . such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support.⁸⁷

This debt was not owed to the spouse, former spouse or child. Therefore, the Code section that DFCS relied on was inapplicable, and the debt could be discharged.⁸⁸ Further, the court reviewed Congress' 1984 amendment to the

before its repeal) as provided under this article." IND. CODE § 31-40-1-2(c) (1998).

78. *In re Platter*, 140 F.3d at 678.

79. *See id.*

80. *Id.*

81. *See id.* "The Eleventh Amendment provides that the Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." *Id.* (quoting U.S. CONST. amend. XI).

82. *See id.* at 679.

83. *Id.* at 678 (citing *Hans v. Louisiana*, 134 U.S. 1, 15 (1890)).

84. *Id.* at 679.

85. *See id.* at 680.

86. *See id.* at 680-81.

87. 11 U.S.C. § 523(a)(5) (1994 & Supp. III 1997).

88. *See In re Platter*, 140 F.3d at 681.

Code section at issue along with the relevant legislative history.⁸⁹ The court concluded that DFCS's position was not supported.⁹⁰

V. ALLOCATION OF TAXES BETWEEN LANDLORD AND BANKRUPT TENANT

The Seventh Circuit decided an important issue last year that had been addressed by numerous lower courts but not by a court of appeals. *In re Handy Andy Home Improvement Centers, Inc.*⁹¹ answered whether the bankrupt tenant's debt to the landlord for taxes paid had to be prorated or whether it was entirely a post-petition debt.⁹² The Seventh Circuit affirmed the lower court decisions that the debt had to be prorated, and it clarified that "the dividing line is . . . not the date on which the petition is filed but the date on which the order for relief is entered."⁹³

In Cook County, Illinois, taxpayers are billed after the period of assessment, and as elsewhere, landlords often pay the taxes as they come due and are later reimbursed by their tenants.⁹⁴ The landlord in this case, National Terminals Corporation ("National"), received the bill for the second installment of 1994 taxes in September 1995. In October 1995, tenant Handy Andy's creditors filed an involuntary petition for bankruptcy. An order for relief, pursuant to 11 U.S.C. § 303(h), was entered on November 1, 1995.⁹⁵ Two weeks after the petition was filed but before the order for relief was entered, National paid the tax bill and invoiced Handy Andy. In February 1996 National received and paid the tax bill for the first installment of 1995 taxes, and it invoiced Handy Andy again. Handy Andy rejected the lease in April 1996.⁹⁶

Post-petition creditors receive high priority in the distribution of the debtor's estate;⁹⁷ moreover, section 365(d)(3) of the Bankruptcy Code provides that the trustee or the debtor in possession "shall timely perform all the obligations of the debtor, . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected . . ."⁹⁸ National argued that Handy Andy's obligation under the lease was a post-petition debt—that it could not have arisen until the billing date for tax reimbursement, (i.e., the rental due date after National paid the county taxes).⁹⁹ The court disagreed.¹⁰⁰

89. *Id.* at 681-82.

90. *Id.* at 683.

91. 144 F.3d 1125 (7th Cir. 1998).

92. *Id.* at 1126.

93. *Id.*

94. *See id.*

95. *See id.*

96. *See id.*

97. *See id.* at 1127.

98. 11 U.S.C. § 365(d)(3) (1994).

99. *See In re Andy*, 144 F.3d at 1126-27.

100. *Id.*

Handy Andy's debt related entirely to an earlier period and was therefore no different from debts to trade creditors incurred in 1994 but never paid.¹⁰¹

A trade creditor does not, by virtue of continuing to sell to the debtor after the latter has gone into bankruptcy, obtain a priority for what the debtor owes him for goods or services sold to the debtor before the bankruptcy. National is in no different situation by virtue of section 365(d)(3).¹⁰²

The court opted for an interpretation of the statute that would not "make the rights of creditors turn on the happenstance of the dating of tax bills and the strategic moves of landlords and tenants."¹⁰³

VI. DISCHARGE OF MARITAL OBLIGATIONS AND THE BURDEN OF PROOF

In the Seventh Circuit case *In re Crosswhite*,¹⁰⁴ the Crosswhites divorced, and Mr. Crosswhite ("husband") agreed to assume and to hold Ms. Ginter ("wife") harmless on two joint debts. Husband did not pay the debts but instead declared bankruptcy.¹⁰⁵ Wife paid one of the debts, and she restructured the other and made payments on it. She then initiated an adversary proceeding in husband's bankruptcy to determine whether husband's obligation under the property settlement was dischargeable under 11 U.S.C. § 523(a)(15).¹⁰⁶ The bankruptcy court held the obligations were dischargeable, and the district court affirmed.¹⁰⁷ Wife appealed.¹⁰⁸

Section 523(a)(15) of the Bankruptcy Code provides that an individual is not discharged from any debt "not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record . . . unless" one of two conditions exists.¹⁰⁹ The debt is dischargeable if "the debtor does not have the ability to pay the debt from disposable income, or . . . the benefit to the debtor in discharging the debt outweighs the detrimental

101. *See id.* at 1127-28.

102. *Id.* at 1128. The court also noted that section 365(d)(3) establishes the date of the order for relief as the cutoff. *Id.* at 1127. Any obligation arising before that date would not fall within this section. Here, that date was November 1, 1995. *Id.* at 1126. National received a bill, paid it, and invoiced Handy Andy for the second installment of the 1994 taxes before November 1, 1995. In no case, then, could that obligation have arisen after the order for relief. However, the court did not rely on this line of reasoning because Handy Andy did not. *Id.* at 1127.

103. *Id.* at 1128.

104. 148 F.3d 879 (7th Cir. 1998).

105. *See id.* at 881.

106. *See id.*

107. *See id.*

108. *See id.*

109. 11 U.S.C. § 523(a)(15) (1994).

consequences to the debtor's former spouse or child."¹¹⁰ The bankruptcy court held that, despite husband's "somewhat parasitic existence," it was appropriate to discharge the debt because the benefit to husband outweighed the detriment to wife.¹¹¹

Wife did not object to carrying the initial burden of showing the existence of a nondischargeable debt—one that was incurred by the debtor pursuant to a divorce but did not fall under section 523(a)(5). Instead, she contended that the court incorrectly failed to place on husband, the debtor, the burden of establishing an affirmative defense—either that he could not pay the debt or that the benefit to him of discharge outweighed the detriment to wife of no discharge.¹¹²

The Seventh Circuit concluded that "there is a clear shift in the burden of proof under [section] 523 (a)(15). The burden of proving initially that she holds a subsection (15) claim against the debtor should be borne by the creditor (nondebtor/former spouse)."¹¹³ Once the creditor has overcome this hurdle, "the burden of proving that he falls within either of the two exceptions to nondischargeability rests with the debtor."¹¹⁴

The court stated that both the bankruptcy court and the district court "appeared to acknowledge, at one point, that the burden of establishing the exception is on the debtor."¹¹⁵ Nonetheless, the court vacated the decision and remanded it,¹¹⁶ because "a reading of both opinions in their entirety leaves us with grave doubt as to whether abstract verbalization of the correct standard actually was applied in the courts' analyses Rather, it appears to us that these courts may well have placed improperly the burden of satisfying the test under [section] 523(a)(15)(B) on the creditor, [wife], rather than on the debtor, [husband]."¹¹⁷ The dissent disagreed.¹¹⁸

110. *In re Crosswhite*, 148 F.3d at 883 (citing 11 U.S.C. § 523(a)(15)(A)-(B)).

111. *Id.* at 883-84.

112. *See id.* at 884.

113. *Id.*

114. *Id.* at 884-85.

115. *Id.* at 886.

116. *Id.* at 889.

117. *Id.* at 886.

118.

Both of the lower courts stated the appropriate burden of proof, but this court remands because it questions whether they actually applied that burden. I conclude that they did apply the burden they recited, leaving the key question of whether the bankruptcy court abused its discretion in balancing the harms under (a)(15)(B) in favor of [husband]. In my view it did not, and therefore, I would affirm.

Id. at 890 (Manion, J., dissenting).

VII. DISCRETION TO DENY FEES

*In re Crivello*¹¹⁹ addressed the issue of compensating professionals employed in the bankruptcy who, as discovered later, were not disinterested. Crivello, the debtor in possession, sought to retain Kravit, Gass & Weber, S.C. ("KGW") as his bankruptcy counsel.¹²⁰ KGW failed to disclose earlier dealings it had with the debtor, and it failed to disclose pre-petition claims it held against him.¹²¹

When KGW later applied to the bankruptcy court for final compensation of more than \$334,000, the U.S. Trustee objected, arguing that "KGW was not disinterested, that KGW failed to disclose its connections to insiders adequately, and that the amount of the request was unreasonable."¹²² After KGW filed an amended affidavit of disinterestedness explaining why certain facts had not been included in the original affidavit, the bankruptcy court revoked the firm's order of employment and denied its request for compensation entirely.¹²³ The district court affirmed.¹²⁴

The court of appeals discussed the issue of professional compensation as a backdrop to its determination of the question "whether a bankruptcy court must deny fees when it subsequently learns that a professional never should have been employed under [section] 327(a) in the first place or whether it has *discretion* to deny fees."¹²⁵

The U.S. trustee relied on the holding in the case *Michel v. Federated Department Stores, Inc.*,¹²⁶ in support of a mandatory denial of fees. The Seventh Circuit rejected the trustee's argument based on the plain language of the statute.¹²⁷ Section 328(c) states that the court "may deny allowance of compensation . . . if, at any time during such professional person's employment . . . such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed."¹²⁸

The court stated that in order to reach the trustee's conclusion, it would have to interpret the word "is" in section 328(c) to mean "becomes," and it would have to insert the word "valid" before the word "employment."¹²⁹ This the court refused to do.¹³⁰ "Under the plain language of the provision, [section] 328(c) covers questions about whether this erroneously employed professional merits

119. 134 F.3d 831 (7th Cir. 1998).

120. *See id.* at 833.

121. *See id.* at 834.

122. *Id.*

123. *See id.* at 834-35.

124. *See id.* at 835.

125. *Id.* at 836 (emphasis in original).

126. 44 F.3d 1310 (6th Cir. 1995).

127. *In re Crivello*, 134 F.3d at 837.

128. 11 U.S.C. § 328(c) (1994).

129. *In re Crivello*, 134 F.3d at 837.

130. *Id.*

compensation. Thus a bankruptcy court has discretion in denying that professional's fees."¹³¹

VIII. TWO OTHER DECISIONS WORTH MENTIONING

*In re Linton*¹³² involved a situation where a party wanted to sue a bankruptcy trustee in state court after the bankruptcy proceeding had been closed. Betty Lasiter and Richard Scharpf sought leave from the bankruptcy court to sue the trustee Paul Gresk for malicious prosecution of an adversary action he filed against them while the bankruptcy proceeding was pending.¹³³ The bankruptcy court denied the motion, and both the district court and the court of appeals affirmed.¹³⁴

Although the court did not find any federal appellate court cases addressing the requirement for leave after the bankruptcy is closed, it concluded such leave to sue the trustee is required.¹³⁵ The rationale for the requirement during bankruptcy also applies after the bankruptcy has been wound up (e.g., if the trustee "is burdened with having to defend against suits by litigants disappointed by his actions on the court's behalf, his work for the court will be impeded"; and "it will be harder for courts to find competent people to appoint as trustees").¹³⁶

In *In re Greenig*¹³⁷ the Greenigs submitted and the bankruptcy court confirmed their Chapter 12 reorganization plans. The plans listed United Feeds as a creditor holding an allowed claim, but United Feeds failed to file the required proof of claim before the deadline passed.¹³⁸ When United Feeds did not receive its first payment from the Greenigs under the reorganization, it filed a motion for leave to file a late proof of claim. The bankruptcy court granted the motion, but the district court reversed.¹³⁹

The Seventh Circuit affirmed the district court's decision.¹⁴⁰ A bankruptcy court does not possess the equitable power to permit a new claim that is filed

131. *Id.* Nevertheless, the court of appeals reversed the district court and remanded the case to the bankruptcy court because the "bankruptcy court's erroneous findings of fact may have tainted its discretion." *Id.* at 839. The district court found no support in the record for the bankruptcy court's determination "that KGW attempted to thwart the Code's disclosure requirements and that KGW willfully failed to disclose its prior representation." *Id.* at 840. Because the district court did not consider whether these erroneous findings may have tainted the lower court's exercise of discretion, the court of appeals was obligated to reverse. *Id.*

132. 136 F.3d 544 (7th Cir. 1998).

133. *See id.* at 544-45.

134. *Id.* at 544, 547.

135. *Id.* at 545.

136. *Id.*

137. 152 F.3d 631 (7th Cir. 1998).

138. *See id.* at 632.

139. *See id.* at 633.

140. *Id.* at 636.

late.¹⁴¹ This is different from a Chapter 11 case where a proof of claim may be deemed filed if the debt is scheduled.¹⁴² “In a Chapter 12 bankruptcy case, the creditor has [ninety] days to file a proof of claim, unless an exception of [Federal Rule of Bankruptcy Procedure] 3002(c) applies. This requirement may not be circumvented, either by the existence of a confirmed plan, or by the presence of equitable considerations.”¹⁴³

CONCLUSION

These decisions address important questions for Indiana practitioners. Next year at this time, attorneys will likely be reading not only about important developments in the case law, but also significant changes in the Bankruptcy Code itself.

141. *See id.* at 635.

142. *See id.* at 633.

143. *Id.* at 636.

