Commercial Law & Bankruptcy Section Case Summaries

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In This Issue:

Meyer v. Lepe (In re Lepe), Case No. 10-60264 (B.A.P. 9th Cir 2012) (Judge Pappas, Judge Dunne, and Judge Markell)

Appellee Angel Lepe (the "Debtor" or "Lepe") filed a petition for Chapter 13 bankruptcy relief on September 2, 2010. He listed assets valued at $393,900, liabilities of $581,380 (including only $549 of unsecured debt), monthly income of $2,631 and monthly expenses of $2,481. Lepe proposed a Chapter 13 plan that would "strip" the $29,000 second mortgage on his house and to treat it as unsecured. Lepe proposed to pay $150 for five months and then $275 a month for 31 months, for a total payment to unsecured creditors of $9,275 or approximately 30% of the total of $29,540 in unsecured claims. No creditors objected to the proposed plan.

The Trustee, however, objected to confirmation and asserted that Lepe's plan and petition had both been filed in bad faith in violation of sections 1325(a)(3) and (a)(7). Specifically, the Trustee alleged that Lepe was a solvent debtor and had filed for Chapter 13 protection solely to strip the second mortgage on his house.

At the confirmation hearing on both Lepe and his girlfriend's plans, the California bankruptcy court found that, while it was a "very close call", the plan should be confirmed.

On appeal, the BAP affirmed that the bankruptcy court did not clearly err in finding that Lepe acted in good faith in proposing his plan. The Court noted that there are two Chapter 13 provisions requiring good faith, § 1325(a)(7) (requiring good faith in "filing the petition") and § 1325(a)(3) (requiring good faith in proposing a plan), and the debtor has the burden to show good faith. The Ninth Circuit has stated that there is no per se rule on what is bad faith, instead a totality of circumstances test is used. *See Goeb v. Heid (In re Goeb)*, 675 F.2d 1386 (9th. Cir. 1982). The Ninth Circuit and BAP have noted numerous factors to consider. *See Leavitt v. Soto (In re Leavitt)*, 171 F.3d 1219, 1224 (9th Cir. 1999) (four factors); *Fid. & Cas. Co. of N.Y v. Warren (In re Warren)*, 89 B.R. 87, 93 (9th Cir. BAP 1987) (eleven factors). The Court distinguished all of the "bad faith" case law cited by the trustee; the cited cases involved proposed plans that either only paid attorney fees or were part of a "Chapter 20." The Court pointed out that all of these cases still involved evidence of more than just one factor of bad faith.

In this case, the Court noted that the trustee was only alleging one factor showing bad faith – filing the case solely to strip a second mortgage. The Court rejected the second factor of solvency, pointing out that the debtor was cash flow solvent but not balance sheet solvent: "While Lepe's cash-flow would arguably allow him to pay his mortgage payments with some small amount remaining each month to apply toward unsecured debts, Lepe's financial circumstances were, indisputably, dire. As noted above, indisputably, Lepe was balance sheet insolvent, in that the amount of his debts greatly exceeded the value of his assets." The Court pointed out that the bankruptcy code did not prohibit a cash flow solvent debtor from filing Chapter 13 and the bankruptcy code and case law specifically permitted stripping a second mortgage that was underwater. Finally, the Court noted that the Chapter 13 plan proposed "not insignificant" payments to unsecured creditors and resulted in a much better return for the second mortgage creditor (who had not filed an objection to the proposed plan) than what would have been obtained if the debtor had first filed Chapter 7. The Court ultimately concluded that the bankruptcy court did not err in its application of the various factors relevant to the totality of the circumstances test in finding that the debtor proposed his plan in good faith.

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Warfield v. Salazar (In re Salazar) Case No. 08-11597 (9th Cir. B.A.P. Mar. 14, 2012) (Dunn, Jury, and Pappas)

The case was originally filed as a chapter 13. The appellees Timothy Andrew Salazar and Gena Annette Salazar (the "Salazars") filed a chapter 13 petition on September 3, 2008 ("Petition Date"). In their Schedule of Personal Property ("Schedule B"), the Salazars marked "None" in response to Schedule B's request that they disclose "[o]ther liquidated debts owed to debtor including tax refunds." However, while the chapter 13 case was pending, the Salazars received refunds based upon their 2008 state and federal tax returns. The prepetition pro rata amount of those refunds totaled $4,084.94 ("Prepetition Refund"). The Salazars never amended their Schedule B to disclose the Prepetition Refund. The Salazars used the Prepetition Refund for living expenses while the chapter 13case was pending. No plan was ever confirmed in their chapter 13 case.

The bankruptcy court converted the Salazars' case from chapter 13 to chapter 7 on August 19, 2009. Appellant Lawrence Warfield was appointed as the chapter 7 trustee ("Trustee") in the converted case. The Trustee filed a motion to compel the Salazars to turn over the Prepetition Refund. The Salazars responded by asserting that because the Prepetition Refund had been spent, i.e., was not in their possession, it no longer constituted property of the estate pursuant to § 348 (f)(1)(A). The bankruptcy court agreed. The Trustee filed a notice of appeal and the Ninth Circuit B.A.P. upheld the bankruptcy court decision.

The BAP determined Section 348(f)(1)(A), by its terms, contemplates that debtors may use up property of the estate in a chapter 13 bankruptcy and no longer possess it, and any such property of the estate used up in a chapter 13 prior to the conversion of the case to chapter 7 is not property of the estate in the converted case. The Court applied a "plain meaning" interpretation of § 348(f)(1)(A) to determine that a prepetition tax refund spent during a chapter 13 was not property of the estate on conversion to a chapter 7.

The court followed the decision in *Bogdanov v. Laflamme (In re Laflamme)*, 397 B.R. 194 (Bankr. D.N.H. 2008) The *Laflamme* court held that property of the estate following conversion from chapter 13 to chapter 7 will consist of the property in the chapter 13 estate on the petition date, less amounts lawfully removed by the debtors in good faith to pay ordinary and necessary living expenses during the period from the petition date to the conversion date.

The Laflamme court declined to adopt a bright-line rule to define under what circumstances and for what purposes a debtor may use chapter 13 estate property other than to stress the use must be reasonable and will usually include normal living expenses, determined by the facts of the case and is subject to "good faith" scrutiny. The good faith test is important to address situations where a debtor could file Chapter 13 only to buy time to spend assets that would otherwise be recoverable in Chapter 7, converting to Chapter 7 once the assets were spent.

The Court noted that treating the tax return funds as non-estate property after conversion was an anomaly (considering they would have been estate property if the case had started as a Chapter 7 and also would have been treated as estate property for purposes of the "best interests of creditors test" if the case had remained in Chapter 13) but it was not an absurd result that would merit ignoring the plain language of the Code.

Following Laflamme and a plain meaning interpretation of § 348(f)(1)(A), the court determined that the debtors spent the prepetition tax refund in good faith to pay ordinary and necessary living expenses during the period from the petition date to the conversion date "in the normal course of living". The court found no error by the bankruptcy court in concluding that the prepetition tax refund, having been used up, did not constitute property of the chapter 7 estate on the conversion date.

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CASE: *In re Warkentin*, Case No. 08-41257-JDP

QUICK SUMMARY: If a party with an interest in property belonging to a chapter 7 debtor is not given notice of a motion proposing the sale of such property, the sale may be voided pursuant to Fed. R. Civ. Proc. 60(b), as incorporated under Bankruptcy Rule 9024.

FACTS/ANALYSIS: In 2008, Jeannine Warkentin ("Debtor") filed for chapter 7 bankruptcy. In 2010, the trustee filed a motion to sell Debtor's real property located at 215 S. Hawk Street, Inyokern, California ("Property"). Debtor's ex-husband Larry Warkentin ("Warkentin") had a fifty-percent interest in the Property. Warkentin was not sent notice of the hearing relating to the above motion. At the hearing, the Court specifically asked the trustee if Warkentin was sent a copy of the notice. The trustee indicated that Warkentin had received notice of the hearing and motion, but did not disclose that notice had never actually been sent. The sale occurred and Warkentin later moved to set it aside. The Court granted the motion. The Court's analysis focused on Fed. R. Civ. Proc. 60(b)(4).

Rule 60(b)(4) allows a Court to relieve a party from a judgment or order if it is void. A judgment or order is void if it is issued without due process. In conjunction, Rule 6004(c) states that "[a] motion for authority to sell property free and clear of liens or other interests shall be made in accordance with Rule 9014 and shall be served on the parties who have liens or other interests in the property to be sold." In this case, the Court found that such notice was never sent to Warkentin. Thus, Warkentin was denied due process and the trustee failed to comply with Rule 6004(c). This rendered the sale and order approving the sale void.

The ultimate purchasers of the Property attempted to retain the Property they had obtained at sale. The purchasers argued that, notwithstanding lack of notice, the sale was sufficient to convey title under Section 363(m). The Court disagreed. First, Section 363(m) states that if an "authorization under subsection (b) or (c) of this section of a sale … of property" is reversed or modified on appeal, such "does not affect the validity of a sale" when made to a good faith purchaser.

The plain language of Section 363(m) indicates that it is limited to an appeal of a sale authorized under 363(b) or (c). This case did not implicate an appeal. Accordingly, Section 363(m) afforded no basis for the relief sought by the purchasers. Second, Section 363(b) allows a trustee to sell property of a bankruptcy estate only "after notice and a hearing." In this case, the Court had already found that notice was lacking. Therefore, even if this case were an appeal, 363(m) still did not apply. Accordingly, the sale was a nullity.

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CASE: *Radlax Gateway Hotel, LLC, v. Amalgamated Bank*, 132 S.Ct. 2065 (May 29, 2012)

QUICK SUMMARY: If a Chapter 11 confirmation plan provides for a sale of assets free and clear of a creditor's lien thereon and does not allow that creditor to credit-bid at the sale, the debtor may not obtain plan confirmation under Section 1129.

FACTS/ANALYSIS: RadLax Gateway Hotel, LLC and related entities ("Gateway Debtors") purchased the Radisson Hotel at the Los Angeles International Airport. Gateway Debtors also purchased an adjacent lot. Gateway Debtors planned to construct a parking structure on the lot. To finance the purchase, Gateway Debtors borrowed money from Amalgamated Bank ("Amalgamated"). Amalgamated securitized its loan by taking a lien on the hotel and lot ("Collateral"). In 2009, the planned construction faltered. Gateway Debtors declared bankruptcy under Chapter 11 and submitted a confirmation plan. The plan proposed the sale of the Collateral according to auction and sale procedures which did not allow Amalgamated to credit-bid at the sale.

Gateway Debtors sought to confirm the plan under Section 1129(b) - Chapter 11's "cram down" provision. The Court rejected the plan and certified a direct appeal to the Seventh Circuit Court of Appeals. The appellate court affirmed, holding that Section 1129 (b)(2)(A) does not permit debtors to sell encumbered assets free and clear of a lien without permitting the lien holder to credit-bid at the sale. Gateway Debtors appealed and the Supreme Court affirmed.

A chapter 11 bankruptcy is implemented according to a "plan." A bankruptcy court may confirm the plan only if each class of creditors consent to their plan treatment. Section 1129(b) is an exception to this rule. It allows confirmation of nonconsensual plans – commonly known as "cram down" plans – if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." To be considered "fair and equitable," the plan must satisfy sub-clauses (i), (ii) or (iii). Under clause (i), a secured creditor retains its lien on the property and receives deferred cash payments. Under clause (ii), the property is sold free and clear, but the creditor retains a lien in the proceeds the sale yields. Notably, clause (ii) is subject to Section 363 (k). Section 363(k) allows a creditor to credit bid at the sale up to the amount of its claim. Clause (iii) allows confirmation on grounds that the plan is fair and equitable where the plan provides the secured creditor with the "indubitable equivalent" of its claim.

Gateway Debtors argued that confirmation was proper under clause (iii) and Amalgamated received the indubitable equivalent of its claim. Gateway Debtors reasoned that because 1129(b)(2)(A) uses the disjunctive "or," satisfaction of (iii) was all that was necessary to obtain judicial confirmation. The Court disagreed, calling Gateway Debtors' position "hyperliteral." The Court's position was based on the rule of statutory construction that specific statutes control over general ones. The specific statute at issue in the case was Section 1129(b)(2)(A)(ii). That provision states that debtors "may not sell their property free of liens under Section 1129(b)(2)(A) without allowing lienholders to credit-bid …" By not allowing Amalgamated to credit-bid at the sale, the plan proposed by Gateway Debtors directly ran afoul of clause (ii), which, because it is a specific provision, controlled the disposition of Gateway Debtors' proposed plan over clause (iii). According to the Court, whether the plan did or did not provide the secured creditor with the "indubitable equivalent" of its claim was not relevant.

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CASE: *Welsch v. Drummond*, 465 B.R. 843 (9th Cir. 2012 BAP).

QUICK SUMMARY: A chapter 13 debtor's confirmation plan is not subject to rejection on grounds of bad faith even though: (a) the plan proposes repayment of secured debts that fall within applicable IRS standards, but which are not debts for necessary items; and (b) the plan contains disposable income calculations which do not include income received from social security.

FACTS/ANALYSIS: In May of 2010, David and Sharon Welsch ("Debtors") filed a chapter 13 petition. Debtors' petition was precipitated by financial difficulties occurring after they obtained a construction loan in connection with the purchase of a new home. In their bankruptcy schedules, Debtors valued their home at $400,000.00. Debtors also stated that they had unsecured claims at $180,501.15, a mortgage of $330,593.00, and other secured debts relating to six (6) motor vehicles. Debtors' plan also listed income at $8,116.31, but omitted social security benefits as part of their income. The trustee objected, in part, on the grounds that the plan erroneously deducted payments for secured debts which the trustee considered to be "luxury items." The trustee also argued that the plan was submitted in bad faith because disposable income did not include social security payments. The Court addressed each issue in turn.

Confirmation of a Chapter 13 plan is governed by Section 1325. Section 1325(b)(2) defines disposable income as "current monthly income received by the debtor … less amounts reasonably necessary to be expended" for certain expenses. "Current monthly income" is defined as the debtor's average monthly income received in the six months before bankruptcy, "but excludes benefits received under the Social Security Act." Section 101(10A)(A), (B). For debtors whose current monthly income exceeds the median income for households of the same size in the debtor's state, "[a]mounts reasonably necessary … shall be determined in accordance with … 707(b)(2)." Section 707(b)(2)(A) allows a debtor to deduct from current monthly income expenses set out in the IRS standards. Trustee argued that Section 707(b)(2)(A) applies only to debts allowed by the IRS that are "necessary" expenses. However, the plain language of the statute imposes no such limitation and the Court refused to judicially impose the same. The Court concluded that "the means test of [Section] 707(b)(2)(A), which is a 12 incorporated into chapter 13, allows a debtor to deduct from current monthly income payments on secured debts, averaged over sixty months as provided in [Section] 707(b)(2)(A)(iii), regardless of whether the collateral is necessary." Accordingly, the appellate panel found that the lower court did not err in allowing Debtors to deduct debt payments on the six vehicles they intended to retain, although such assets may not have been considered necessary.

The Court also found that the plan was proposed in good faith. It is settled law that the debtor must act equitably in proposing his or her Chapter 13 plan. In determining whether the debtor acted equitably, the Court looks to the totality of the circumstances. Because the Debtor in this case properly calculated income, the question for the Court was whether "items used in that calculation [can] be the basis for a finding that the plan was not proposed in good faith." In other words, the issue was whether or not Debtors acted in good faith in not including Social Security benefits as income, even though the Code allows Debtors to take such action. The Court answered in the negative, stating, "In our view, taking advantage of a provision of the Code, such as calculating disposable income under the test explicitly set out in the Code, is not an indication of lack of good faith … [A finding that the plan was not proposed in good faith] may not, however, be based on the mere fact that the debtor has excluded income or deducted expenses that the Code allows … In making its good faith determination under [Section] 1325(a)(3), the bankruptcy court cannot find lack of good faith based on a debtor's deduction of those allowed expenses in their calculation of disposable income. To do so would be to second-guess the Congressional policy choice about what expenses are reasonably necessary for a debtor's maintenance and support." Based on the foregoing analysis, the Court overruled trustee's objections to the plan.

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CASE: *Hoskins v. Citigroup, Inc., et al.*, 469 B.R. 1 (9th Cir. 2012 BAP)

QUICK SUMMARY: The power to avoid a transfer and recover proceeds only applies against a transferee, which the Ninth Circuit defines as one who has: (a) legal authority over the money or other asset transferred; and (b) the right to use the subject property however the transferee wishes. Additionally, a trustee lacks standing to assert its strong arm powers to vindicate injuries suffered by third parties.

FACTS/ANALYSIS: Joseph J. Viola ("Viola") involuntarily filed a Chapter 7 petition in 2010. Before doing so, Viola opened up a trust account at Citibank in San Francisco entitled "The Ralph Napolitano Irrevocable Living Trust DTD April 13, 1999." Viola began using the trust account to run a Ponzi scheme. To that end, investors entrusted Viola with roughly $17,000,000.00. Viola used some of the monies to purchase Citigroup stock (Citigroup, Citibank, and CMGI are hereinafter collectively referred to as "Citi"). Peculiarly, Citi provided Viola with assistance in his scheme, making representations to investors that Viola was a practicing attorney and a skilled investment advisor.

Upon declaring for bankruptcy, the Chapter 7 trustee ("Hoskins") filed an adversary proceeding against Citi for its role in Viola's attempts to defraud investors. Hoskins asserted two claims seeking to avoid certain fraudulent transfers and one claim for aiding and abetting such transfers. Citi successfully dismissed the claims asserted by Hoskins. Hoskins appealed and the Bankruptcy Appellate Panel affirmed.

On appeal, three (3) issues were raised: (a) whether any of the Citi entities were transferees for purposes of imposing fraudulent transfer liability; (b) whether a bankruptcy trustee has standing to bring a claim for aiding and abetting a fraudulent transfer; and (c) whether Section 546(e) protects the Citi entities in the sale of stock through CMGI, a Citi subsidiary.

The first issue is governed by Section 550(a), which states that a trustee may recover a fraudulent transfer from "the initial transferee of such transfer …" This required that the Court determine whether the Citi entities were "transferees." The Court applied the dominion test to determine transferee status. According to that test, a transferee must have "dominion over the money or other asset [and] the right to put the money to one's own purposes … The inquiry focuses on whether an entity had legal authority over the money and the right to use the money however it wished." The complaint filed by Hoskins did not allege that any of the Citi entities had dominion over the funds - solely Viola. As such, none of the Citi entities could be considered a transferee under Section 550(a) since they did not legally have authority to control the disposition of the funds.

The Court then found that Hoskins did not have standing to assert claims under Section 544(a)(2). That provision gives the trustee the power to "avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by … a creditor that extends credit to the debtor at the time of the commencement of the case … whether or not such a creditor exists …" Section 544(a)(2). The Court stated that Section 544(a)(2) was intended to give a trustee the power to pursue equitable remedies. However, the Ninth Circuit had never interpreted the clause in a manner that would give a trustee all the substantive rights of a hypothetical lien creditor, including the standing to bring a cause of action on behalf of others. According to the Court, if Hoskins recovered monies from the Citi entities, the proceeds would go to the investors and not Hoskins. As such, Hoskins was really just asserting claims for injuries allegedly sustained by third parties. Hoskins thus did not have standing to assert such a claim.

The final issue addressed by the Court was whether Hoskins could avoid the transfer of $1,007,600 for Citigroup Stock because the transfer was through CMGI. The Court found that the trustee lacked the power to set aside the above transfer. The operative provision was Section 546(e). That section limits a trustee's power to avoid certain transfers when made by, to, or for the benefit of certain entities. Hoskins conceded that CMGI is covered under Section 546 (e)'s safe harbor provision. Hoskins asked, however, that CMGI be treated as a "mere conduit" under Section 550. The Court rejected this argument on the grounds that the Code did not provide any basis for the Court to interpret Section 550's transferee test as also applicable to Section 546(e).

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***In re Gables Management, LLC*, 2012 WL 1857015 (Bankr. D. Idaho May 21, 2012)**

In *Gables Management, LLC*, the Bankruptcy Court for the District of Idaho was faced with the determination of whether two transactions should properly be classified as loans or equity investments and thus, whether the parties that made the loans/equity investments held unsecured claims or instead held equity securities.

Debtor, Gables Management, LLC owned and operated Gables of Pocatello, an assisted living facility. Creditors Ernie and Patricia Geiger, and Ernie's mother June Geiger (a resident of Gables of Pocatello) were persuaded into making "loans" to debtor by Keith Rasmussen, an individual whom Ernie and Patricia had met while visiting June at Gables of Pocatello and who purported to be the owner of Gables of Pocatello. Rasmussen told the Geigers that the purpose of the loan was to return another investor's money, "that he would retain [the Geigers'] money for no more than three years, that he would not touch the principal, and that he would pay them interest at the rate of 16% per annum."

Ernie and Patricia agreed to provide $25,000 to Rasmussen, and June, with Ernie's blessing, also provided Rasmussen $25,000. The money was given to Rasmussen in the form of checks made payable to Gables Management. In return, Ernie and Patricia on the one hand, and June on the other hand, each received a promissory note, a deed of trust, and a "Gables Management Investor Contract." June further received a document titled "June Geiger Investment Agreement." Debtor commenced making payments of $333.33 to Ernie and Patricia and began crediting June $333.33 per month on her monthly rent.

Debtor subsequently filed bankruptcy and Ernie, Patricia and June filed proofs of claim in debtor's bankruptcy case (Ernie and Patricia's claim in the amount of $25,333.33 and June's claim in the amount of $22,886.31). The chapter 11 trustee objected to the Geigers' proofs of claim arguing (1) that the claims were against Rasmussen, not debtor (based on the fact that the promissory notes identified Rasmussen, not debtor, as the borrower, the deeds of trust identified Rasmussen as the grantor and the Investor Contracts were signed by Rassmussen as "Owner"); and (2) that the Geigers' transactions with debtor were investments, not loans.

Addressing the first issue, the Court determined that regardless of whether Rasmussen was obligated on the Geigers' claims, debtor too was obligated to the Geigers on their claims. Central to this determination was the Court's conclusion that Rasmussen represented himself to the Geigers as the owner of debtor, that many of the transaction documents were set out on Gables letterhead, that the Geigers' money was paid to and utilized by debtor and that Ernie and Patricia had received monthly checks of $333.33 drawn on debtor's bank account.

Turning to the question of whether the Geigers' transactions with debtor were loans or investments, the Court undertook a close factual analysis in which it first looked to the instruments evidencing the transaction. The Court noted that on the one hand, the Geigers had received "investment contracts," but that on the other hand, the Geigers had also received promissory notes and deeds of trust, and further noted that nothing in the documents suggested that the Geigers were acquiring any ownership interest in debtor.

Because the transaction documents could be read to evidence either a loan or an investment, the Court turned to parol evidence to aid its analysis. On the one hand, debtor provided Ernie a 1099-INT (used for interest) as opposed to a form 1099-DIV (used for dividends) for the $333.33 payments made from debtor to Ernie and Patricia. Also, some of debtor's check stubs for the $333.33 payments denoted "Loans Payable." Further, debtor scheduled the obligation to Ernie as a "loan" on its Schedule F. Patricia also testified that the Geigers never believed that they were acquiring equity interests in debtor. On the other hand, the Geigers had identified the transactions as "investments" on their proofs of claim and had referred to their interests as investments in a letter to debtor. The Court noted that "regrettably, the extrinsic evidence . . . does not clearly resolve the ambiguity."

Turning to the definitions of "loan" provided in Black's Law Dictionary and Idaho's Credit Code, and the definition of "security" provided in Idaho's Uniform Security Act (which specifically includes an "investment contract"), the Court noted that the transactions could fit under either definition. The Court then turned to the *Howey-Forman* test, adopted by the Idaho Supreme Court to characterize transactions under the Idaho Securities Act, to aid its analysis. Under *Howey-Forman*, an "investment contract" exists where 1) [there is] an investment of money, 2) a common enterprise, and 3) a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of others."

While the Court determined that prongs (1) and (2) of the *Howey-Forman* test were met, it ultimately determined that the Geigers could not "expect either capital appreciation or participation in earnings generated by Debtor" and that thus, prong 3 was not satisfied. The Court further noted that "while transactions resembling loans have traditionally been held to be investment contracts, such appears to be more likely when the interest rates are extremely high" and that while the 16% interest on the Geigers' loans was above-market, it was not extreme. The Court concluded by stating that while it was a "close call," the subject transactions better fit the definition of loans than investments and that the transactions were "therefore properly treated as debts in the bankruptcy case."

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***Wolfe v. Jacobson, (In re Jacobson)*, 676 F.3d 1193 (9th Cir. 2012)**

In *Jacobson*, the Ninth Circuit reversed the Bankruptcy Appellate Panel and the bankruptcy court in holding that under California's homestead exemption laws, a debtor forfeited her exemption in her share of the proceeds from the judicial sale of her homestead when she failed to reinvest the proceeds within California's six-month reinvestment period, despite the fact that the homestead was not sold until after the debtor filed for bankruptcy.

In response to a judgment creditor's attempts to force a judicial sale of her home, debtor Myrna Jacobson filed for chapter 7 bankruptcy and claimed a homestead exemption under California law. After Ms. Jacobson filed for bankruptcy, the bankruptcy court granted judgment creditor stay relief to continue with the judicial sale of Ms. Jacobson's home (California's homestead exemption does not prevent a judgment creditor from forcing a judicial sale of the debtor's homestead, but instead, allows the sale to go forward as long as the sale proceeds are sufficient to satisfy all liens and encumbrances on the property and to provide the debtor with the statutorily mandated exemption amount). After receiving $150,000 in proceeds (the amount she was statutorily entitled to), Ms. Jacobson failed to reinvest the proceeds within the six-month window required under California law. As a result of Ms. Jacobson's failure to reinvest, the chapter 7 trustee filed an adversary proceeding seeking turnover of the proceeds.

The bankruptcy court ruled that the proceeds remained exempt based upon its reasoning "that bankruptcy exemptions are fixed at the time of the bankruptcy petition and cannot be changed by post-petition events . . . [and that because in the bankruptcy court's view] the homestead exemption [covered] the . . . property itself . . . post-petition conversion of the . . . property into sales proceeds could not change its exempt status." The BAP affirmed.

The Ninth Circuit in overruling the BAP initially noted that because California has opted out of the federal exemptions of 11 U.S.C. § 522, California law controlled in determining Ms. Jacobson's entitlement to a homestead exemption. In determining whether the proceeds lost their exempt status as a result of Ms. Jacobson's failure to reinvest, the Court looked to the "snapshot" rule, which provides that exemptions are fixed at the time the debtor files her bankruptcy petition. Important though, the exemptions must be determined in accordance with the *entire* state law applicable on the date of filing.

Looking to California's homestead exemption laws and the rights they conferred upon Ms. Jacobson when she filed her bankruptcy petition, the Court noted that while Ms. Jacobson was in fact entitled to a homestead exemption of $150,000, her exemption was not absolute and was subject to the express condition that any proceeds from a judicial sale of her homestead must be reinvested within six-months. Ms. Jacobson's argument that she had filed for bankruptcy before the judicial sale of her home and that she had thus claimed an exemption in the property and not the proceeds, was unavailing. The Court stated that "[t]he homestead exemption merely gave [Ms. Jacobson] a conditional right to a portion of the proceeds from the sale of the [property]. There was no exemption in the [property] itself. To the contrary, the exemption explicitly allowed [judgment creditor] to force a judicial sale . . . [Ms. Jacobs] could thus expect no more than $150,000 in proceeds that were subject to a reinvestment requirement." Because Ms. Jacobson failed to reinvest the $150,000 in proceeds within California's six-month reinvestment window, the Court determined that the proceeds lost their exempt status and were subject to turnover.

Separate from the homestead proceeds question, the Court affirmed the BAP and the bankruptcy court in determining that rental property titled solely in Ms. Jacobson's non-debtor spouse's name and the income therefrom, were not subject to turnover. The property was titled solely in Mr. Jacobson's name (and in California record title is presumptively correct). California's community property presumption did not apply because Mr. Jacobson had acquired the rental property in his name with Ms. Jacobson's consent (prior to acquiring the property, Ms. Jacobson had executed an interspousal transfer deed confirming that the rental property was her husband's separate property). The community property presumption was further inapplicable because the down payment was traceable to Mr. Jacobson's separate property, an inheritance that he received in 1996. As a result, the Court concluded that the rental property and income therefrom were Mr. Jacobson's separate property, not community property, and were properly excluded from Ms. Jacobson's bankruptcy estate property, and were properly excluded from Ms. Jacobson's bankruptcy estate.

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***Mattson v. Howe (In re Mattson)*, 468 B.R. 361 (9th Cir. BAP 2012)**

In *Mattson*, the Bankruptcy Appellate Panel of the Ninth Circuit, in affirming the bankruptcy court's denial of above-median-income chapter 13 debtors' request to modify the term of their confirmed plan under 11 U.S.C. § 1329 (a)(2) from 60 to 36 months, addressed the standard to be applied in evaluating such a requested modification.

Debtors, Robbyn and Renee Mattson, moved to modify their confirmed plan under 11 U.S.C. § 1329 due to their increased income (the Mattsons' income had increased from $4,267 per month to $5,936 per month). The Mattsons sought to increase their plan payments from $150 per month to $1,000 per month, but also sought to decrease the length of their plan from 60 to 36 months. The bankruptcy court granted the Mattsons' request to increase their payments, but denied the Mattsons' request to decrease the length of their plan based on its determination that in addition to the requirement that the Mattsons establish good faith for plan modification under §Section1329, the Mattsons also had to establish that there had been "a substantial change in the [Mattsons'] circumstances after confirmation which was unanticipated or otherwise could not be taken into account at the time of the confirmation hearing, and that the change in the plan correlate[d] to the change in circumstances." (internal quotations and emphasis omitted). The bankruptcy court rejected the requested modification because the Mattsons' request to shorten the term of their plan did not correlate to their change in circumstances—their increase in income. The bankruptcy court's adoption of the "substantial unanticipated change" requirement was out of its concern that the good faith analysis required under Section 1329 lacked predictability.

On review, the BAP affirmed the bankruptcy court's ruling that the Mattsons could not shorten the length of their plan under Section 1329, but in so doing, rejected the bankruptcy court's "substantial and unanticipated change" threshold requirement, and instead affirmed on the grounds that the Mattsons did not act in good faith in requesting the modification.

Section 1329(a) provides that after confirmation but before completion of payments under a plan, the plan may be modified upon request of the debtor to "(1) increase or reduce the amount of payments . . . (2) extend or reduce the time for such payments." Section 1329(b)(1) provides that "[s]ections 1322(a), 1322(b), and 1323 (c) of this title and the requirements of section 1325(a) of this title apply to any modification under subsection (a) of this section." The reference to Section 1325(a) means that among the other requirements set forth in Section 1325(a), the modification requested under Section 1329 must be sought in good faith as required by Section 1325(a)(3).

Despite the fact that other courts, including the Fourth Circuit, have adopted the "substantial and unanticipated change" test as a threshold requirement to a plan modification under Section 1329, the BAP, based on the plain language of Section 1329, and the fact that the Ninth Circuit has not adopted any such test, declined to do so. The Court stated that "contrary to the bankruptcy court's belief that the good faith test lacks predictability, we continue to accept that a good faith analysis under § 1325(a)(3), although not an exact science, adequately guides the exercise of the court's discretion for deciding plan modification issues."

Looking to the Mattsons' requested change, the Court noted that the Mattsons could not meet their burden of showing that their request to shorten the length of their plan was made in good faith. Neither of the Mattsons had lost a job, was retiring, or was otherwise leaving their employment. To the contrary, and in light of the Mattsons' increased income, allowing them to shorten the length of their plan would be inequitable and would be "inconsistent with the overall policies of chapter 13 and the enactment of BAPCPA, which has been read to tighten, not loosen, the ability of debtors to avoid paying what can reasonably be paid on account of debt." (Internal quotations omitted).

The BAP concluded noting that because Section 1329(b)(1) does not make Section 1325(b) applicable in determining whether a debtor is entitled to a modification under Section 1329(a), the debtor may in fact modify his plan to reduce the plan's term below the applicable "commitment period" required in the debtor's original plan under Section 1325(b). The BAP went on to state that "[i]n the end, the appropriateness of any particular modification is subject to the court's discretion, as limited by § 1329

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Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop), 465 B.R. 525 (9th Cir. BAP 2012)

In *Loop 76, LLC*, the Bankruptcy Appellate Panel of the Ninth Circuit affirmed the bankruptcy court's determination that the unsecured portion of an undersecured creditor's claim may be classed separately from other unsecured creditors' claims when the undersecured creditor has a third-party guarantor from whom it can seek recovery on its claim.

In 2005, Wells Fargo made a $23,125,000 construction loan to debtor, Loop 76, LLC, secured in debtor's real property, an office/retail complex. Wells Fargo's loan matured in 2008, however, due to tightened credit markets and the general downturn in the real estate market, debtor was unable to secure replacement financing and defaulted. Debtor filed a single asset real estate chapter 11 case on July 20, 2009. Shortly thereafter, Wells Fargo filed suit in state court against debtor's guarantors.

Debtor filed a plan of reorganization under which, for voting purposes, the stipulated value of the real property securing Wells Fargo's claim was $17,050,000. Because Wells Fargo was undersecured (Wells Fargo's allowed claim was roughly $23 million), Debtor's plan proposed to bifurcate Wells Fargo's claim into a secured portion (class 2) and an unsecured portion (class 8(B)), classed separately from debtor's other unsecured claimants. Wells Fargo moved to have its unsecured claim classed with all other unsecured claims and objected to confirmation of debtor's plan. The bankruptcy court denied Wells Fargo's objection on the grounds that Wells Fargo's unsecured claim had to be classed separately from the other unsecured claims under 11 U.S.C. § 1122(a) because "a claimant who has a third-party source of repayment for its claim is dissimilar from a claimant who lacks such alternative source of payment." The bankruptcy court subsequently confirmed debtor's plan.

On appeal, the BAP, in addressing the classification question, stated that classification of claims is governed by Section 1122(a), "which provides that a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." (Internal quotations omitted). The BAP noted that the threshold issue in applying Section 1122(a) is the determination of whether the claims are "substantially similar." If the claims are not substantially similar, but are instead dissimilar, the inquiry is at an end because Section 1122(a) mandates that they be classified separately. However, where the claims are substantially similar, "the plan may place such claims in different classes if the debtor can show a business or economic justification for doing so." The BAP noted that "a court must not approve a plan placing similar claims differently solely to gerrymander an affirmative vote on the reorganization plan."

Turning to the Ninth Circuit case of *Steelcase Inc. v. Johnston (In re Johnston)*, 21 F.3d 323, 327 (9th Cir. 1994), the BAP, in affirming the bankruptcy court, held that the bankruptcy court was properly allowed to consider the fact that Wells Fargo had a third-party source of repayment in determining that Wells Fargo's claim was not substantially similar to the other unsecured claims in debtor's bankruptcy case. In so holding, the BAP rejected Wells Fargo's argument that classification must be based solely on the nature of the creditor's claim as it relates to the assets of the debtor. Because it determined that the bankruptcy court did not commit error in determining that Wells Fargo's claim was dissimilar from the other unsecured claims, the BAP concluded that it did not need to address the question of whether debtor was attempting to gerrymander an affirmative vote on the plan, or whether debtor had a business or economic justification for the classification.

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In Re Samuel R. Davis and Neva L. Davis, Bankruptcy Case No. 11-40242-JDP (January 17, 2012)

In Re Davis is a case that addresses the homestead exemption and abandonment issues. In In Re Davis, at the time of the bankruptcy filing, the debtors owned and lived in a home in St. Anthony ("St. Anthony Property"). The debtors claimed a homestead exemption in a home that they jointly owned with others in Shoup, Idaho ("Shoup Property"). In a prior bankruptcy case filed in 2000, the Debtors lived in a home in Monteview ("Monteview Property").

The Chapter 7 trustee objected to the debtors exemption claim in the Shoup Property arguing that the debtors had not properly abandoned the homestead exemption in the St. Anthony Property and also claimed that the Shoup Property homestead declaration was technically deficient.

In analyzing the issue, the Court explained that under Idaho's homestead exemption statutes there are two methods for establishing the exemption. First, if an owner occupies property as a principal resident, the property is automatically considered his or her homestead and gains the protection of the homestead exemption pursuant to Idaho Code Section 55-1004(1). Alternatively, a debtor may establish and claim an exemption in property in which he or she is currently not residing by recording a declaration of homestead with the county recorder where the property is located pursuant to Idaho Code Section 55-1004(1), (2). If electing the second approach, and if the owner also owns and occupies a different property as a residence, the owner must also record a declaration of abandonment of homestead for the property in which he or she resides, pursuant to Idaho Code Section 55-1004(2).

The question in this case was what affect did the debtors' establishment of the St. Anthony Property as their principal residence have on the Shoup Property homestead exemption? In other words, did the debtors' relocation to St. Anthony establish an automatic exemption in that property that would trump the exemption by declaration, previously established for the Shoup Property.

The Court explained there are several ways in which an established homestead exemption may terminate. First, a property owner may file a declaration of abandonment of homestead with the county recorder, where a homestead is located. Second, a presumption of abandonment arises if a property owner vacates a homestead for a continuous period of at least six months, and does not record a declaration of nonabandonment. Third, where a debtor claims a homestead exemption in property in which he or she is residing, Idaho statutes limit the exemption to his principal residence. Thus, when an Idaho debtor establishes a new principal residence, the new residence becomes the debtor's homestead, protected by the exemption, and any prior residency-based exemption is extinguished.

Once a property owner has a properly established homestead exemption, he or she cannot claim a homestead exemption in any other property; as an owner may have only one homestead exemption, in only one property, at a time. Thus, if an owner with a valid exemption by declaration later wishes to take advantage of the automatic homestead in a newly established principal residence, he or she must first record a declaration of abandonment as to the homestead by declaration. Otherwise, the homestead by declaration continues in effect and the second exemption is not established.

Where an owner desires to declare an exemption in property in which he or she does not currently reside, the owner must file both a declaration of homestead, and, if he or she presently owns and occupies other property, a declaration of abandonment of homestead for the residence property. If an owner records a homestead declaration for unoccupied property, but does not record a declaration of abandonment in occupied property, the homestead by declaration is not valid.

Thus, in In Re Davis, when the debtors recorded their homestead declaration in 2000 in the Monteview Property, the recorded homestead exemption in the Shoup Property was not valid because they had not recorded a declaration of abandonment for the Monteview Property.

Further, the acknowledgment that is required for the homestead exemption was not sufficient in this case. The language required in the certificate is much more extensive that the jurat included in the debtors' recorded homestead declaration. Because the homestead declaration did not contain a sufficient acknowledgment, it did not satisfy the clear statutory requirements to establish a homestead via declaration.

Thus, the trustee's objection to the homestead exemption was upheld.

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Friedman v. P+P, LLC, BAP Nos. AZ-11-1105, AZ 11-1149 (Ninth Circuit BAP, 2012)

The issue in Friedman, is whether the absolute priority rule applies in an individual debtor Chapter 11 case. The Ninth Circuit BAP determined that the absolute priority rule set forth in Section 1129(b)(2)(B)(ii) does not apply to Chapter 11 debtors who are individuals. In making that determination, the Ninth Circuit BAP applied the "plain meaning" analysis of the language contained in § 1129 and § 1115, within the contextual statutory scheme and logic of plan confirmation requirements of Chapter 11.

The Court observed that there are no conflicting provisions within Chapter 11 relative to their view that the absolute priority rule does not apply in individual Chapter 11 cases. They found no anomalies, inconsistencies or conflicts created by that interpretation. Further, the Court found contextual concordance with the other requirements for plan confirmation, including but not limited to (1) the new requirement for dedication of all of debtor's disposable income for five years, (2) the straight forward best interest of creditors test, and (3) the delay of issuance of discharge until the plan has been fully consummated.

The Court explained that including the § 541 property within the universe of property contained in § 1115, does no violence to the logical impact of the reorganization process or scheme established in Chapter 11. The Court found it illogical to thereafter remove the debtor's means of production of debtor's disposal income by maintaining the absolute priority rule in an individual case, with the new additional requirement of five years of debtor's disposable income. The Court cited the numerous provisions under BAPCPA that were akin to the Chapter 13 plan provisions in support of their reasoning.

Judge Jury dissented arguing that the panel premised the simplistic outcome on its conviction that Congress intended to align individual Chapter 11s almost entirely with Chapter 13s because of some alterations in BAPCPA which made the two previously divergent proceedings more similar. Judge Jury disagreed with that analysis and found that the interpretation was contrary to the primary purpose of the BAPCPA amendments. Judge Jury argued that the long standing purpose behind Chapter 11, as stated by the Supreme Court, is to strike a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate. Judge Jury argued that the majority approach lost sight of the balance allowing the reorganized individual debtor to retain all his or her assets while disenfranchising the vote of unsecured creditors who seek more value.

Judge Jury explained that the statute's use of the word "included" and its cross-reference to § 1115 is what has caused the interpretive problems, namely what property is included in the Estate by § 1115 that an individual Chapter 11 debtor may retain. Other bankruptcy courts, in equally well reasoned decisions, narrowly interpreted § 1115 to supplement § 541 by adding only the debtors' post-petition earnings and other property acquired after the commencement of the case. Under the narrow view, the absolute priority rule still applies to individual Chapter 11 debtors with respect to their pre-petition property, but post-petition property is not subject to its strictures. As a result, Judge Jury believes that the word "included" in § 1129 (b)(2)(B)(ii) means that property "added to" the Estate under § 1115, and is not property which the debtor acquires post-petition.

Judge Jury explained that individual Chapter 11 debtors are not simply Chapter 13 debtors with larger debts. Rather Chapter 11 debtors, individuals or not, stay in possession of their property and enjoy all the rights and powers of the trustee. They are authorized to operate their business and can choose to extend their plan beyond five years. In exchange, the Chapter 11 process does not leave unsecured creditors by the wayside by affording individual Chapter 11 debtors the luxury to retain all pre- and post-petition property at their expense. not simply Chapter 13 debtors with larger debts. Rather Chapter 11 debtors, individuals or not, stay in possession of their property and enjoy all the rights and powers of the trustee. They are authorized to operate their business and can choose to extend their plan beyond five years. In exchange, the Chapter 11 process does not leave unsecured creditors by the wayside by affording individual Chapter 11 debtors the luxury to retain all pre- and post-petition property at their expense.

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Kekauoha-Alisa v. Ameriquest Mortgage Co. (In re Kekauoha-Alisa), No. 09-60019 (9th Cir. Mar. 26, 2012).

In *Kekauoha-Alisa*, the Ninth Circuit affirmed the bankruptcy court's order voiding the foreclosure sale of the debtor's property by the defendant.

The debtor filed for Chapter 13 bankruptcy three days before a scheduled foreclosure sale of her property by the defendant. A law firm employed by the defendant successfully postponed the sale three times by "public announcement," as it was permitted to do under Hawaii law. On September 23, 2005, the date of the rescheduled sale, the law firm sent a legal secretary—who had never before postponed a foreclosure sale—to the specified location of the sale at the appointed hour to postpone the sale. She spoke personally to several people in the area to find out if they were there for the sale of the debtor's property; none were. She even waited until another auction taking place in the area ended and the area was vacant before she left the area. However, she never shouted out the postponement of the sale, nor did she post any information about the postponed sale. The defendant eventually bought the property via credit bid after obtaining relief from the stay, but the debtor sued to void the sale, arguing that the defendant had violated various Hawaii laws by failing to properly postpone the sale via "public announcement."

The bankruptcy court agreed with the debtor that the secretary's actions failed to meet the definition of "public announcement" under Hawaii law and breached the contract between the parties. Therefore, the bankruptcy court voided the foreclosure sale.

The Ninth Circuit agreed with the bankruptcy court. The appeals court found that the phrase "public announcement" unambiguously required "mortgagees [to] publicly announce the postponement of a foreclosure sale to a subsequent date." The secretary had failed to announce to anyone that the sale had been postponed. Therefore, the law firm failed to properly postpone the sale.

Under Hawaii law, the proper remedy for such a failure is to void the foreclosure sale. The 9th Circuit predicted that Hawaii courts would void the foreclosure sale even if there was no showing of prejudice, even though that conclusion placed Hawaii squarely in the minority. The court also affirmed the bankruptcy court's conclusion that the improper postponement violated the contract between the debtor and creditor (which required the creditor's compliance with applicable statutes as a condition precedent to foreclosing on the property) and was a deceptive trade practice under Hawaii law.

The 9th Circuit remanded, however, on the question of monetary damages due to the creditor's deceptive trade practice. The bankruptcy court had awarded damages based wholly on the foreclosure sale; the proper measure of damages was the difference between the Debtor's "situation had [the creditor] properly postponed the foreclosure sale and Debtor's actual situation, given that the sale was improperly postponed."

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***Stanbrough v. Valle (In re Valle),* Adv. No. 11-06051-TLM**

In Stanbrough v. Valle, a creditor filed a proof of claim in the debtors' chapter 7 bankruptcy, notwithstanding that the Notice of Chapter 7 Bankruptcy instructed creditors not to file proofs of claim because there did not appear to be any assets for the trustee to distribute. The creditors also filed a nondischargeability action against the debtors based on fraud and violations of federal RICO and Idaho Racketeering Act. The creditors alleged that their action was a core proceeding, except for the racketeering claims - claims they alleged the court could hear under its "related to" jurisdiction of 28 U.S.C. s.157(c). The creditors also demanded a jury trial on the racketeering claims.

In their Answer, the debtors included a motion to strike the jury trial demand because the creditors had allegedly waived the right to a jury on the racketeering claims by filing a proof of claim. The debtors subsequently attempted to withdraw their proof of claim, to which action the debtors objected. The creditors acknowledged that the withdraw of their proof of claim was an attempt to preserve their right to have a jury hear the racketeering claims.

Although the parties focused their attention of whether the creditors could withdraw their claim as a matter of right under Rule 3006 and whether their right to a jury trial would be preserved by that action, the court did not reach that question. Instead, the court held that "a creditor has no right to a jury trial in a non-dischargeability proceeding, even on determinations as to liability and damages on its underlying claims."

The court reviewed the two-part test from Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 41 (1989) for determining whether the Seventh Amendment right to a jury attached to a particular cause of action. First, the court compares thestatutory cause of action at issue with similar causes of action in 18th century English courts.

Second, the court determines whether the cause of action at issue is legal or equitable in nature. If those two factors indicate the party is entitled to a jury, the court then examines whether Congress has assigned the adjudication of that action to a non-Article III tribunal.

The latter question is hinges on whether the action asserts a public or private right: only a legal claim that asserts a private right is entitled to a jury. A public right is one that is "so closely integrated into a public regulatory scheme as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary."

Turning to the question of whether a bankruptcy court has the authority to hear both the question of non-dischargeability as well as the question of underlying liability and damages, the court turned to 9th Circuit precedent holding that the determination of non-dischargeability is equitable. See Hashemi, 104 F.3d 1122. The 9th Circuit had also held that the bankruptcy court had jurisdiction to liquidate the underlying state law claim by rendering a money judgment - "it is impossible to separate the determination of dischargeability function from the function of fixing the amount of the non-dischargeable debt." Cowen v. Kennedy (In re Kennedy), 108 F.3d 1015 (9th Cir. 1997). The 9th Circuit BAP had also held that the questions of liability and damages were "a mere adjunct to the determination of discharge issue" and it is "integral to the restructuring of the debtor-creditor relationship." Locke v. United States Trustee (In re Locke), 205 B.R. 592 (9th Cir. BAP 1996).

Based on the foregoing reasoning of the 9th Circuit and BAP, the court in Valle held that although the underlying state and federal RICO claims were legal in nature, the resolution of those claims as part of the non-dischargeability adversary action was so closely integrated with the subject of bankruptcy that the bankruptcy court could resolve those claims without the aid of a jury. This is so because the question of dischargeability is an integrated two-step process in which first, the court establishes the debt itself, and second, determines whether that debt is dischargeable. The bankruptcy court will necessarily encounter debts that have not previously been liquidated: in that situation, the resolution of that claim "becomes part and parcel of the dischargeability determination and thus integral to restructuring the debtor-creditor relationship. As a result, no Seventh Amendment right to a jury trial attends such an adjudication."

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Aguirre, Bankr. Case No. 11-41126-JDP (February 27, 2012 Bankr. Idaho), Pappas

Quick summary:

Court found debt arising out of divorce decree was not a Domestic Support Obligation because it was not "in the nature of alimony, maintenance, or support" under the totality of the circumstances, but rather was a property equalization payment; thus the debt was not entitled to priority in Chapter 13 plan.

Facts/Analysis:

Joseph Aguirre and Emily Vaden divorced in September of 2008. They drafted their own divorce decree. They had no children, few assets, and both were employed. One of their few assets was a 401K account for Aguirre and the divorce decree provided that Aguirre would pay $6,000 to Vaden for her community share of that account. Aguirre could pay the $6,000 in full at any time but he was required to at least make monthly payments of $200, with no accruing interest.

Vaden and her new spouse filed Chapter 7 bankruptcy. The Chapter 7 trustee ("7 trustee") learned of the debt owed to the estate by Vaden. Vaden then filed his own Chapter 13 bankruptcy. It is not clear how much was owing on the debt. Aguirre's initial Chapter 13 plan indicated that the debt to Vaden would be paid outside of the plan, with plan contributions to increase once the "401k loan" was paid in full. The 7 trustee objected to the plan and Aguirre filed a second plan that listed the debt as a DSO, with priority to payment under the plan. The chapter 13 trustee objected, asserting that the debt was not a DSO and was therefore an unsecured debt rather than a priority debt.

The Court concluded that the debt was not a DSO as that term is defined in 11 USC § 101(14A)(B) because it was not in the "nature of alimony, maintenance, or support" under a totality of the circumstances analysis. The Court noted several relevant factors: the decree did not designate the debt as either support or a property settlement; Vaden was employed and had few debts and thus was not necessarily in need of support; the debt could be paid in a lump sum and it was not structured to terminate upon Vaden's remarriage; and Aguirre believed he owed Vaden half of his 401(k) account and this debt was merely his "mechanism to fulfill that perceived obligation." In footnotes, the Court noted that the 7 trustee's arguments for dismissal of the first case and chapter 13 plan were likely unfounded based on the plain language of Section 1307(c)(11) and the Court questioned whether the 7 trustee (rather than the actual ex-spouse) could assert a priority DSO under the plain language Section 507(a)(1)(A), an issue upon which bankruptcy courts are split.

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Hall v. United States, 132 S. Ct. 1882 (2012)

Quick summary

A capital gains tax debt on the proceeds from family farm sold during Chapter 12 proceedings must be treated as a priority debt in any reorganization plan and cannot be treated as unsecured debt, despite the language of section 1222(a)(2)(A). The *Hall* decision is of interest to anyone who is managing bankruptcy taxation issues.

Facts/Analysis

In August 2005, Lynwood and Brenda Hall (the "debtors") commenced a bankruptcy case under Chapter 12, which governs reorganizations of family farms. The debtors sold the family farm they operated shortly afterward, and the Internal Revenue Service asserted a capital gains tax of approximately $30,000. The debtors proposed a reorganization plan pursuant to section 1222 that provided that the income tax liability from the sale of the farm would be paid pro rata with other general unsecured claims and any outstanding balance would be discharged. The debtors relied on section 1222(a)(2)(A), which provides that a Chapter 12 plan shall:

(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless— (A) the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge.

The debtors contended that the sale occurred post-petition for the benefit of creditors of the estate, and thus the tax was incurred by the estate within the meaning of 11 U.S.C. Section 503(b)and was stripped of priority status and downgraded to a general unsecured claim by 11 U.S.C. Section 1222(a). The debtors pointed to the legislative history behind the recent amendments to Section 1222, legislative history that seemed to indicate that priority-stripping provision of section 1222(a)(2)(A) was specifically intended to address this very fact scenario. The IRS objected to the debtors' plan, arguing that the plain language of the bankruptcy code and the Internal Revenue Code (IRC) trumped any arguments about legislative history. The IRS argued that the debtors' post-petition farm sale was not incurred by the estate under Section 503(b) and thus was neither collectible nor dischargeable in the debtors' Chapter 12 plan.

The Bankruptcy Court sustained the IRS objection, the District Court reversed, and the Ninth Circuit reversed the District Court. The Ninth Circuit held that because a Chapter 12 estate is not a separate taxable entity under the IRC, 26 U.S.C. Sections 1398, 1399, it does not "incur" post-petition federal income taxes, and because the tax was not "incurred by the estate" under Section 503(b), it was not a priority claim eligible for the Section 1222(a)(2)(A) exception. The Ninth Circuit's ruling split with the Eighth Circuit and Tenth Circuits, which have held that a federal capital gains income tax liability arising from post-petition sales of farm assets is dischargeable as non-priority unsecured debt under section 1222(a)(2)(A).

The Supreme Court, in an opinion written by Justice Sonia Sotomayor, affirmed the Ninth Circuit. The court's decision rested on three grounds. First, the court held that the phrase "incurred by the estate" in section 503(b) of the Bankruptcy Code had a "plain and natural reading" as a tax for which the estate itself is liable. Under IRC Sections 1398 and 1399, a Chapter 12 estate is not a separately taxable entity. The debtor--not the trustee--is generally liable for taxes and files the only tax return. The post-petition income taxes are thus not "incurred by the estate." Second, the court turned to provisions of Chapter 13, and noted that post-petition income taxes are not automatically collectible in a Chapter 13 plan and are not administrative expenses under Section 503(b). To hold otherwise in Chapter 12 would disrupt settled practices in Chapter 13 cases. Third, the court declined to consider legislative history purportedly reflecting Congress's intent in enacting section 1222(a)(2)(A). The court sought to avoid "allowing ambiguous legislative history to muddy clear statutory language." The court expressed concern, given the unambiguous statutory text, about "rewrit[ing]" the statute, "particularly in this complex terrain of interconnected provisions and exceptions enacted over nearly three decades." The court concluded that the postpetition federal income tax asserted by the IRS in the debtors' case was not collectible or dischargeable in the debtors' Chapter 12 plan.

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