A REVIEW OF 1997 SEVENTH CIRCUIT BANKRUPTCY DECISIONS

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INTRODUCTION

The Seventh Circuit Court of Appeals rendered a number of interesting and important decisions in 1997, addressing a variety of bankruptcy issues. While some questions were left unresolved, the court did make some significant, if not always well-founded, decisions.

I. COURT RESOLVES FIFTY-DOLLAR DISPUTE

In re Heath[1] involved an unusual factual scenario: a bankruptcy trustee pursued an adversary proceeding through three courts in an attempt to recover $50.00 for the debtor.[2] The court questioned the trustee's motivation, but it also noted that the Bankruptcy Code requires no minimum amount in controversy and that this case involved important legal questions.[3] Heath filed for bankruptcy under Chapter 13, and the bankruptcy court confirmed a plan by which Heath would pay her creditors their allowed claims over five years at the rate of $32.00 per week. The judge's order confirming the plan stated that Heath's income and other assets would "'remain estate property to the extent necessary to fulfill the plan.'"[4]

When the debtor changed jobs a year later, a new garnishment order was issued. Heath's new employer, the U.S. Postal Service, charged her a one-time $50.00 garnishment fee. The fee did not directly affect payments to creditors, but it did reduce the debtor's income. The trustee sued for the return of the $50.00, which the trustee would have returned directly to the debtor, not to the estate, if he had prevailed. The bankruptcy court ruled in the trustee's favor, but the district court reversed, concluding that the trustee had no standing to bring the claim.[5]

The Seventh Circuit Court of Appeals affirmed the district court's decision, noting that the bankruptcy trustee holds, with some exceptions, the right to sue on behalf of the debtor's estate.[6] While it is theoretically possible that a plan for repayment of creditors could retain in the debtor's estate all of the debtor's

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1. 115 F.3d 521 (7th Cir. 1997).
2. *Id*. at 522.
3. *Id.*
4. *Id.* at 522-23.
5. *Id.* at 523.
6. *Id.*

income during the pendency of the plan,[7] the burden on the bankruptcy court would be immense, and in any event, that was not the case with this debtor. The plan in Heath's case placed only so much of her income and other property in the estate as was necessary to fulfill the plan, and there was "no effort to establish that Heath's financial situation was so fragile that the loss of $50 will jeopardize fulfillment of the plan . . . ."[8]

The court added that although the Bankruptcy Code states that all of a Chapter 13 debtor's earnings are estate property,[9] it also states that "confirmation of a plan vests all of the property of the estate in the debtor."[10] The court concluded that, read together, the two code sections indicate "that while the filing of the petition for bankruptcy places all the property of the debtor in the control of the bankruptcy court, the plan upon confirmation returns so much of that property to the debtor's control as is not necessary to the fulfillment of the plan."[11] The court's reasoning here is sound. The $50.00 garnishment fee was not estate property. Furthermore, no other basis of core jurisdiction existed, and no evidence was presented to suggest that the action was "related" to the bankruptcy proceeding under 28 U.S.C. § 1334(b). The district court's decision was correctly affirmed.

II. CHAPTER 13: VALUING SECURED CLAIMS

In re Hoskins[12] involved a 1990 Ford Tempo owned by the Chapter 13 debtor and upon which NBD Bank held a lien. In the proposed plan, the bankruptcy trustee valued the bank's secured claim at $3,987.50, half way between the stipulated retail and wholesale values of the car. The bankruptcy court approved the plan, the district court affirmed, and the bank appealed, arguing that the retail value was the correct measurement.

The Seventh Circuit Court of Appeals had not previously established a standard for valuing secured claims in Chapter 13 bankruptcies. Other courts of appeals are split on the issue, with one (the Fifth Circuit) using the wholesale value and most others using the retail value.[13] Judge Posner concluded that a third alternative provided the most appropriate standard: the midpoint of the two values.

Under section 506(a) of the Bankruptcy Code, the value of the secured creditor's claim is defined in terms of the estate's interest in the property and "in light of the purpose of the valuation and of the proposed disposition or use of

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7. "One can imagine a person so incompetent (in the practical, not legal, sense) in the management of his or her money that the only way in which the creditors would be paid would be if someone controlled all the debtor's expenditures." *Id.* at 524.

8. *Id.*

9. 11 U.S.C. § 1306(a)(2) (1994).

10. *Id.* § 1327(b).

11. *Heath*, 115 F.3d at 524.

12. 102 F.3d 311 (7th Cir. 1996).

13. *Id.* at 313.

such property . . . ."[14] The majority opinion emphasized the word "use" in this definition, commenting on the Ninth Circuit Court of Appeals' interpretation of that word[15] and noting: "The significance of the statute's reference to different possible uses of retained collateral is that it invites judicial attention to an economic problem [of bilateral monopoly] that may well be acute in cases in which the collateral is essential to the debtor's livelihood."[16]

Bilateral monopoly, a situation where two parties have only each other with whom to bargain over something, (i.e., they cannot rely on competition to influence the price),[17] can be illustrated by a straightforward two-person lawsuit for damages or by the interaction between a secured creditor and a defaulting debtor (absent Chapter 13). As Judge Posner logically explained, if there were no bankruptcy proceeding, the bank could have seized the car upon Hoskins' default. In theory, the bank would have then sold the car for the wholesale value (banks are not car retailers), and Hoskins would have had to purchase a comparable car at a higher retail price.[18] If the two parties were negotiating, both would be better off at any value between the two extremes (wholesale and retail): the debtor would be permitted to keep the car for an obligation that was less than the retail purchase price of a different comparable vehicle, and the creditor would receive value at some level above the wholesale price it could have received had it seized and sold the car.[19] The midpoint is a logical and natural gravitation point, as Judge Posner noted.[20]

Application of this theory makes sense and leads to a just result. As the example in Judge Easterbrook's concurring opinion (concurring "only because the Trustee, representing the interests of the unsecured creditors, has not taken cross-appeal")[21] illustrates,[22] the secured creditor would receive a windfall if retail value were the measure, and the unsecured creditors would receive a windfall if wholesale value were the standard.[23] This new approach comes closer to preserving the positions the creditors held before the bankruptcy.[24] In any event, Seventh Circuit practitioners now have a clear standard for valuing secured claims involving automobiles and similar income-producing assets in Chapter 13 cases.[25]

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14. 11 U.S.C. § 506(a) (1994).

15. The word "use" suggests retail value in the situation where the debtor will use the property. Wholesale value is the value realized when the property is not used, but instead is sold. *Hoskins*, 102 F.3d at 315 (citing *In re* Taffi, 96 F.3d 1190, 1192 (9th Cir. 1996)).

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* at 316.

20. *Id.*

21. *Id.* at 317.

22. *Id.* at 319.

23. *Id.* at 317.

24. *See* Butner v. United States, 440 U.S. 48, 55-56 (1979).

25. *Hoskins*, 102 F.3d at 316.

III. ATTORNEY FEES "PURSUANT TO CONTRACT"

As a general rule in the United States, a prevailing party in federal litigation collects a reasonable attorney's fee from the non-prevailing party only when authorized by federal statute or pursuant to an enforceable contract between the parties.[26] This rule applies to bankruptcy litigation, as well.[27] In *In re Sheridan*,[28] a creditor bank argued that Sheridan's debt to the bank should not be discharged. The bankruptcy court disagreed, and the district court affirmed that decision. Sheridan subsequently sought to recover over $266,000 in attorney's fees and other costs incurred in defending the bank's discharge action. The bankruptcy court denied the debtor's request, and again the district court affirmed.

Because no statutory authority provided for the award of attorney's fees in this case, Sheridan relied on the contracts underlying his debt to the bank to support his position. Those contracts entitled the bank to recover reasonable attorney's fees and costs, and under Florida law, which governed the contracts, Sheridan arguably was entitled to a reciprocal benefit.[29] The court concluded that no basis existed for incorporating the Florida reciprocity statute, and it affirmed the district and bankruptcy courts' decisions not to award attorney's fees to Sheridan.[30]

Analyzing the meaning of a Florida contract statute is beyond the scope of this article,[31] but it should be noted that the Seventh Circuit's reasoning in affirming the district court's decision was less than convincing. The court stated that if a creditor is contractually entitled to attorney's fees and if the contract is enforceable under applicable state law, the court may enforce the contractual provision in a dischargeability action.[32] Thus, if the bank had shown "that the underlying debt was non-dischargeable, it would have been entitled to recover its attorney's fees *pursuant to the contracts*."[33]

The court placed great weight on the fact that in *In re Mayer* the attorney's fees provided for in the contract became part of the debt.[34] As the dissent pointed

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26. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975).

27. *In re* Reid, 854 F.2d 156, 161-62 (7th Cir. 1988).

28. 105 F.3d 1164 (7th Cir. 1997).

29. "If a contract contains a provision allowing attorney's fees to a party when he or she is required to take any action to enforce the contract, the court may also allow reasonable attorney's fees to the other party when that party prevails in any action . . . with respect to the contract." *Id*. at 1166 (quoting FLA. STAT. ch. 57.105(2)).

30. *Id*. at 1167.

31. *See id.* at 1167 n.1 (discussing the difficulty Florida bankruptcy courts have had in interpreting this statute in similar situations).

32. *Id.* at 1166 (citing *In re* Mayer, 51 F.3d 670, 677 (7th Cir.), *cert. denied*, 516 U.S. 1008 (1995)).

33. *Id.* (emphasis added).

34. *Id.* at 1166-67.

out, the situation where the debtor is collecting the fees is not nearly so neat.[35] However, this fact alone does not suffice to support the majority's conclusion that "this federal action does not qualify as one 'with respect to the contract' under the Florida statute."[36] It is illogical to assert several paragraphs earlier that the bank could recover the fees "pursuant to the contracts" and later baldly to conclude that this action is not one "with respect to the contract." The contracts either applied, or they did not.

Whether the result would be correct under the Florida statute is not clear. But this is not a well-reasoned opinion, and it does little to assist Seventh Circuit practitioners with the more general question regarding the applicability of a contractual provision for the payment of attorney's fees in a dischargeability action.

IV. RESERVING A CAUSE OF ACTION IN A REORGANIZATION PLAN

The holder of a secured note raised the debtor's interest rate and subsequently accelerated the loan, resulting in the debtor's filing of a bad faith breach of contract action and its subsequent filing for Chapter 11 bankruptcy protection. The contract action was removed to the bankruptcy court, and after a hearing, the court denied the debtor's requested relief. Later, the bankruptcy court approved a plan that included the following provision: "From and after the Effective Date [of the plan], the Disbursing Agent, on behalf of the Debtor and the Estate, shall enforce all causes of action existing in favor of the Debtor and the Debtor in Possession."[37]

The bankruptcy court then granted the debtor's (D & K's) motion, whereby the disbursing agent abandoned the breach of contract cause of action.[38] D & K re-asserted the contract claim in state court, and it was removed to federal district court based on diversity. The district court dismissed the complaint on *res judicata* grounds, and D & K appealed.

The court of appeals noted that "the disbursing agent had no claim for breach of contract that was not barred by *res judicata*," so D & K could receive no such claim under the abandonment order.[39] Moreover, another basis for a *res judicata* bar arose when D & K failed to object to the claim of Mutual Life Insurance Company of New York (the creditor) in the bankruptcy proceeding.[40] Despite these independent bases for affirming the district court's decision, the Seventh

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35. *Id*. at 1169.

36. *Id*. at 1167.

37. D & K Properties Crystal Lake v. Mutual Life Ins. Co., 112 F.3d 257, 259 (7th Cir. 1997).

38. "'[T]o the extent the Breach of Contract Action may be deemed a cause of action within the purview of Section 7.1 of the Plan, . . . [the disbursing agent] prays for the entry of an order authorizing it to abandon same.'" *Id*.

39. *Id*. at 262.

40. *Id.* at 262 n.4.

Circuit explored in some detail the issue of reserving a cause of action.[41]

The court concluded that D & K's "reservation" was not sufficient to take the claim outside the *res judicata* bar. "To avoid *res judicata* the reservation of a cause of action must be both express, as in writing, and express, as in specifically identified."[42] Although the opinion was muddied somewhat by a paragraph or two of vague and confusing language, the standard provided by the court is clear: the reservation of a cause of action not only must be in writing but also must identify the claim sought to be reserved.[43] If these criteria are met, the parties may then negotiate over the language, and they are "thereafter on notice about which claims [are] reserved and which claims [are] not."[44]

V. The New Value Corollary to the Absolute Priority Rule

In order for a reorganization plan to be confirmed, the plan must satisfy the requirements of 11 U.S.C. § 1129. These requirements include, with respect to each class of claims or interests, that each such class accept the plan or that the class not be impaired under the plan.[45] If all the requirements of subsection (a) are met except paragraph (8), "the court . . . shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable . . . ."[46] It is within this context that the absolute priority rule comes into play.[47]

"The general rule for a reorganization plan that has not been approved unanimously by the impaired classes is that it must meet the strictures of the absolute priority rule to be approved."[48] Before the Bankruptcy Code was passed, there existed a corollary to the absolute priority rule, called the "new value" corollary.[49] The corollary provided that if a junior interest holder contributed substantial new capital (in the form of money or money's worth) to the enterprise, that was necessary for the reorganization to succeed and that was reasonably equivalent to the value retained, the junior interest holder could retain

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41. In analyzing this issue, the court relied extensively on an unpublished opinion from the Sixth Circuit, *Micro-Time Management Sys., Inc. v. Allard & Fish, P.C.*, 983 F.2d 1067 (Table) (6th Cir.), *cert. denied*, 510 U.S. 906 (1993). The court noted, tongue in cheek, that the Sixth Circuit places "no limitation on citation to unpublished opinions by courts." *D & K Properties*, 112 F.3d at 260 n. 2.

42. *D & K Properties*, 112 F.3d at 261.

43. *Id.*

44. *Id.*

45. 11 U.S.C. § 1129(a)(8) (1994).

46. *Id.* § 1129(b)(1).

47. The absolute priority rule is codified at 11 U.S.C § 1129(b)(2)(B)(ii) (1994). A class of unsecured creditors that does not approve of the plan "must be provided for in full before any junior classes can receive or retain any property under the plan." Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 197 (1988).

48. *In re* 203 N. LaSalle Street Partnership, 126 F.3d 955, 962-63 (7th Cir. 1997).

49. *Id.*

his or her equity interest over the impaired senior creditor class' objection.[50]

When Congress codified the absolute priority rule, it did not codify the new value corollary. The issue the Seventh Circuit resolved, affirmatively, in *In re 203 N. LaSalle Street Partnership* was whether the new value corollary (also called the new value exception) survived the passage of the Bankruptcy Code.[51]

In *LaSalle Street* the debtor owed Bank of America more than $93 million, which was secured by a mortgage on a piece of property. When LaSalle filed for bankruptcy under Chapter 11, the value of the property was approximately $54.5 million, leaving the bank with a deficiency of approximately $38.5 million. The reorganization plan provided that LaSalle's partners would contribute new capital, which the bankruptcy court concluded had a present value exceeding $4 million. Both the bankruptcy court and the district court concluded that the corollary did survive the passage of the Code and that LaSalle's plan did not violate the absolute priority rule because it met the requirements of the corollary.

The court of appeals first decided that the absolute priority rule was ambiguous and thus that the court would have to look beyond the language of the statute itself.[52] The court gave great weight to the Supreme Court's statement suggesting its reluctance judicially to effect significant changes to a pre-Code practice that was not at least the subject of discussion in the legislative history of the statute.[53] Accordingly, the court of appeals concluded that the "on account of" language in the absolute priority rule permitted "the continued existence of the new value corollary."[54]

This conclusion, however, was met with a reasonably sound dissent. Judge Kanne placed his argument on a "plain language" hook.[55] The plain language of the absolute priority rule does not include a new value exception, and thus none exists. The argument continued: "One cannot contest the fact that the partners' new capital contributions are one reason why they are able to maintain their ownership of the indebted property. LaSalle's partners, however, receive this *exclusive* ownership right *only* 'on account of' their unique status as prior equity holders."[56] If the former owners earned their new interests at an open auction, it would not be "on account of" their prior interests but because of their capital contributions.[57] The majority opinion, in essence, inserts the words "solely" or "primarily" before the words "on account of."

However, as the dissent moved to a discussion of pre-Code practices, it lost

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50. *In re* Woodbrook Assocs., 19 F.3d 312, 319-20 (7th Cir. 1994).

51. The Seventh Circuit considered this issue on other occasions without resolving it. *LaSalle Street*, 126 F.3d at 963 n.7.

52. *Id.* at 964-65; *see also id.* at 964 n.8.

53. *Id.* at 965 (citing Dewsnup v. Timm, 502 U.S. 410, 419 (1992)).

54. *Id.*

55. "Because the straightforward text of the statutory absolute priority rule prohibits such a Plan where there are dissenting, unsecured creditors, I see no need to look beyond the words of the statute." *Id.* at 973 (Kanne, J., dissenting).

56. *Id.* at 971 (Kanne, J., dissenting).

57. *Id.* at 972 (Kanne, J., dissenting).

some of its vigor and did not hold up well against the majority position. In any event, practitioners now have a clear answer to the new value corollary question. At least until the issue reaches the Supreme Court, the new value corollary survives in the Seventh Circuit.

VI. COMMENTS: OTHER INTERESTING DECISIONS

A. In re USA Diversified Products, Inc.[58]

Paul Davis retained a Florida law firm to represent him, his wife, and his company in a fraud action. A few months later Davis wired $125,000 from the company's money-market account to the law firm to fund a settlement that was being negotiated. The following day the company filed for bankruptcy under Chapter 11. Four days later Davis informed the law firm about the bankruptcy filing, but he said that the money came from his personal funds. Approximately two months passed, and Davis instructed the law firm to return the money to him, which the firm did after deducting $14,000 in fees.

The Chapter 11 proceeding was subsequently converted into a Chapter 7 bankruptcy, and the trustee brought this action pursuant to 11 U.S.C. § 542(a) to recover the $125,000 from the law firm.[59] Both the bankruptcy and district courts ruled in the trustee's favor. The court of appeals affirmed.

The court stated that it was unable to find a case to support its position but that Congress could not have intended a literal reading of 11 U.S.C. § 542(c) because of the potentially absurd results.[60] Instead, the court held that "the relevant knowledge or notice is knowledge or notice to a possessor of property that a bankruptcy proceeding had begun *and* that the property in the possessor's custody was property of a debtor in that bankruptcy proceeding."[61] The law firm here knew that Diversified was in bankruptcy and knew enough to inquire further as to whom the $125,000 belonged.

B. In re Milwaukee Cheese Wisconsin, Inc.[62]

Milwaukee Cheese set up a "thrift savings plan" for its employees, their friends, and their relatives. When the company found itself in financial trouble, much of the money was withdrawn, and within 90 days the firm faced involuntary bankruptcy. The trustee sought to recover the "withdrawals" as

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58. 100 F.3d 53 (7th Cir. 1996).

59. A person possessing or controlling property that belongs to the debtor's estate "shall deliver to the trustee, and account for, such property or the value of such property . . . ." 11 U.S.C. § 542(a) (1994). The bankruptcy code further provides, however, that "an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate . . . as if the case under this title concerning the debtor had not been commenced." *Id.* § 542(c).

60. *See USA Diversified*, 100 F.3d at 56-57.

61. *Id.* at 57 (emphasis added).

62. 112 F.3d 845 (7th Cir. 1997).

preferential transfers, and after ten years of delays, the district agreed, finding that the transfers were preferences avoidable under 11 U.S.C. § 547(b). Despite the fact that some individuals would be especially hard hit by the requirement to return funds (one family would owe nearly $130,000 plus ten years' interest), the court of appeals affirmed. Other innocent creditors also have claims that should not be diminished simply because a judge sympathizes with "a group of unfortunates. Judges are not entitled, in or out of bankruptcy, to favor the litigants they think most worthy, as opposed to those who have the best legal position."[63]

C. In re Lopez[64]

The Seventh Circuit reiterated its position regarding the situation where, following an appeal to the district court, the action is remanded for further proceedings in the bankruptcy court. Even if the bankruptcy court's decision was final, the district court's decision is not final and therefore is not appealable "unless the further proceedings contemplated are . . . purely ministerial . . . ."[65] The appellate courts are split on the issue, but this circuit's position is clear.[66]

D. Koopmans v. Farm Credit Services of Mid-America, ACA[67]

Here, the creditor was oversecured and under 11 U.S.C. § 506(b) was entitled to interest in the bankruptcy. The court had to decide what rate of interest would provide the "indubitable equivalence" of Farm Credit Services' property interest.[68] The bankruptcy court used a "prime-plus" method of approximating the market rate of interest, and the district court affirmed. The court of appeals agreed that this rate was appropriate. Though there is more than one method by which the market rate may be approximated, "the creditor is entitled to the rate of interest it could have obtained had it foreclosed and reinvested the proceeds in loans of equivalent duration and risk."[69]

E. In re Volpert[70]

Finally, the court was presented with an opportunity to resolve the issue of whether a bankruptcy court has the power to sanction under 28 U.S.C. § 1927.[71] In *Volpert* the bankruptcy court explicitly relied on this statute in fining an

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63. *Id*. at 848.

64. 116 F.3d 1191 (7th Cir. 1997).

65. *Id*. at 1192.

66. For those interested in this subject, the court includes a survey of other appellate court opinions on this topic. *Id.*

67. 102 F.3d 874 (7th Cir. 1996).

68. *Id*. at 874 (citing *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935)).

69. *Id*. at 875.

70. 110 F.3d 494 (7th Cir. 1997).

71. 28 U.S.C. § 1927 (1994).

attorney $1,000 for conduct that "unreasonably and vexatiously multiplied the bankruptcy court's proceedings."[72] The district court affirmed. After extensive discussion of the relevant issues, the court of appeals chose to leave the issue unresolved: "Given that we have determined . . . that the bankruptcy court in this case had ample authority, apart from § 1927, to sanction Mr. Ellis' behavior, we shall travel the more prudent course and leave unanswered whether bankruptcy judges can exercise the authority of a 'court of the United States.'"[73] Perhaps the next volume of the *Indiana Law Review* will include in its survey a decision resolving this question.

72. *In re Volpert*, 110 F.3d at 496.

73. *Id*. at 500.