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Bankruptcy in the Seventh Circuit: 1995

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INTRODUCTION

This Article discusses some bankruptcy and bankruptcy-related cases decided by the Seventh Circuit during the year ending October 31, 1995. As in past years, it reviews only opinions of more than routine interest.

I. POWERS OF AVOIDANCE

There were three very interesting avoiding-power decisions during the period of time covered by this Article.

Freedom Group, Inc. v. Lapham-Hickey Steel Corp. (In re Freedom Group, Inc.) involved a challenge to the creditor’s prebankruptcy garnishment of funds in the debtor’s bank account. The creditor in this case obtained a judgment against the debtor in an Indiana state court. Shortly thereafter, the court issued a “notice of garnishment.” The creditor served this “notice of garnishment” on the debtor’s bank ninety-one days before the debtor filed for bankruptcy protection. At that time, the debtor’s account contained $108.25. The next day, i.e., the ninetieth day before bankruptcy, the debtor deposited $18,000 in the account. On the following day, the state court entered a final order directing the bank to pay the creditor in accordance with its order, and the bank complied.

After receiving bankruptcy protection, the bankruptcy estate sought to avoid the garnishment under 11 U.S.C. § 547, arguing that the garnishment was a preferential transfer because the actual transfer of the funds occurred within ninety days of the debtor’s filing for bankruptcy protection. The creditor claimed that the transfer occurred when it served the notice of garnishment because, in its view, it had acquired a property interest at that time. According to the creditor, this constituted a transfer that occurred “before the ninety-day portcullis descended.”

This argument was not well received: “It is a nice, tidy, ‘logical’ argument but so manifestly contrary to the purpose of the statute as to incite grave doubts, at least in judges who are not in thrall to the syllogistic style of legal reasoning.”

The court’s opinion did not explore whether the result in In re Freedom Group, Inc. can be reconciled with another Seventh Circuit decision, In re Coppie, which held that wages earned within ninety days of bankruptcy cannot be recovered by the trustee when they are paid to a creditor pursuant to a...
garnishment obtained outside the ninety-day period.\(^6\) Both *In re Freedom Group, Inc.* and *In re Coppie* involve voluntary debtor activity, earning wages or making bank deposits, resulting in a transfer of value to a creditor pursuant to a judicial writ within ninety days of bankruptcy. Only *In re Freedom Group, Inc.* adopts the better\(^7\) view that the value transferred in that ninety day period can be recovered for the bankruptcy estate, notwithstanding the age of the writ. As Judge Posner observed,

Freedom Group did not have to deposit $18,000—or 1¢—in its bank account after the notice of garnishment was issued. That was a decision made (or effectuated) by Freedom Group within ninety days of declaring bankruptcy, and thus during the period of avoidable preferences. The effect was to put one of its creditors, the one that had succeeded in garnishing its bank account, ahead of the others—and that is just the sort of thing that the preferential-transfer statute is intended to prevent.\(^8\)

This reasoning is very persuasive.\(^9\) It suggests that *In re Coppie* was incorrectly decided.

The court in *In re Freedom Group, Inc.* also held that the debtor could recover the $108.25 that had been in the account even though it had been deposited before the ninetieth day prior to the filing. The court reasoned that the creditor’s right to the funds was not fully established until the final order in the garnishment was entered:

There might be another creditor ahead of it; there might be some serious defect in the judgment; the judgment might not be against this debtor; the garnishee might not be holding funds owed to the debtor; and so forth. Suppose the debtor wanted this creditor to get his money. The debtor might decide not to interpose valid defenses to the garnishment. This decision might come, or take effect, well into the preference period. The effect would be, within that period, to favor one creditor over another.\(^10\)

This reasoning, which focuses on uncertainty of collection, if carried to its logical conclusion, casts doubt on the validity of all security interests in

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6. *In re Coppie* ignores 11 U.S.C. § 547(e)(3) which states: “For purposes of [§ 547], a transfer is not made until the debtor has acquired rights in the property transferred.” Thus, the age of the writ is irrelevant. Any rule of state law purporting to transfer unearned wages to a creditor at an earlier date is invalidated by the quoted language.


8. *In re Freedom Group, Inc.*, 50 F.3d at 411.

9. The operation of an after-acquired property clause can similarly improve the position of a secured creditor on the eve of bankruptcy. However, the Bankruptcy Code protects the subsequently acquired security interest in certain circumstances. See 11 U.S.C. § 547(c)(5) (1994). No similar protection is available for after-acquired property interests attributable to the operation of judicial liens.

10. *In re Freedom Group, Inc.*, 50 F.3d at 412.
bankruptcy. The secured creditor is completely sure of payment only when payment actually occurs. Until then, there is the possibility that the collateral may be lost, destroyed or misappropriated by the debtor. These possibilities make collection uncertain in that the creditor may not be paid. One can assume that the court in In re Freedom Group, Inc. did not intend to restructure so radically the debtor-creditor relationship. A less expansive, more sensible interpretation of this part of the opinion is possible: The uncertainty of recovery should include only the legal uncertainty of non-final court orders, not the general uncertainty regarding collection that any secured creditor experiences until the secured obligation is satisfied.

Scholes v. Lehmann, while not arising in a bankruptcy proceeding, contains a discussion of fraudulent conveyance law that should be of interest to bankruptcy practitioners. Scholes sued various defendants in his capacity as receiver of an insolvent corporation. Some of the defendants were charitable religious organizations that had received gifts of corporate assets. They argued unsuccessfully that the state fraudulent conveyance statute should be interpreted to exclude charitable contributions. The same result should obtain if a bankruptcy trustee seeks to avoid a debtor’s charitable contributions under § 548.

Scholes did not consider whether these donative transactions were protected by the First Amendment because this issue was not properly raised in the trial court. There is also the possibility that avoidance may conflict with the Religious Freedom Restoration Act of 1993. Until these issues are resolved, the ability of a trustee to avoid transfers by a Chapter 7 debtor to a religious charitable entity remains unclear. Scholes probably does not require any change in the way charitable contributions are handled in Chapter 13 plans, even if such contributions are regarded as fraudulent transfers, because the disposable income test allows a debtor to build a budget containing expenditures that do not benefit its creditors.

11. It also calls into question the validity of prejudgment seizures pursuant to provisional writs of attachment and garnishment. The ultimate effect of these remedies cannot be determined until a final judgment is rendered.
13. The court’s treatment of the fraudulent conveyance issue did not make any distinction between direct and indirect transfers to the charities. Id. at 762.
16. Scholes, 56 F.3d at 760.
18. See 2 Keith Lundin, Chapter 13 Bankruptcy § 5.36, at 5-109 to 5-111 (2d ed. 1994).
Steinberg v. Buczynski, the third interesting avoiding power decision, reexamines the scope of a trustee's ability to maintain a veil-piercing or alter ego action against the shareholders of the debtor corporation. Koch Refining v. Farmers Union Central Exchange, Inc., had given the trustee wide latitude. Steinberg suggests that a retreat from the holding in Koch may be underway because it explicitly conditions the trustee's right upon a showing of an injury to a separate identifiable interest of the corporate entity. We do not question the right of a trustee in bankruptcy to maintain a "veil piercing" suit on behalf of a bankrupt corporation . . . , but the qualification "on behalf" must be stressed. If the corporation is injured by the shareholders' disregard of corporate formalities, or stated differently but equivalently if a claim against the shareholders arising from their disregard of corporate formalities is the property of the corporation then the trustee can sue; otherwise he cannot.

This language indicates a lack of enthusiasm for Koch's approval of alter ego suits by bankruptcy trustees. Although policy arguments support the position adopted in Koch, it would be unwise to rely heavily on the continued vitality of this holding until the position of the Seventh Circuit is clarified.

20. 40 F.3d 890 (7th Cir. 1994).
22. In Steinberg, the court determined that the shareholders of a subchapter S corporation had not harmed the corporation, and, therefore, the corporation had no claim against them. The harm done was to another entity (i.e., a pension fund). It was the fund that could sue the shareholders, not the trustee, because the trustee had no interest in the suit. Steinberg, 40 F.3d at 892-93.
23. Id. at 892 (citations omitted).
24. The court in Koch was satisfied with a vague allegation of injury to the corporation. Koch, 831 F.2d at 1349.
25. "Veil-piercing actions are in many respects identical to the avoiding actions that the trustee undoubtedly enjoys under § 544. It is hard to explain why the trustee should be able to avoid transfers of property that the creditors could have avoided, but not bring damage actions." DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 108 (rev. ed. 1993).
27. Logically, alter ego actions are related to creditor-related avoiding powers under § 544 because the corporation itself has not been harmed by the disregard of corporate form. Reliance on § 544 is problematic in view of Congress' failure to overrule Caplin v. Marine Midland Grace Co., 406 U.S. 416 (1972) (bankruptcy trustee has no standing to sue indenture trustee on behalf of individual bondholders). See In re Ozark Restaurant Equip. Co., 816 F.2d 1222 (8th Cir. 1987).
II. Exemptions

In re Voelker\(^27\) examined the enforceability of a federal tax lien on exempt property during Chapter 13 proceedings. All of the debtor's property was subject to the tax lien imposed by § 6331 of the Internal Revenue Code.\(^28\) Some of his assets, namely, clothing, hand tools, a lawnmower, a weed-eater, a bow and some arrows, were exempt from levy under I.R.C. § 6334. Outside of bankruptcy, the debtor is entitled to retain these assets without paying any of the tax obligation. However, the property remains subject to the lien that must be satisfied if a sale occurs.

When the IRS filed a proof of a secured claim, two issues were before the court. Did the IRS have a secured claim, and, if so, did the debtor need to make payments during the term of the plan because of the lien? The court correctly answered the first question affirmatively. The IRS was the holder of a secured claim—because the property was not exempt, as that term is commonly understood. But then, the court required the debtor to include the allowed amount of the secured claim ($825) in his proposed plan on the assumption that this was required by 1325(a)(5)(B)(ii).\(^29\) The latter conclusion is questionable.

Section 1325(a)(5) of 11 U.S.C. establishes the cost of cramdown.\(^30\) It is not applicable when the debtor does not choose to attempt cramdown.\(^31\) The debtor should have been allowed to retain the semi-exempt assets without paying anything to the IRS and without affecting the tax lien. This is exactly what would have occurred if the debtor had not filed for bankruptcy. No considerations of bankruptcy policy require a different result. As the Supreme Court observed in Butner v. United States: "Property interests are created and defined by [nonbankruptcy law—federal and state]. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently because an interested party is involved in a bankruptcy proceeding."\(^32\)

Another interesting decision, In re Salzer,\(^33\) examined the effect of a trustee's...
failure to object to an exemption claim within the thirty days provided by Bankruptcy Rule 4003(b). Following expiration of the objection deadline, the debtor demanded the exempt assets. When the trustee failed to comply with this request, the debtor sued, alleging a violation of 11 U.S.C. § 362(a)(3). Obviously anxious to protect the trustee from liability, the court rejected the claim on the grounds that the exemption valuation process was not complete. Therefore, the asset remained properly in his control. This reasoning is inconsistent with the holding in Taylor v. Freeland & Kronz. It is also at odds with the policy supporting Bankruptcy Rule 4003(b). As Collier observes, "[T]he debtor's valuation of the property for exemption purposes must be accepted once the deadline for exemptions has passed. Otherwise, that deadline would be meaningless."

Hard cases make bad law. There was a much easier path to the same result. The conduct in question did not violate § 362(a)(3). That provision only prohibits conduct that interferes with the title or possession of the bankruptcy estate. If the trustee withholds improperly exempt property from the debtor, the correct way to challenge this action is to request abandonment in accordance with 11 U.S.C. § 554(b).

III. EXECUTORY CONTRACTS

As a result of the efforts of two writers, Jay Westbrook and William Andrews, the approach in this country to executory contract analysis is slowly changing. In re C&S Grain Co. shows how painfully slow the process of change

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34. "[T]he failure to object to an exemption does not waive any right to contest the validity of the exemption, [however], such a failure does not waive the estate's right to any excess value over the allowed exemption limit." Id. at 712 (citations omitted). This reasoning is difficult to see. If property is exempt, it is exempt. The fact that it is exempt means, a fortiori, that creditors have no right to it.

35. 503 U.S. 638 (1992) (holding that even bad faith claim of exemption is final after passage of thirty days if trustee or creditors do not object).

36. 8 COLLIER ON BANKRUPTCY ¶ 4004.04, at 4003-14 to -15 (Lawrence P. King et al. eds., 15th ed. 1995)

37. Another problem with the opinion is the court's suggestion that the Indiana process for claiming an exemption must be followed in bankruptcy proceedings. In re Salzer, 52 F.3d at 711-12.


40. 47 F.3d 233 (7th Cir. 1995).
can be. As noted in last year’s survey article, traditional analysis focuses on whether a transaction is an executory contract.\textsuperscript{41} Unless it is, the bankruptcy estate cannot assign the contract under 11 U.S.C. § 365. The traditional approach is problematic when the estate is seeking to take advantage of an asset that does not fit neatly within the definition of an executory contract.\textsuperscript{42} The new approach is functional, permitting the bankruptcy estate to act whenever it is advantageous to do so.

In \textit{C&S Grain}, the debtor unsuccessfully sought to assume and assign contracts for the purchase of grain at a fixed price. This request was denied solely because the contracts were no longer executory. According to the court, the debtor’s prebankruptcy relinquishment of its grain dealer’s license amounted to an anticipatory repudiation of its obligations.\textsuperscript{43} At that point, the grain purchase contracts ceased being executory because the repudiation relieved the nondebtor parties of their obligation to perform.

There are two problems with this line of analysis. First, the executory contract analysis is incorrect. A contract does not necessarily cease being executory simply because one party is in breach. The contractual relationship must be terminated prior to bankruptcy.\textsuperscript{44} In \textit{C&S Grain}, the nondebtor party had not exercised its right to rescind before bankruptcy. The court incorrectly concluded that breach by the debtor, without anything else, put an end to the contractual relationship between the parties.

Second, and more fundamentally, adherence to the traditional definition of an executory contract (unperformed material obligations on both sides of the transaction) unduly restricts the trustee’s ability to take advantage of § 365. The estate should be free to act in any situation when completion of the transaction will be advantageous to the estate. In this instance, the debtor had surrendered its dealer’s license leaving it unable to complete the grain purchase. Nonetheless, it should have been permitted to take advantage of the profit opportunity by assigning the purchase rights to a licensed dealer.

IV. CLAIMS

In an interesting case, \textit{In re Penrod},\textsuperscript{45} a creditor filed a secured claim in a


\textsuperscript{42} Suppose, for example, that the debtor holds a valuable option to purchase real estate. See, e.g., \textit{In re G-N Partners}, 48 B.R. 462 (Bankr. D. Minn. 1985).

\textsuperscript{43} \textit{In re C&S Grain Co.}, 47 F.3d at 237. An Illinois statute required that a certain debt to equity ratio was necessary to maintain the grain dealer’s and warehouseman’s licenses. When C & S Grain experienced financial difficulties, it turned its licenses over to the state. \textit{Id.} at 236. The court found that by turning over its licenses, which were preconditions for the doing of the acts specified in its contracts, C & S Grain made the contracts void. \textit{Id.} at 237. This cut off the inquiry into whether C & S Grain could assign its contractual rights.

\textsuperscript{44} 2 \textsc{collier on bankruptcy}, supra note 36, ¶ 365.02, at 365.21 to .23.

\textsuperscript{45} 50 F.3d 459 (7th Cir. 1995).
Chapter 11 proceeding. There was no objection and the claim was allowed. The
debtor’s treatment of the claim in its plan was inconsistent with its allowed status.
*Penrod* held that the treatment in the plan controls. Accordingly, the creditor lost
the lien associated with its allowed secured claim.

*Penrod* is apparently the first court of appeals decision to consider the
relationship between the claim process and the confirmation process in Chapter 11
proceedings. This issue has been the subject of a long standing controversy
in Chapter 13 proceedings. The majority view is that a confirmed Chapter 13 plan
cannot adversely affect the lien rights of an allowed secured claim. The Seventh
Circuit, however, adheres to the minority position that a confirmed plan prevails
even if its terms are inconsistent with the lien status of the secured claimholder.
Thus, the result in *Penrod* is consistent with previous Chapter 13 decisions in this
circuit. It represents a minority view, but it has the support of the leading treatise
on Chapter 13. One must choose between inconsistent results produced by the
claims allowance process and the confirmation process. *Penrod* represents the
better view because it reduces the possibility of post-confirmation challenges to
the reorganization plan.

Judge Posner carefully limited the holding in *Penrod* to situations in which the
lienholder has participated in the bankruptcy. However, he also noted that the
secured claimholder may be “dragged into the bankruptcy involuntarily because
[another party] . . . may file a claim on the creditor’s behalf . . . .” Thus, the
limitation he mentioned seems to be of little practical consequence as long as the
claimant has adequate notice of the bankruptcy proceeding.

V. SUCCESSOR LIABILITY

*Chicago Truck Drivers, Helpers & Warehouse Workers Union (Independent)
Pension Fund v. Tasemkin, Inc.* is a successor liability case. Although the
result achieved is correct, the reasoning in this rather bizarre opinion is muddled.

46. The existing authority is reviewed in H. Gray Burks, IV, *Obtaining the Release of Liens
Through Reorganization Plans: The Circuit Courts Sharpen the Debate with Penrod and Cen-Pen,
48. *In re Pence*, 905 F.2d 1107 (7th Cir. 1990).
49. “To the extent [that] cases . . . suggest that the confirmation process always gives way
to the claims allowance process, these cases are wrongly decided.” 2 LUNDIN, *supra* note 18, § 6.10,
at 6-22.
50. *In re Penrod*, 50 F.3d 459, 462 (7th Cir. 1995) (citing 11 U.S.C. §§ 501(b),(c) (1994);
*In re Lindsey*, 823 F.2d 189, 171 (7th Cir. 1987)).
51. *See In re Chappell*, 984 F.2d 775, 783 (7th Cir. 1993) (holding that a creditor with
notice of a bankruptcy proceeding runs risk of losing its claim if it does not bring the claim to the
court’s attention).
52. 59 F.3d 48 (7th Cir. 1995).
53. Successor liability exists when an asset remains subject to a regulatory burden, e.g.,
application of labor laws notwithstanding its transfer to a new entity.
Old Tasemkin filed under Chapter 11 in May 1991. This filing triggered ERISA withdrawal liability. New Tasemkin was incorporated for the purpose of acquiring the assets of Old Tasemkin. It did not, however, purchase the assets from the estate. Instead, it acquired the blanket security interest of Northern Trust, obtained relief from stay, and obtained title through the foreclosure of its security interest. The plaintiff then sought to enforce the ERISA liability by applying the successorship doctrine. New Tasemkin argued that this conflicted with bankruptcy policy. The court disagreed. This result is correct. Because New Tasemkin acquired the assets as a successor to the secured creditor, the rehabilitative features of a bankruptcy proceeding were not involved.

Unfortunately, the court did not choose this simple rationale. Instead, it observed, "This case does not directly implicate the Bankruptcy Code, since the underlying bankruptcy proceeding is long over." The court also explained, "Once a bankruptcy proceeding is completed and its book closed, the bankruptcy has ceased to exist and the priorities by which its creditors have been ordered lose their force." Many discharged individual debtors and reorganizing businesses will be surprised to learn that the effects of bankruptcy evaporate as soon as the case is closed. Of course, there is absolutely no support for such statements.

54. Tasemkin, 59 F.3d at 50.
55. Id. at n.2.
56. Id. at 51.
57. For a recent discussion of whether successor liability can exist after bankruptcy, see J. Maxwell Taylor, The Clash of Successor Liability Principles, Reorganization Law, and the Just Demand that Relief Be Afforded Unknown and Unknowable Claimants, 12 BANKR. DEV. J. 1 (1995).