Bankruptcy in the Seventh Circuit: 1989-1990

Douglass Boshkoff
Indiana University Maurer School of Law
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DOUGLASS G. BOSHKOFF*

On May 12, 1989, the Seventh Circuit handed down what probably will turn out to be the most widely discussed and controversial bankruptcy opinion originating in any circuit during the 80s, *Levit v. Ingersoll Rand Financial Corporation (In re V. N. Deprizio Construction Co.)*. This survey of Seventh Circuit bankruptcy opinions begins a few weeks later and spans a period of fourteen months. None of the court's work during this time span will attract as much attention as *Deprizio*. Nonetheless, the output of the Seventh Circuit during this period was substantial and several of its decisions already have been cited by, or should attract the attention of, other circuits. I have not attempted to discuss every opinion that resolves a bankruptcy dispute. Rather, this Article focusses on the most significant and interesting decisions.

I. POWERS OF AVOIDANCE

The ability of a trustee to avoid pre-bankruptcy transfers was the primary issue in only two decisions. Both opinions, however, are important. *Belisle v. Plunkett* already has found its way onto the pages of a bankruptcy casebook, and the more recently decided *In re Taxman Clothing Co., Inc.* seems likely to attract the attention of both academics and practitioners.

The debtor in *Belisle*, ostensibly acting on behalf of a partnership, purchased a fifty-year leasehold interest in a shopping center with funds provided by several partners. Although Debtor appeared as the owner of record, he recognized the partnership for tax purposes and informed

* Professor of Law, Indiana University-Bloomington. My colleague, Bruce Markell, has not reviewed this Article. However, we have discussed many of the cases mentioned in the text, much to my profit. I am also indebted to Alexander C. Nigh, Class of 1992, for valuable research assistance.
1. 874 F.2d 1186 (7th Cir. 1989).
4. 877 F.2d 512.
6. 905 F.2d 166.
the partners of the income and deductions they should report on their own tax returns. From the perspective of tenants and creditors, however, Debtor appeared to be the sole owner of the premises. The court held that the leasehold interest is part of the bankruptcy estate, unencumbered by the interest of any of the partners.7

Section 544(a)(3)8 of the Bankruptcy Code was the vehicle for bringing this parcel of real property into the bankruptcy estate.9 Under non-bankruptcy state law, because the partnership's interest in the leasehold was not recorded, a constructive trust for the benefit of the other partners was imposed on the debtor's interest. Normally, property in a trust is not used to satisfy the claims of the fiduciary's unsecured creditors.10 However, in the Virgin Islands, a bona fide purchaser will take free of the unrecorded partnership interests.11 Therefore, the hypothetical bona fide purchaser test contained in section 544(a)(3) permitted incorporation of this asset into the bankruptcy estate.12

Judge Easterbrook found no contradiction between this aspect of the strong-arm power and section 541(d),13 which denies the trustee access to "property in which the debtor holds, as of the commencement of the case, only legal title . . . ."14 He observed:

Section 541(d) does not have anything to say about the effects of § 544(a)(3). It forbids including property in the debtor's estate "under subsection (a) of this section" and does not address whether property may be included under some other part of the Code. The courts that have perceived a conflict between §§ 541(d) and 544(a)(3) did not discuss this limitation on the domain of § 541(d).15

Judge Easterbrook misreads the statute. Property can become part of the bankruptcy estate only through the operation of section 541(a). The existence of rights arising under section 544(a) or any other avoiding power does not alone create an estate asset. A potentially avoidable transfer must actually be avoided pursuant to section 55016 and then

7. 877 F.2d at 515.
11. Belisle, 877 F.2d at 514.
12. Id. at 515.
14. Id.
15. Belisle, 877 F.2d at 515.
incorporated into the estate via section 541(a)(3) before the transaction is complete. Thus, the language of section 541(d) cannot be ignored. A contradiction exists between this statutory limitation on the augmentation of the bankruptcy estate and the avoidance power exercised in Belisle. One possible resolution of the statutory impasse is to rely on the legislative history of section 541(d), which was designed to protect traditional mortgage servicing arrangements, a type of transaction not present in Belisle.

Such a construction of section 541(d) does not, however, produce a solution for another problem caused by the interaction between the various parts of the statute. Suppose that Debtor is the duly constituted trustee of an express trust with a power of sale. It is well established that a sale by such a trustee to a bona fide purchaser cuts off any equitable interest of the beneficiary even if the transfer was a breach of the trust. If the trustee is involved in bankruptcy proceedings, can its bankruptcy trustee use section 544(a)(3) to bring any of the trust's realty into the bankruptcy estate unburdened by the equitable rights of the beneficiary? It is hard to believe that any court would so hold, yet this result seems to flow naturally from the current statutory language.

This situation could not arise under the prior bankruptcy statute because the bankruptcy trustee was not permitted to claim bona fide purchaser status. Collier approved of this limitation on the trustee's power of avoidance, and noted the mischief that would result from allowing the trustee to place himself in the position of a bona fide purchaser:

17. Judge Easterbrook's reading of the statute is correct after the 1984 amendment to § 541(d). See infra note 20. However, he did not view the statutory change as relevant to the disposition of this case. See Belisle, 877 F.2d at 514 n.3.
18. This legislative history is used to confirm the court's reading of § 541. See Belisle, 877 F.2d at 516.
20. Prior to 1984, the risk posed by operation of § 544(a)(3) to a beneficiary of an express trust was less than obvious. Section 541(d) applied to all categories of property in the bankruptcy estate, including property acquired through exercise of an avoiding power, and it may have been assumed that beneficiaries of an express trust did not need to fear use of § 544(a)(3). To a casual reader of § 541(d), the language chosen by Congress probably appeared broad enough to protect the beneficiary of an express trust. The situation changed when § 456(c) of the Bankruptcy Amendments and Federal Judgeship Act of 1984 [98 Stat. 392] amended § 541(d) and restricted its application to the first two clauses of § 541(a). See Billings v. Cinnamon Ridge, Ltd. (In re Granada, Inc.), 92 Bankr. 501, 508 (Bankr. D. Utah 1988). Since then, the argument that the beneficiary of an express trust should lose its interest to the bankruptcy trustee has become more obvious.
Since such an interpretation [of the strong-arm clause] would mean that the trustee would not be subject to liabilities such as to return property fraudulently obtained by the bankrupt, or to account for trust funds, the theory received short shrift in the courts.\(^{21}\)

The potential for mischief foreseen by Collier now exists, and it is predictable that a trustee will attempt to gain control of real estate assets held by a fiduciary.\(^{22}\)

Several years ago, the Seventh Circuit attracted attention when it chose cost (to the debtor) as the appropriate measure of asset value for the purpose of determining whether there had been any pre-bankruptcy improvement in the position of a partially secured creditor.\(^{23}\) A majority of the \textit{Ebbler} court was willing to allow the decision of the bankruptcy judge to stand without an extensive discussion of the statutory policy behind section 547(c)(5).\(^{24}\) This prompted Judge Easterbrook to write a concurring opinion in which he offered some guidance on the search for statutory meaning. Approving of the use of wholesale value, he observed:

To give the Bank more than the wholesale value is to induce a spate of asset-grabbing among creditors, which could make all worse off. If the Bank gets the whole increment of value (from wholesale to retail) during the last 90 days, other creditors may respond by watching the debtor closely and propelling it into bankruptcy when it has a lower inventory (and therefore less "markup" for the Bank to seize). The premature filing may reduce the value of the enterprise. There are other defensive measures available to creditors. The principle function of Section 547(c)(5) is to reduce the need of unsecured creditors to protect themselves against the last-minute moves of secured creditors. It would serve this function less well if goods subject

\(^{21}\) 4B Collier on Bankruptcy § 70.52 (14th ed. 1978) (emphasis supplied).
\(^{22}\) In Re Mill Concepts Corp., 123 Bankr. 938, 947 (D. Mass. 1991) criticizes the reasoning and result in \textit{Belisle}. Cf. Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corporation), 917 F.2d 424 (10th Cir. 1990). In \textit{Research-Planning}, the debtor, an escrow agent, improperly used trust funds to pay a creditor. Following the settlement of a preference action, its funds became part of the bankruptcy estate. The court rejected the argument that the recovered funds should be impressed with a constructive trust to protect the beneficiary of the escrow arrangement. \textit{Id.} at 428 n.4. The reasoning in this decision supports a concern that all express trusts are at risk.
\(^{23}\) In re Ebbler Furniture and Appliances, Inc., 804 F.2d 87 (7th Cir. 1986).
\(^{24}\) \textit{Id.} at 91. See 11 U.S.C. § 547(c)(5) (1988). Once the trustee has established the existence of a preferential transfer, § 547(c)(5) protects the transferee except to the extent that the transferee has improved its position "to the prejudice of other creditors holding unsecured claims" in the pre-bankruptcy period of vulnerability.
to a security interest were appraised at their retail price.25

Judge Easterbrook’s conclusion is inconsistent with this reasoning. When the issue is whether section 547(c)(5) of the Bankruptcy Code prevents avoidance, the use of retail values rather than wholesale values is more helpful to the bankruptcy trustee.26 Nonetheless, the Easterbrook concurrence is significant because it is the initial articulation of a pro-avoidance approach to statutory interpretation, an approach that was reaffirmed in In re Xonics Imaging, Inc.27 and, most recently during this survey period, in In re Taxman Clothing Co., Inc.28

In In re Taxman, Judge Posner observed:

We begin by asking — what is always a useful type of question to ask in a case — why the law is interested in whether the debtor was insolvent at some point before he declared bankruptcy. The reason is that once a firm is in acute peril the temptation to try to keep afloat in the hope that its luck will change may lead it to strike a deal with its key creditors to the prejudice of its other creditors. Knowing this, the other creditors, unless protected by the voidable-preference rule, will be quick to force the firm into bankruptcy in order to crystallize their own entitlements. The rule induces creditors to be more forebearing, and by doing so makes it less likely that firms will be pushed into bankruptcy prematurely. . . .29

Despite the Seventh Circuit’s repeatedly professed tilt in favor of avoidance, Taxman’s value determination is not going to help bankruptcy trustees in avoiding transfers. Taxman determined that assets should be valued at their going-concern value, rather than their liquidation value for the purpose of determining whether the debtor was

25. Ebler, 804 F.2d at 92.
26. When there is an improvement in position, the dollar disparity will be greater when retail value is used. Because the improvement in position test limits the trustee’s right to recover assets, the use of wholesale values in this subsection will produce smaller recoveries than the use of retail values.

For example, assume a loan of $12,000,000 secured by a lien on inventory that was completely replaced during the 90 days preceding bankruptcy. The wholesale value of the inventory at the beginning of the 90 day period is $5,000,000. By the date of bankruptcy it has increased to $6,000,000. Assuming that the wholesale value is 50% of retail, the net recovery using wholesale values is $1,000,000 ($6,000,000 gross transfer limited to $1,000,000 improvement in position), while retail values produce a $2,000,000 recovery ($12,000,000 gross transfer limited to a $2,000,000 improvement in position).

27. 837 F.2d 763, 765 (7th Cir. 1988).
28. 905 F.2d 166 (7th Cir. 1990).
29. Id. at 169.
solvent ninety days before bankruptcy. This going-concern valuation led to a finding of solvency and to the frustration of the trustee's attempt to avoid the transfers.

II. Claims

Within a span of three months, the Seventh Circuit decided three significant cases in which the propriety of equitable subordination was the principal issue. The first decision, In re Virtual Network Services Corp., decided that a non-pecuniary loss tax penalty should be subordinated to the claims of other general unsecured creditors in a Chapter 11 liquidating bankruptcy. The same result would occur if the liquidation had been under Chapter 7. To accomplish this result, the court turned to and analyzed the equitable subordination provision contained in section 510(c)(1) of the Bankruptcy Code. Although equitable subordination ordinarily requires some inequitable conduct associated with the subordinated claim, Virtual Network appears to be the first Court of Appeals decision under the 1978 Code to invoke section 510(l)(c) in the absence of wrongful activity. Nonetheless, the decision makes sense because it helps to minimize the substantive differences between a straight bankruptcy and a liquidating 11.

It may be argued that incorporating the result required by section 726 into a Chapter 11 bankruptcy is inconsistent with the direction found in section 103(b) that "Subchapters I and II apply only in a case under such Chapter." A recent Eighth Circuit opinion that cites Virtual Network with approval addresses this issue, and adds some helpful observations on the relationship between Chapters 7 and 11.

31. In re Virtual Network Services Corp., 902 F.2d 1246 (7th Cir. 1990); Kham & Nate's Shoes No. 2 v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990); In re Lapiana, 909 F.2d 221 (7th Cir. 1990).
32. 902 F.2d 1246.
33. "Non-pecuniary loss tax penalty" is a claim by the IRS to collect money for delinquent taxes. See 26 U.S.C. § 6653 (1988). Because the amount is in excess of the tax due and owing, these claims are considered non-pecuniary losses. Virtual Network, 902 F.2d 1246, 1246 n.1.
34. Virtual Network, 902 F.2d at 1250.
The Government additionally argues that the current Bankruptcy Code precludes subordination of non-pecuniary loss penalties in proceedings under chapter 11. In support of this contention, the Government points out that Congress, in enacting the Bankruptcy Reform Act of 1978, rejected a proposal to automatically subordinate non-pecuniary loss penalty claims to the claims of unsecured creditors in all bankruptcy proceedings. Instead, Congress expressly subordinated non-pecuniary loss penalty claims only in chapter 7. Thus, under the Government's view, Congress intended to restrict subordination of punitive claims to proceedings under chapter 7. We again disagree.

We first consider that the equitable subordination provisions of Section 510(c)(1) apply to all chapters of the Bankruptcy Code. We further observe that chapter 7, which applies purely to liquidations, is more conducive to a uniform rule subordinating penalty claims than is chapter 11, which can be used both by reorganizing businesses and by liquidating businesses. In other words, in proceedings under chapter 7, Congress could be certain that in most cases the debtor would cease operations with assets that were insufficient to cover the creditors' claims in full. Therefore, in the chapter 7 context, a uniform rule subordinating penalty claims recognizes that ordinary creditors should receive protection from debtors' punitive obligations.

The same rule, however, would be inappropriate for proceedings under chapter 11. In chapter 11 proceedings, Congress expected that many debtors would continue their operations under a reorganization plan and ultimately return to a viable and profitable economic state. In such cases, the debtor, quite rightly, should bear the burden of its full punitive obligations. Where a chapter 11 debtor opted to liquidate, however, the consequences to creditors could be very similar to a proceeding under chapter 7. Accordingly, we are not persuaded by the Government's argument that the silence of chapter 11 as to penalty claims exempts such claims from subordination under section 510(c)(1). We deem it just as likely that Congress deliberately chose to leave to the Bankruptcy Court, to determine on a case-by-case, the question of whether a penalty claim should be subordinated in a proceeding under chapter 11.40

It is too early to tell whether Virtual Network represents a sharp break with traditional views concerning equitable subordination or is

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40. Id. at 233-234 (citations omitted).
only an attempt to conform a liquidating 11 to the provisions of Chapter 7. In July 1990, another panel of the Seventh Circuit declined the invitation to extend Virtual Network’s no-wrongful conduct rule to a bank that had engaged in post-petition financing pursuant to section 364(c)(1)\textsuperscript{41} and then exercised its discretionary right to discontinue advances.\textsuperscript{42} As for Virtual Network, the court observed:

Equitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in an anticipation of bankruptcy. Courts require the insiders to return to their position at the end of the line. Virtual Network extends principles of equitable subordination to a penalty created by operation of law, where delay in collecting the penalty injured other creditors. But Bank is neither an insider nor a person seeking to collect a penalty, and it has not delayed without justification. It contributed new value under a contract, and it wants no more than the priority Judge Toles promised as the lure.

... Debtor submits that conduct may be “unfair” and “inequitable” ... even though the creditor complies with all contractual requirements, but we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do “more” — just how much more resting in the discretion of a bankruptcy judge assessing the situation years later...

... Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of “good faith”. Although courts often refer to the obligation of good faith that exists in every contractual relation, this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. “Good faith” is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting. ... When the contract is silent, principles of good faith ... fill the gap. They do not block use of terms that actually appear in the contract.

... Although debtor contends, and the bankruptcy judge found,

\begin{itemize}
\item 42. Kham & Nate’s Shoes No. 2 v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990).
\end{itemize}
that Bank's termination of advances frustrated Debtor's efforts to secure credit from other sources, and so propelled it down hill, this is legally irrelevant so long as Bank kept its promises.

The only breach on Bank's part that Debtor has identified is the technical one: the contract calls for five calendar days' telephonic and written notice, while Bank gave only written notice. . . . Equitable subordination under § 510(c) is not a device to magnify the damages available for inconsequential breaches of contract.43

The last in the trio of equitable subordination cases, In re Lapiana,44 involved conduct by a senior lienor alleged to be detrimental to a junior lienor. In 1981, two parcels of land owned by the Debtors were burdened with a senior federal tax lien and a junior judgment lien. One of the parcels was sold but the sale did not produce enough money to satisfy the tax claim. Accordingly, the Government's prior lien on the second parcel of land continued to accrue interest as permitted by section 506(b) of the Bankruptcy Code.45 In 1983, the bankruptcy judge ordered the trustee to pay the proceeds of the sale to the Internal Revenue Service in partial satisfaction of its claim. The trustee did not do so until some twenty months later and, even then, only paid over part of the sale proceeds. He embezzled the rest. Shortly thereafter, the second property was sold and the United States Government claimed all of the proceeds. The junior lienor argued that the Government was not entitled to accrue post-petition interest because of the delay in collecting the proceeds of the first sale. The District Court reversed because it believed the junior lienor was equally culpable in not forcing a timely pay-over of the proceeds.

The Seventh Circuit affirmed the District Court because it agreed that the junior lienor was culpable.

[I]t behooved Lee [the junior lienor] to take the proper steps to stop the interest clock from running. Even if interest is not accruing on senior liens, moreover, the prudent junior lienor will be ever mindful of the importance of clearing senior liens from the property they encumber. . . . [The junior lienor] assumed that the proceeds of the first sale would be enough to pay off the government in full, leaving the remaining property free and clear of any liens (except mortgage liens) superior to

43. Id. at 1356-59 (citations omitted).
44. 909 F.2d 221 (7th Cir. 1990).
his own. But like many assumptions this was a dangerous one, as it ignored the government's colorable right to interest. 46

The most interesting aspect of this decision, however, is the warning offered to the Internal Revenue Service and presumably to other secured creditors enjoying senior status.

The Internal Revenue Service would be well advised to institute a procedure for notifying junior liens of the status of the Service's liens; we were told at argument, without contradiction, that no such procedure exists. The existence of such a procedure would at small cost lighten the burden that we conclude rests on the junior lienor to protect himself from the consequences of section 506(b) and would head off lawsuits such as this. . . . 47

Although the Seventh Circuit does not explicitly state that failure to provide such a warning will prejudice the rights of a senior lienor, an argument for equitable subordination can be made. Fairly read, Lapiana suggests that presented with different facts, the court might very well accept the argument that inequitable conduct — either delay in enforcement or failure to notify — will prevent a senior lienor from accruing interest under section 506(b) to the detriment of a junior encumbrancer. Moreover, nothing in Lapiana suggests that the enforcement delay theory of subordination can be invoked only by junior lienors. Unsecured claimants also should be able complain if such delay occurs.

III. Procedure

In re Powelson 48 provides an excellent illustration of how the awkward procedural framework for bankruptcy litigation adopted by Congress in the wake of Northern Pipeline Construction Co. v. Marathon Pipe Line Co. 49 offers litigants numerous opportunities for delaying tactics. This opinion should be required reading for any person interested in an example of what is wrong with the current relationship between the district court and bankruptcy judges.

In January of 1986, the Powelsons, who are farmers, petitioned for relief under Chapter 11. Almost two years later, the bankruptcy

46. Lapiana, 909 F.2d at 225.
47. Id.
48. 878 F.2d 976 (7th Cir. 1989).
judge finally confirmed a liquidating plan offered by creditors\(^9\) after the debtors had failed to file an acceptable disclosure statement and reorganization plan. The farmer-debtors' attempt to secure reconsideration of the confirmation order and/or a conversion to Chapter 12 was unsuccessful, and they filed a notice of appeal to the district court on February 19, 1988. On the same day, the debtors also filed a motion to withdraw the reference to the bankruptcy judge.\(^{51}\) Thus, they simultaneously were asking the district court to act as a trial court and as an appellate court. This delaying tactic was successful. The district judge withdrew the case and stayed enforcement of both the creditor's liquidating plan and the debtors' appeal. The district court also accepted, but did not formally confirm, a substituted plan offered by the debtors, which allowed them to remain in possession for four years while repaying their creditors.

The Seventh Circuit expressed doubt as to whether the motion for withdrawal was either timely or warranted by the facts. Its concern with this confusing maneuver was well founded. Withdrawal is one of the mechanisms employed by Congress to ensure adequate participation by an Article III judge in the bankruptcy decision-making process.\(^{52}\) Exercise of the power to withdraw results in a shift of initial decision-making authority from an Article I judge to an Article III judge. Once a ruling has been made by the bankruptcy judge, however, appeal rather than withdrawal is the proper way to challenge this decision.\(^{53}\) Withdrawal should no longer be considered appropriate except as to matters still unresolved at the trial level. For example, in Powelson, since confirmation had occurred, withdrawal would be appropriate only to deal with post-confirmation matters still remaining to be resolved by the bankruptcy judge,\(^{4}\) and even then should only be for cause.\(^{55}\) The Fifth Circuit has offered some guidance as to when withdrawal is appropriate:

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50. Farmers are normally protected against involuntary liquidation. However, a creditor-sponsored liquidation in Chapter 11 is permissible. Button Hook Cattle Co. v. Commercial Nat'l Bank and Trust Co. (*In re* Button Hook Cattle Co.), 747 F.2d 483 (8th Cir. 1984); Jasik v. Conrad (*In re* Jasik), 727 F.2d 1379 (5th Cir. 1984).

51. 28 U.S.C. § 157(d) (1988) requires withdrawal of the reference to the bankruptcy judge in certain instances and also permits withdrawal for "cause." A permissive withdrawal request, if by a party, must be timely. It has been suggested that a "timeliness restriction" should also apply to withdrawal of the reference *suo sponte*. *In re Pruitt*, 910 F.2d 1160, 1171-72 (3d Cir. 1990) (Mansmann, J., concurring).


53. Cf. Powelson, 878 F.2d at 983.


55. Powelson, 878 F.2d at 983.
Marathon provides the outer boundary of original referred jurisdiction of bankruptcy courts, but considerations of judicial economy also bear on the decision to withdraw the reference or refer to the bankruptcy court. The district court should consider the goals of promoting uniformity in bankruptcy administration, reducing forum shopping and confusion, fostering the economical use of the debtors' and creditors' resources, and expediting the bankruptcy process.56

None of these suggested factors supports the action taken in Powelson. Indeed, the opposite is true. The action of the district court in Powelson sends the wrong message to future litigants, thereby creating an incentive to forum shop, producing confusion, and resulting in a waste of resources.57 Powelson recognizes this, but only in a tentative fashion.

The timing of the court's withdrawal of the reference here, even if not improper, seems to be in conflict with the statutory objectives of utilizing the expertise of bankruptcy judges, reducing forum shopping and preserving the appellate processes provided by the Bankruptcy Act.58

Unfortunately, the final order doctrine59 made it impossible to achieve normal appellate review of the district court's activity, a review that surely would have resulted in a reversal and an unequivocal condemnation of what occurred following withdrawal. However, none of the challenged actions — the decision to withdraw, the stay of confirmation, or the substitution of a revocable interim plan — qualified as a final order subject to normal appellate review. Judge Cudahy indicated that the facts ordinarily would warrant the issuance of a writ


57. For a decision that clearly recognizes how inefficient withdrawal would be in a situation similar to Powelson, see In re Dunes Casino Hotel, 63 Bankr. 939 (D.N.J. 1986).

58. Powelson, 878 F.2d at 983 (emphasis added) (citation omitted).

of mandamus, but not in this case because of possible creditor ac-
quiescence in the highly unusual action taken by the district court.60
Since Powelson, the Third Circuit has unequivocally condemned this
type of maneuvering in the context of a Chapter 13 proceeding.61

Ordinarily, we would remand this matter to this district court
with instructions that it make findings on cause to withdraw
the reference. In this case, however, because the bankruptcy
judge did all he could do and entirely disposed of the case,
we believe cause to withdraw did not exist.62

Marathon casts a long shadow. Its effect also can be seen in the
distinction drawn between core and non-core proceedings by 28 U.S.C.
§ 157. The bankruptcy judge is permitted to act as the ultimate decision-
maker only when a controversy is a core proceeding.63 Without the
parties' consent, disputes designated as non-core proceedings, however,
only can be resolved by an Article III judge.64 A recent Seventh Circuit
case, Barnett v. Stern,65 considers how the core/non-core distinction
can affect application of claim preclusion rules. In Barnett, proceeding
#1 was an adversary proceeding before a bankruptcy judge in which
the trustee successfully established that a trust was the debtor's alter-
ego and that trust assets were property of the estate. Proceeding #2,
in a federal district court, alleged a RICO violation because the trust
had been used to conceal assets of the bankruptcy estate. Relying
heavily on a recent Fifth Circuit opinion,66 the court refused to give
res judicata effect to proceeding #1.67 The RICO claim, if asserted in
that litigation, would have been a related, non-core proceeding.68 Be-
cause the bankruptcy judge would not have had authority to make a
final determination on the RICO claim, claim preclusion could not be
a consequence of the first lawsuit.

Neither the Seventh Circuit's opinion in Barnett nor its predecessor
in the Fifth Circuit acknowledges the possibility that claim preclusion
effect can follow a determination rendered in a forum that lacks full

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60. Powelson, 878 F.2d at 984. The case was remanded to the district court for
findings concerning the alleged creditor consent. Id. There have been no published reports
of further proceedings.

61. In re Pruitt, 910 F.2d 1160 (3rd Cir. 1990).

62. Id. at 1169 (citing Powelson, 878 F.2d at 983-84).


64. Id. § 157(c)(1).

65. 909 F.2d 973 (7th Cir. 1990).


67. Barnett, 909 F.2d at 981-82.

68. Id.
jurisdictional competence. Such a result is possible under the rule stated in section 24 of the Restatement (Second) of Judgments.69

When a valid and final judgment rendered in an action extinguishes the plaintiff's claim pursuant to rules of merger or bar . . . the claim extinguished includes all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction, or series of connected transactions, out of which the action arose.70

The comments explain:

The rule stated in this Section [barring further litigation] . . . is applicable although the first action is brought in a court which has no jurisdiction to give a judgment for more than a designated amount. When the plaintiff brings an action in such a court and recovers judgment for the maximum amount which the court can award, he is precluded from thereafter maintaining an action for the balance of his claim. It is assumed that a court was available to the plaintiff in the same system of courts . . . where he could have sued for the entire amount. . . . The same considerations apply when the first action is brought in a court which has jurisdiction to redress an invasion of a certain interest of the plaintiff, but not another, and the action goes to judgment on the merits. The plaintiff, having voluntarily brought his action in a court which can grant him only limited relief, cannot insist upon maintaining another action on the claim.71

This general rule, however, is qualified by section 26(1)(c).72

When any of the following circumstances exists, the general rule of § 24 does not apply to extinguish the claim, and part or all of the claim subsists as a possible basis for a second action by the plaintiff against the defendant:

(c) The plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy or form of relief in the

69. Restatement (Second) of Judgments § 24(1) (1982).
70. Id. (citations omitted). In Barnett, because the first action was successful and the bankruptcy court ordered a turnover of trust assets, 909 F.2d at 975, the rule of merger should have precluded further litigation. See Restatement (Second) of Judgments § 18 (1982).
71. Restatement (Second) of Judgments § 24 comment g (emphasis added) (illustrations omitted).
72. Id. § 26(1)(c).
first action because of the limitations on the subject matter jurisdiction of the courts or restrictions on their authority to entertain multiple theories or demands for multiple remedies or forms of relief in a single action, and the plaintiff desires in the second action to rely on that theory or to seek that remedy or form of relief.\textsuperscript{73}

Again, a helpful elaboration appears in the comments:

The general rule of § 24 is largely predicated on the assumption that the jurisdiction in which the first judgment was rendered was one which put no formal barriers in the way of a litigant's presenting to a court in one action the entire claim including any theories of recovery or demands for relief that might have been available to him under applicable law. When such formal barriers in fact existed and were operative against a plaintiff in the first action, it is unfair to preclude him from a second action in which he can present those phases of the claim which he was disabled from presenting in the first.

The formal barriers referred to may stem from limitations on the competency of the \textit{system of courts} in which the first action was instituted, or from the persistence in the system of courts of older modes of procedure—the forms of action or the separation of law from equity or vestigial procedural doctrines associated with either.\textsuperscript{74}

The reference to a "system of courts" found in each comment accurately describes the post-\textit{Marathon} arrangement in which the bankruptcy judge exercises some, but not all, of the decision-making authority necessary to dispose of bankruptcy-related litigation. The limitation on the adjudicative authority of the bankruptcy judge is a limitation applicable to a category of decision-makers within a system, not a "limitation on the competency of the system of courts in which the first action . . . [is] instituted."\textsuperscript{75} It is reasonable, then, to conclude that claim preclusion can be a consequence of a determination in a core proceeding.

Less than a decade ago, the significance of jurisdictional competence was before the United States Supreme Court in \textit{Marrese v. American Academy of Orthopedic Surgeons}.\textsuperscript{76} The precise question was whether

\textsuperscript{73.} \textit{Id.}

\textsuperscript{74.} \textit{Id.} § 26 comment c (emphasis added).

\textsuperscript{75.} \textit{Id.}

a state court judgment in a common law tort action should be given preclusive effect in subsequent antitrust litigation that only could be maintained in federal court. If the court had given an affirmative answer, that outcome would be strong support for the view that preclusive effect can be given to a core proceeding. Marrese, unfortunately, provides no definitive answer because the case was remanded for further proceedings. Justice O'Connor's majority opinion, however, assumes that jurisdictional competency is a normal condition for claim preclusion.

With respect to matters that were not decided in [the first proceeding], we note that claim preclusion generally does not apply where "[t]he plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy because of the limitations on the subject matter jurisdiction of the courts . . . ." Restatement (Second) of Judgments § 26(1)(c) (1982). If state preclusion law includes this requirement of prior jurisdictional competency, which is generally true, a state judgment will not have claim preclusive effect on a cause of action within the exclusive jurisdiction of the federal courts. 77

Nonetheless, later in the same opinion, Justice O'Connor recognized that a different rule might be called for when an intramural, as contrasted with an intersystem, law of preclusion is applied.

If we had a single system of courts and our only concerns were efficiency and finality, it might be desirable to fashion claim preclusion rules that would require a plaintiff to bring suit initially in the forum of most general jurisdiction, thereby resolving as many issues as possible in one proceeding. The decision of the Court of Appeals approximates such a rule inasmuch as it encourages plaintiffs to file suit initially in federal district court and to attempt to bring any state law claims pendant to their federal antitrust claims. Whether this result would reduce the overall burden of litigation is debatable and we decline to base [the outcome in this case] on our opinion on this question. 78

The authorities just discussed do not warrant the conclusion that Barnett was incorrectly decided. They do, however, support the view that the availability of claim preclusion in bankruptcy litigation is a topic that merits more careful consideration by appellate courts than

77. Marrese, 470 U.S. at 382 (brackets and emphasis in original).
78. Id. at 385 (citations omitted).
it has received to date. The precise content of preclusion rules will, of course, ultimately reflect both the special characteristics of bankruptcy disputes and the general attitudes toward claim preclusion in all types of federal litigation. 79

In re Pence 80 merits attention because it departs from the normal practice in bankruptcy, placing a burden of inquiry on creditors. The appellant, Pacesetter Bank, objected to the treatment provided for its lien in a confirmed Chapter 13 plan. It argued that the plan should be revoked because it had never received notice of the confirmation hearing. The Seventh Circuit was unsympathetic. Either Pacesetter received actual notice 81 or

[as] a sophisticated and organized creditor, [it] had knowledge of Mrs. Pence's bankruptcy petition and should have known that a reorganization plan would have to be filed within fifteen days of the petition. Creditors, especially lending institutions like Pacesetter, must follow the administration of the bankruptcy estate to determine what aspects of the proceeding they may want to challenge. Pacesetter was not entitled to stick its head in the sand and pretend it would not lose any rights by not participating in the proceedings. 82

Neither the Bankruptcy Code nor the Bankruptcy Rules place a duty of inquiry on creditors. Indeed, the opposite is true. Both the statute 83 and rules 84 clearly require that creditors be given notice of the confirmation hearing. Although there is some authority for not always insisting on notice in dischargeability litigation, 85 the monitoring obligation imposed by Pence has the potential to be extraordinarily burdensome in most bankruptcy contexts. 86


80. 905 F.2d 1107 (7th Cir. 1990).

81. The basis for disposing of the appeal on this ground is unclear. The Certificate of Mailing for the notice of the confirmation hearing did not contain a listing for Pacesetter Bank. Brief for Appellant at 4, 14-15, In re Pence, 905 F.2d 1107 (No. 89-2416).

82. In re Pence, 905 F.2d at 1109 (citations omitted).


84. Bankr. R. 2002(b) (25 days notice required).


86. Cf. In re Leading Edge Products, 120 Bankr. 616 (Bankr. D. Mass. 1990) (knowledge of the fining of a Chapter 11 plan does not obligate creditor to inquire as to date of hearing on confirmation).
IV. CROSS-BORDER INSOLVENCY

In the typical cross-border insolvency, a bankruptcy proceeding will be commenced in the jurisdiction where the debtor is domiciled or has the greater portion of its assets. The representative appointed in this proceeding will then try to gain control of assets located elsewhere through negotiation or litigation. Several options are available if an asset is located in the United States and litigation is necessary. The foreign insolvency representative may sue in state court, may invoke federal diversity jurisdiction, may commence a full American bankruptcy, or institute an ancillary proceeding as authorized by section 304 of the Bankruptcy Code.\(^7\) The main issue in most reported litigation is the extent to which, if at all, an American court should defer to action taken or proposed by the foreign representative. The adversaries usually are the foreign insolvency representative who wishes to repatriate the assets and domestic creditors who wish to keep them in the United States. The American court must decide whether to grant comity to the foreign proceeding and allow the assets to be moved abroad. *Ma v. Continental Bank*\(^8\) presents the recognition question in a different context. Ma, a citizen of Hong Kong, was a depositor in an Illinois bank. A receiver appointed by a Hong Kong court was able to persuade the bank to return the funds without the benefit of a formal court order. Later Ma challenged this return, claiming that it was a breach of his contract with the bank because it was not pursuant to a court order.\(^9\)

The Seventh Circuit’s rejection of this argument\(^9\) will be welcomed by those who hope for greater and more flexible cooperation between countries in the administration of cross-border insolvencies. *Ma* is significant because the court decided that activity of a foreign representative can be entitled to recognition even though no formal proceedings for an ancillary administration have been initiated in the United States.\(^9\) The bank in *Ma* had the option of demanding an order issued in a section 304 proceeding. However, it was not obliged to do so.\(^9\)

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88. 905 F.2d 1073 (7th Cir. 1990).
90. *Ma*, 905 F.2d at 1076.
91. *Id.*
92. *Id.* at 1076-77. This result is in accord with the better view that an American court can grant comity to a foreign insolvency proceeding even though the foreign representative has not commenced a § 304 proceeding. Cunard S.S. Co. Ltd. v. Salen Reefer Servs. AB, 773 F.2d 452 (2d Cir. 1985) (recognition of foreign proceeding possible although § 304 proceeding is the preferred remedy). *Contra* Refco F/X Assoc., Inc. v. Mebco Bank, S.A., 108 Bankr. 29 (S.D.N.Y. 1989) (section 304 proceeding mandatory).
Moreover, having determined that commencement of a section 304 proceeding would not be required in every case, the court went on to find that it also was not required by the facts of this particular case. Ma argued that the receiver’s informal negotiation approach was prejudicial because it deprived him of the opportunity to collaterally attack the foreign proceeding. The court concluded, however, that, even if a section 304 proceeding had been commenced, the collateral attack would have failed.93

V. DEBTORS’ BENEFITS

There were two interesting debtors’ benefits decisions during the period covered by this survey.94 In re Sanderfoot95 permitted a debtor to exercise the avoidance power contained in section 522(f)96 and set aside a lien created in connection with a division of marital property. The issue of avoiding liens imposed incident to a dissolution of marriage has divided the other circuits as well as this particular panel.97 The Seventh Circuit’s decision is not acceptable when one considers the purpose behind section 522(f). The avoidance power authorized by this provision is designed to prevent impairment of the debtor’s power to exempt property. Two conditions must exist if avoidance is to occur: (1) the impairing event must be the creation of a judicial lien and (2) prior to the creation of the lien, the debtor must have been entitled to an exemption.98

In Sanderfoot, the lien on the Debtor’s property was imposed by a Wisconsin state court in connection with a divorce settlement. A jointly-owned home had been awarded to the husband. The wife’s interest was protected by an order of payment and a lien. This was clearly a judicial lien. Nevertheless, the second condition for exercise of the power was not satisfied — prior to the creation of the lien, the debtor was merely a co-owner of the property. Therefore, the debtor could not have claimed an exemption for his sole benefit in his spouse’s share of this property.

93. Ma, 905 F.2d at 1076.
94. Farrey v. Sanderfoot (In re Sanderfoot), 899 F.2d 598 (7th Cir.), cert. granted, 111 S. Ct. 507 (Nov. 26, 1990); In re Edwards, 901 F.2d 1383 (7th Cir. 1990).
95. 899 F.2d 598.
97. For avoidance: Stedman v. Pederson (In re Pederson), 875 F.2d 781 (9th Cir. 1989); Maus v. Maus, 837 F.2d 935 (10th Cir. 1988). The Maus decision is distinguished in Borman v. Leiker (In re Borman), 886 F.2d 273, 274 (10th Cir. 1989) and Parker v. Donahue (In re Donahue), 862 F.2d 259, 265 (10th Cir. 1988).
Against avoidance: Boyd v. Robinson, 741 F.2d 1112 (8th Cir. 1984).
Section 522(f)(1) is designed to nullify lien acquisition only when the property is already exemptible prior to the creation of the lien. That was not true in Sanderfoot. Judge Posner saw this clearly and his dissent is much more persuasive than the majority opinion.

No creditor beat the debtor into court. The lien was created by a court, it is true, but not to enable a creditor to defeat his debtor's household exemption; it was done to protect a spouse's preexisting property rights.

I am at a loss to understand why we should strain the language and ignore the purpose of the lien-avoidance statute in order to achieve a result that does not promote, but instead denies, simple justice — layman's justice.100

In re Edwards101 addresses an issue that also has been the subject of some controversy. The court determined that a Chapter 7 debtor, even one current in payments to a secured creditor, must either redeem or reaffirm if she wishes to retain the collateral — the debtor may not simply remain in possession and continue making payments. In Edwards, the debtor indicated a desire to retain the collateral over the objection of the secured creditor. The bankruptcy judge ordered her to choose between a reaffirmation agreement satisfactory to the creditor, redemption, or surrender of the collateral. The Seventh Circuit correctly affirmed.103

The debtor who wishes to retain property subject to the security interest is not entitled to redeem the collateral through installment payments. Section 722 clearly requires a lump sum cash redemption. The individual who wishes to redeem his property through installment payments, and who cannot obtain the creditor's consent to a reaffirmation arrangement, always has the option of filing under Chapter 13. Nonetheless, the Tenth Circuit has allowed the debtor to remain in possession without entering into an enforceable reaffirmation agreement.105 This is unfair from the perspective of the secured creditor. If a discharge is granted, the original recourse loan becomes a non-recourse obligation.

100. Id. at 606-07.
101. 901 F.2d 1383 (7th Cir. 1990).
102. Id. at 1386.
103. Id. at 1387.
105. Lowry Fed. Credit Union v. West, 882 F.2d 1543 (10th Cir. 1989).
without any creditor consent to the change in status. The Seventh Circuit wisely refused to follow this precedent.106

106. In re Edwards, 901 F.2d at 1386.