BANKRUPTCY LAW NEWSLETTER

Published By Federal Bar Association
Western District of Michigan Chapter

Vol. I, No. 11 **July, 1989**

CREDITORS' COMMITTEES

*By Timothy J. Curtin**

(Part One)

This two-part article will deal generally with the selection, representation, and duties of a Creditors' Committee. Part One discusses the formation of the Committee and the eligibility of creditors to serve on the same. The authors will focus on practical suggestions rather than legal theory.

Background

While Creditors' Committees have existed in bankruptcy cases at least since the Bankruptcy Act of 1898, Committees originally were only advisory bodies in liquidation cases. Section 44(b) of the Bankruptcy Act ("Act") contemplated that the creditors at the first meeting could, but were not required to, elect a Committee to "consult and advise with the Trustee" on the administration of the case. However, the Committee's duties were necessarily limited as the Trustee was charged with the complete responsibility for liquidating and distributing the assets.

The Committee's role began to change with the addition of the reorganization chapters to the Act. Chapter XI specifically provided for the appointment of an official committee of creditors and case law developed under Chapters X and XII to authorize the appointment of Committees.

Creditors' Committees were not mandatory under the reorganization chapters of the Act. However, the Court was empowered to appoint a Committee, even if the creditors did not elect one, if the Court believed it was in the best interest of creditors.

With the increasing appointment of Creditors' Committees in cases under the reorganization chapters, Committees began to assume a larger role in such cases. This role further was expanded by the adoption of the Rules of Bankruptcy Procedure in 1972. Those rules contemplated, in Chapter XI cases, that the debtor would ordinarily stay in possession to operate the business. This was a substantial change in many districts, including the Western District of Michigan, where the Court had routinely appointed operating receivers in Chapter XI cases. With fewer receivers being appointed, Creditors' Committees, by default, were left as the only court-appointed watchdog of a debtor.

Congress gave additional legislative blessing to the Committee's expanded role in the Bankruptcy Code ("Code") of 1978. The legislative history of the Code stated that the Creditors' Committee would be the primary negotiating body for the formulation of the Plan of Reorganization and would also "provide supervision of the debtor-in-possession." (HR 95-595, 95th Cong 1st Sess 401, 1977.)

Unfortunately, beyond making the Committee a party in interest in all matters in a Chapter 11 case, Congress did very little else to arm the Committee with the information and resources necessary to effectively negotiate a Plan and supervise the debtor. This is particularly true in the medium- and small-sized Chapter 11 cases which are the focus of this article. In such cases Committees do not ordinarily have the financial resources with which to employ a team of specialized professionals. Even when a competent counsel can be found for the Committee, he/she many times is constrained in retaining other professionals, such as accountants. As a result, although Committees are contemplated by the legislative scheme as being one of the principal builders of a Chapter 11 Plan, they, all too often, are called upon to make bricks without straw. See, "Debtors-Out-Of-Control," Curtin, Gross and Togut, Annual Survey of Bankruptcy Law 1988, Callaghan and Company 1988; and "The Debtor In Full Control," LoPucki, 57 Am Bankr LJ 99 (1983).

Eligibility To Serve

Eligibility to serve on the Creditors' Committee is generally set out in Section 1102(b) of the Code. Only two criteria are specified. A Committee member must be a "person" and that person must hold an unsecured "claim."

Both "person" and "claim" are defined in Section 101 of the Code. With regard to a "person," it is clear that it does not include a governmental entity except in certain, narrowly defined circumstances. The Internal Revenue Service, for instance, may not serve upon a Creditors' Committee. And neither may the Pension Benefit Guarantee Corporation. See, In Re Mansfield Tire & Rubber Co, 11 CBC 2d 381 (ND Ohio 1983).

It is assumed that governmental entities generally were excluded from serving on Creditors' Committees because those entities routinely enjoy one type of priority for their claims. However, as we will see later, the mere holding of a priority claim has not prevented the appointment of other types of "persons" to a Creditors' Committee.

Courts have further held that trusts are not eligible to serve on a Creditors' Committee because they are not within

* This is the first installment of a two-part article. The second installment will be authored by Robert W. Sawdey.

Mr. Curtin is a partner in the law firm of Varnum, Riddering, Schmidt & Howlett of Grand Rapids, Kalamazoo, and Lansing. Mr. Curtin received his Juris Doctor from the University of Michigan Law School in 1967. He is a member of the Subcommittee on Chapter 11 of the ABA's Business Bankruptcy Committee. Mr. Curtin is also a member of the Debtor-Creditor Law Section of the Business Law Section, State Bar of Michigan.

the definition of a "person" found in § 101, which defines a person as an "individual, partnership, and corporation." One would have also thought that a union, as an unincorporated association, would likewise be ineligible to serve. However, the definition of "corporation" under § 101 does include "unincorporated associations." As a result, unions have been found to be "persons" eligible to serve. See, In Re Matter of Schatz Federal Bearings Co Inc, 2 CBC 2d 741 (Bankr Ct SD NY 1980), and In Re Altair Airlines Inc, 727 F2d 88 (3rd Cir 1984).

Because of the broad provisions of Section 1102, almost no creditor holding an unsecured claim is automatically prohibited from serving on the Creditors' Committee.

The Appointment Process

With the adoption of the 1986 amendments to Section 1102, the power to initially appoint the Creditors' Committee was given to the United States Trustee. Ordinarily, that officer takes the list of the twenty largest unsecured creditors as filed by the Debtor at the commencement of the case and, depending upon the apparent urgency of the situation, either calls or writes those creditors to determine their willingness to serve. Although not specifically required by the Code or the Rules, the U.S. Trustee ordinarily requires a creditor to indicate his/her willingness to serve in writing.

Once the U.S. Trustee has completed the survey, he/she presents to the Judge the Order For Appointment Of The Unsecured Creditors' Committee (Official Form No. 15). Official Form 15 contemplates that no more than seven creditors will be appointed to serve on the Committee. This accords with Section 1102 which provides that ordinarily the Committee will be appointed from those persons who are willing to serve that hold the seven largest unsecured claims against the creditor. However, in practice, the U.S. Trustee occasionally appoints more than seven members to a Committee.

It is also possible for the U.S. Trustee to appoint a pre-filing committee to serve as the Creditors' Committee in the case. (See Section 1102(b)(1).) While this is routine in some jurisdictions, it is not normal in the Western District of Michigan. The rather stringent provisions of Bankruptcy Rule 2007 relating to the qualification of a pre-filing committee severely restrict the number of cases in which such a committee can be appointed as the Official Committee.

In some measure, it is unfortunate that Rule 2007 incorporates the rather inflexible procedural restrictions on appointment of pre-filing committees. As will be discussed in the second part of this article, in many cases the most important time to have a Creditors' Committee is at the commencement of the Chapter 11 case. The provisions of Rule 2007 can lead to unnecessary delay in the organization of the creditor body, leaving it, effectively, without a voice in the important initial negotiations.

The U.S. Trustee has attempted, with the staff available, to address this problem by acting as quickly as possible, at least in larger cases, to see that the creditors are given notice of the proceedings and an opportunity to form a Committee. All practitioners would do well to emphasize to their clients who may be asked to serve on a Creditors' Committee that time is of the essence. Many important Orders, such as Cash Collateral orders and borrowing orders under Section 364 of the Code, are routinely entered in the initial stages of a Chapter 11. If the creditor body receives notice but fails to organize, it may find that very significant rights are lost at the very commencement of the case.

In addition, if counsel is requested by one or more potential Committee members to make a presentation to the Committee in connection with possibly representing it, that counsel should move immediately to cooperate with the U.S. Trustee and to provide whatever assistance he/she can to see that the Committee is formed absolutely as soon as possible. While the U.S. Trustee's office will of course insist that all firms who have been asked to make a presentation to a Committee are given a fair hearing, it will ordinarily cooperate with any and all counsel to see that the process of Committee formation is expedited.

Initial Meeting of Committee

It is essential that the first meeting of the Committee be held as soon as possible. Under Section 1103 of the Bankruptcy Code, the Committee cannot organize, choose professionals, and begin to supervise the Debtor until it is first brought together in a meeting. While ordinarily the U.S. Trustee will call a meeting of the Committee, there is no prohibition against the members of the Committee scheduling a meeting themselves at an earlier date. For the reasons given above, it, in fact, is crucial that the Committee do so.

The place of the meeting is immaterial. However, the most convenient place should be chosen. In cases where Committee members come from all over the country, consideration should be given to meeting at a central airport location, at least for the initial meeting, where Committee members are able to get in and out of the meeting conveniently. Of course, even if the Committee members decide to convene the initial meeting in a location outside of the District, the U.S. Trustee should be given notice of the meeting and an opportunity to appear and address the Committee.

At the initial meeting, the U.S. Trustee ordinarily gives a brief explanation of the duties of the Committee, the selection of a chair, and the ability of the Committee to appoint professionals. In those remarks, the U.S. Trustee usually also will cover the question of how Committee professionals are to be compensated under the Bankruptcy Code.

Necessarily, however, the U.S. Trustee does not have a substantial amount of time to devote to each individual case and his/her remarks are necessarily quite general in nature. With Committees that our office represents, we supplement the initial remarks with information gained before the meeting from the schedules, if available, and from conversations with major creditors and the Debtor. If schedules have been filed, we will distribute a copy to all members at the initial meeting.

In addition, we find it very helpful to supplement the remarks, particularly on the duties of Committee members and the role of a Creditors' Committee, by letter sent to all members of the Committee following the meeting. In that letter, we detail the most important duties of Committee members and rights of Creditors' Committees generally.

At the initial meeting, it is very helpful for someone (the U.S. Trustee, a major creditor instrumental in forming the Committee, or counsel who have been asked to appear and make a presentation to the Committee) to have prepared an agenda for consideration by the Committee. This helps organize the meeting and cut down on wasted time.

If we prepare the agenda, it covers such things as the election of the Chair of the Committee, a brief description of the duties of the Committee, a determination of any conflicts of interest or extraordinary connections that members may have with the Debtor or its principals, consideration of the necessity for a Secretary, consideration of the employment of professionals, consideration of possible formal bylaws for the Committee, consideration of the type of voting to be used by the Committee, consideration of the appointment of an Executive Committee, and the like. While each of these matters merits substantial discussion, I will touch on only two or three.

First is a consideration of whether or not formal bylaws need to be adopted. While our office has represented a number of Committees with formal bylaws, we ordinarily do not insist on the adoption of such bylaws. However, counsel should strongly advise the adoption of bylaws if it appears that there could be substantial divisions within the Committee. If Committee actions are going to be subject to constant wrangling within the Committee, the ground rules might as well be established at the outset. This is even more true when counsel senses a substantial risk that the confidentiality of Committee discussions will be breached by a member who, for one reason or another, may have loyalties more directly aligned with the Debtor than with its creditors. Once appointed to a Committee, such a person is difficult to remove and the Committee should act to protect itself, to the extent possible, through the adoption of appropriate bylaws on confidentiality.

Selection of Committee counsel is many times the most important decision a Committee makes. This is true not because lawyers are smarter than everyone else, but because Chapter 11 is literally <u>running a business through Court proceedings</u> employing a very specialized body of law. Technical expertise is of course the single most important quality that a Committee should look for in its counsel. Happily, the Western District of Michigan has a number of qualified practitioners who represent Creditors' Committees, most of whom are quite willing to make presentations to Committees as to the qualifications of their firms.

However, the selection of the Committee's lawyers is only the beginning of the process of the consideration of professionals in a Chapter 11 case. It is also possible for a Committee to employ accountants, appraisers, investment bankers, and the like. Because of the tradition in the Western District of Michigan and because most of the cases filed in the District are not "mega-cases," it has not been routine for Committees to employ other professionals. This, on the whole, is generally good in that it keeps down administrative expenses. There are several jurisdictions across the country where each law firm which represents Creditors' Committees is effectively a package deal with an accounting firm in that area. In a modest case, the administrative burden can be crushing to a Debtor. Of course, in the appropriate circumstances, other professionals, such as accountants, are absolutely necessary for a Committee. While Committees should not hesitate to retain such other professionals, where needed, I would hate to see it become a routine practice in our District.

In addition to the agenda items noted above, I believe that in many cases it is wise to arrange to have a representative of the Debtor attend a portion of the meeting of the Committee and address the Committee members regarding the Debtor's plans, both long- and short-term. Even if it is not possible to have a representative of the Debtor attend the initial meeting, a meeting with a representative of the Debtor should be arranged as quickly as possible after the Committee's formational meeting.

Finally, beyond the formal considerations of governance of the Committee, such as adoption of the bylaws and the type of voting, two practical questions of Committee governance should be addressed. First, if the Committee has an even number of members, some consideration should be given to the addition or requested resignation of one member so that tie votes can be avoided where possible.

Second, the delegation of a substantial portion of the Committee's duties, particularly as they relate to the Committee's function to oversee the Debtor's day-to-day activities, should be delegated to an Executive Committee of approximately three members, including the Chairman. In every Chapter 11 case of any significant size, matters arise almost daily upon which the Court or the Debtor or some other party in interest wishes a statement of the position of the Creditors' Committee. It is simply too cumbersome and too expensive to try to have all of such decisions made by a Committee of the whole. While counsel for the Committee can feel comfortable in making some of these decisions within the general guidelines of the Committee, there are numerous times where that counsel requires the thoughts of some members of the Committee who, after all, at least initially are most familiar with the Debtor. Our office strongly urges Committees which we represent to select an Executive Committee and to grant to it rather broad powers so that we have a recognized body with which to consult.

Of course, for very major decisions, such as the negotiation of a Plan or a decision as to a motion for the appointment of a Trustee or for a conversion of the case, it is necessary to consult the Committee as a whole.

<u>Changing Committee Membership</u>

This topic has generated a substantial amount of law. However, it is not the purpose of this article to write a treatise on the various decisions Courts have made as to which creditors may or may not serve as members of a Creditors' Committee because they are "insiders" or competitors or hold positions in actual or potential conflict with the Debtor or the creditor body generally. Rather, I will attempt to state some general considerations which routinely arise relating to the makeup of Creditors' Committees and decisions as to who should, and should not, be allowed to serve.

Prior to the 1986 amendments, the Bankruptcy Court was specifically empowered under Section 1102(c) to change the membership or size of a Creditors' Committee. However, that entire Section was deleted. While the case law is still developing in the area, many commentators believe that the U.S. Trustee now has plenary power over at least the initial size and membership of a Creditors' Committee.

Unfortunately, although Section 1102(c) was deleted, there was no comparable section adopted relating to the power of the U.S. Trustee to remove persons from a Committee. What case law has developed in the area, principally in U.S. Trustee Districts under the pilot program, supported the ability of the U.S. Trustee to remove persons from the Committee. <u>See, e.g., In Re Hadar Leasing International Co</u>, 4 CBC 2d 646 (Bankr Ct SD NY 1981), and <u>In Re Daig Corp</u>, 5 CBC 2d 233 (Bankr Ct D Minn 1981).

As a result, when a substantial majority of the members of a Committee believe that it is inappropriate for a member originally appointed to continue to serve, the Committee should raise the matter with the U.S. Trustee. At least initially, that official's decision will generally be dispositive. However, in extraordinary circumstances, it seems to me to be that the Bankruptcy Court's general powers under Section 105, including the newly added language giving the Court sua sponte powers to take "any action" and to make "any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process," could be utilized to bring the matter before the Court should the U.S. Trustee refuse to act.

The reasons why a Committee may move for the removal of one of its members are varied. A member may be a technical "insider" as defined by Section 101. A member, although not technically an insider, may have other close relationships to the Debtor which threaten the confidentiality of the Committee's deliberations or otherwise constrain the Committee from a frank and fair review of the Debtor's actions and plans. A member of the Committee may hold some type of a priority or secured claim which, by the nature of the case, makes it inappropriate for that member to serve on the Committee.

While Committees should not be at all reticent about seeking the removal of a member who, in the Committee's opinion, seriously compromises the Committee's function, I urge some caution in this regard, at least in a couple of areas. First, there has been a substantial amount of litigation as to whether or not a union should be allowed to serve as a member of a Creditors' Committee. Creditors have a legitimate concern that a union may have a much more substantial interest in preserving jobs than it does in maximizing a monetary dividend to unsecured creditors. However, in a great many cases, it is simply not possible to reorganize the Debtor without the cooperation of the union. Automatically seeking the removal of a union from the Committee is not, in my opinion, warranted in most cases. It isolates a very important player in the reorganization process and it cuts the Committee off from a potentially valuable source of information about the Debtor's abilities and prospects. Rather, our office, on several occasions, has suggested, when we represent a Committee to which a union has initially been appointed, that the union give certain assurances with regard to confidentiality of matters discussed and nonparticipation in certain types of discussions and votes by the Committee. This is best done in the initial stages of the case, before a particular question arises.

A second type of creditor who should not be routinely excluded from the Committee are former professionals who worked for the Debtor, such as attorneys and accountants. Unfortunately, many times these persons end up being among the larger unsecured creditors. While there is a natural suspicion of such persons because of their former close associations with the Debtor, they may be extremely valuable sources of information about the Debtor's prospects. When the situation has arisen, we have requested from the Debtor immediate waivers of any privileges that it could assert in connection with information that may be divulged by these professionals. Ordinarily, if asked early in the case, the Debtor will waive any applicable privilege.

The final matter that should be discussed on the makeup of the Committee itself is the question of additions to the Committee. I think it is fair to say that in our District the U.S. Trustee follows the axiom of "the more, the merrier." While this is not objectionable in and of itself, it can become a problem if the Committee becomes too large. The sheer logistics in calling Creditors' Committee meetings of eight or more creditors are sometimes quite severe. Important decisions in some cases have to be delayed because a quorum of Committee members is not available. The larger the Committee, the more difficult the problem becomes.

Congress recognized that more is not necessarily better in the makeup of Creditors' Committees. It, therefore, provided that Committees will ordinarily be made up of those of the seven largest creditors willing to serve. The implication is, of course, that seven was a maximum. Except in the most unusual case, consideration should be given to requesting the U.S. Trustee not to willy-nilly add additional members to a Committee, at least if that Committee is already five members or larger and is generally representative of the unsecured creditors.

Information For The Committee

The final area to be covered by this first article relates to the information to be made available to Committee members so that they can adequately perform their duties and advise their counsel. The Definitive Order routinely entered in the Western District contemplates that the Creditors' Committee will receive copies of the same type of reports as are made to the U.S. Trustee. This, unfortunately, is many times honored in the breach. It is impossible for the Committee to perform its functions without sufficient information.

The problem should be addressed in several ways. First, the Committee's counsel should automatically file a Notice of Appearance and request to be placed on the matrix immediately. Second, that counsel should monitor, with the U.S. Trustee, the reports to be filed by the Debtor and insist through appropriate Motions or otherwise that he/she receive the reports immediately after they are filed and that the reports are filed timely. Third, counsel should review with the U.S. Trustee the initial provisions of the Definitive Order, if it has been entered before the formation of the Committee, to see that the Committee agrees that the reports required are sufficient. If the Committee believes that additional or more frequent reports are necessary, this should be discussed with the U.S. Trustee and made the subject of a formal Court Order.

Finally, those reports do only a limited amount of good unless they are routinely circulated by counsel to the members of at least the Executive Committee. It is gratifying that members of Creditors' Committees, even though they are not being paid, many times give substantial attention to the Debtor's reports and bring to the attention of counsel and the Court matters which otherwise may go unnoticed. Many of the creditors serving on the Committee may have a long history with the Debtor and a substantial amount of background, not available to Committee counsel or to the U.S. Trustee, which they bring to the reports. While not true in all cases, many members of the Creditors' Committee take very seriously their duties to monitor the Debtor's activities and they can be an invaluable aid to Committee counsel in protecting the interests of the unsecured creditors. However, they cannot perform this function unless they have the information in a timely manner. As a result, our office routinely delegates a paralegal to monitor the filing of reports by the Debtor and to see that those reports are circulated to Committee members as soon as they are available and have been reviewed by the principal counsel in charge of the case.

Summary

The Committee is now up and operating. Part Two will discuss the duties and responsibilities of the Committee.

RECENT BANKRUPTCY DECISIONS

The following are summaries of recent decisions rendered by the United States Supreme Court, the Sixth Circuit Court of Appeals, and federal district and bankruptcy courts in Michigan that address important issues of bankruptcy law and procedure. These summaries were prepared by Patrick E. Mears with the able assistance of Larry A. Ver Merris.

Hoffman v. Connecticut Department of Income Maintenance, Case No. 88-412 (Sup. Ct. June 23, 1989). In this decision, the United States Supreme Court resolved a conflict that existed among several circuit courts of appeal by holding that the doctrine of sovereign immunity insulates a state that has not filed a proof of claim in a bankruptcy case from being sued for the turnover of moneys or the return of voidable preferences. The Supreme Court held that 11 U.S.C. § 106(c) does not abrogate the doctrine of sovereign immunity granted to states by the Eleventh Amendment to the U.S. Constitution.

Granfinanciera, S.A. v. Nordberg, Case No. 87-1716 (Sup. Ct. June 23, 1989). This Supreme Court decision arose from the Chapter 11 case commenced by Chase & Sanborn Corporation in the United States Bankruptcy Court for the Southern District of Florida. In this case, the Chapter 11 trustee commenced an action for recovery of a fraudulent conveyance against two entities that had not filed proofs of claim in the bankruptcy case. This action, originally filed in federal district court, was thereafter referred to the bankruptcy court for decision. The defendants thereupon requested that court to conduct a jury trial. This request was denied on the ground that the action was a core proceeding and, therefore, the defendants were not entitled to a jury trial. The bankruptcy court thereafter conducted a bench trial and, at its conclusion, entered money judgments against the two defendants. Both the federal district court and the Eleventh Circuit Court of Appeals affirmed the bankruptcy court's decision. This latter court specifically held that, since actions to recover fraudulent transfers were equitable in nature and since bankruptcy proceedings are also equitable, the Seventh Amendment to the U.S. Constitution did not grant the defendants a right to a jury trial in these actions. On appeal, the Supreme Court reversed.

The Opinion of the Court, authored by Justice Brennan, first concluded that fraudulent conveyance actions to recover money had to be tried at law and not in equity in Eighteenth Century England. Therefore, the Seventh Amendment's grant of the right to a jury trial would apply to the instant action commenced by the trustee. The court then cited its earlier decision in Schoenthal v. Irving Trust Co., 287 U.S. 92 (1932), in support of its finding that the trustee's cause of action is properly characterized as legal rather than equitable. In Schoenthal, the defendants had not filed proofs of claim in the bankruptcy case and were sued by the trustee for the recovery of preferences. The Supreme Court held in Schoenthal that the preference action had to proceed at law and not in equity.

The Supreme Court then addressed the 1984 Amendments to the Bankruptcy Code that characterized fraudulent conveyance actions as core proceedings. The Court phrased the issue before it as follows: "whether the Seventh Amendment confers a right to a jury trial in face of Congress' decision to allow a non-Article III tribunal to adjudicate the claims against them." The Court answered this question in the affirmative, rejecting the argument that Congress' classification of fraudulent conveyance actions as core proceedings evidenced a legislative intent to abrogate defendants' Seventh Amendment rights. The Court characterized this classification as a mere "taxonomic change" that could not alter its analysis of the Seventh Amendment.

The final two paragraphs of the Court's opinion left open a number of issues concerning the authority of a bankruptcy court to conduct jury trials:

> We do not decide today whether the current jury trial provision--28 U.S.C. section 1411 (1982 ed., Supp. IV)--permits bankruptcy courts to conduct jury trials in fraudulent conveyance actions like the one respondent initiated. Nor do we express any view as to whether the Seventh Amendment or Article III allows jury trials in such actions to be held before non-Article III bankruptcy judges subject to the oversight provided by the district courts pursuant to the 1984 Amendments. We leave those issues for future decisions.
>
> We do hold, however, that whatever the answers to these questions, the Seventh Amendment entitles petitioners to the jury trial they requested.

California State Board of Equalization v. Sierra Summit, Inc., Case No. 88-681 (Sup. Ct. June 12, 1989). In this case, the California State Board of Equalization appealed to the United States Supreme Court from a decision of the Ninth Circuit Court of Appeals enjoining the State from assessing and collecting sales and use taxes on the proceeds of a bankruptcy trustee's liquidation sale. The Supreme Court vacated the Ninth Circuit's judgment, holding that states are not prohibited by the intergovernmental tax immunity doctrine from assessing these taxes upon property of bankruptcy estates. This decision resolved a conflict that previously existed among various circuit courts of appeal.

First Federal of Michigan v. Barrow, Case Nos. 86-1855, 87-1402/1414 (6th Cir. June 16, 1989). This appeal arose from the Salem Mortgage Co. Chapter 11 cases that were commenced in the Bankruptcy Court for the Eastern District of Michigan in 1983. Salem Mortgage Co. and several related corporations acted as "mortgage brokers" locating investors to supply mortgage money for persons seeking real estate loans. Salem and its affiliates originally established separate escrow accounts for each mortgage, into which the mortgagor's payments would be deposited. From these accounts, the real estate taxes, insurance, and first mortgage payments (if any) would be disbursed along with payments to the investor/lender. When Salem began to experience cash flow problems in 1982, Salem abandoned the use of separate escrow accounts and deposited all mortgage payments into a zero balance Depository Account. These commingled moneys were thereafter transferred into a Central Account, thereupon becoming commingled once again. Disbursements to investors, insurance companies, and tax authorities were thereafter made from this Central Account, which often resulted in five-figure negative balances. Within 90 days prior to Salem's bankruptcy, Salem was "disbursing its commingled funds from the Central Account to certain favored creditors and appellants herein on behalf of selected investors."

On March 30, 1983, Salem and its affiliates filed Chapter 11 petitions with the Detroit Bankruptcy Court. Approximately 1 year later, the trustee appointed in these Chapter 11 cases commenced a class action under FRCP 23(b)(1) against investors, first mortgage holders, taxing authorities, insurance companies, and insurance agencies to recover alleged preferences. On September 16, 1985, 2 months prior to the conversion of these Chapter 11 cases to Chapter 7, the bankruptcy court granted the trustee's motion for summary judgment against the preference defendants. The district court affirmed this decision on appeal, whereupon certain of the defendants filed an appeal with the Sixth Circuit Court of Appeals.

In the Sixth Circuit, the appellants argued that they should not be held liable for the return of preferences on the following grounds: (i) the moneys received by them within the 90-day period were impressed with a constructive trust and, therefore, immune from a preference challenge; (ii) the payments were not made on account of antecedent debts owed by Salem; (iii) the transfers did not enable defendants to receive more than they would have recovered in a Chapter 7 case had the transfers not been made; and (iv) that the payments were transfers made in the ordinary course of business under 11 U.S.C. § 547(c)(2).

The Sixth Circuit first rejected appellants' constructive trust argument since appellants failed to trace the moneys they received through Salem's commingled accounts. The Court did not accept appellants' contention that the earlier decision of Selby v. Ford Motor Co., 540 F.2d 642 (6th Cir. 1979) dispensed with this tracing requirement. According to the Barrow Court, "[i]t is beyond peradventure that, as a general rule, any party seeking to impress a trust upon funds for the purposes of exemption from a bankrupt estate must identify the trust fund in its original or substituted form."

Further on in the opinion, the Sixth Circuit rejected the appellant's argument that the transfers were not made on account of an antecedent debt owed by Salem. Appellants contended that the debts were owing by the mortgagors and not by Salem, which merely serviced the mortgages involved. The Sixth Circuit declared that Salem's wrongful conduct in violation of its fiduciary duties "realigned the configuration of certain debtor-creditor relationships." Salem therefore became indebted to appellants because of its misappropriation of trust moneys. These transfers also resulted in preferences since they were made at a time "when the bankrupt estate was incapable of 100 percent satisfaction of general creditor claims."

The Sixth Circuit then rejected the appellant's assertion that the transfers were made in the ordinary course of business. This defense could not apply "given the totally unorthodox and illegal manner in which debtors conducted their collective business operations" during the preference period.

Finally, the bankruptcy court's certification of the adversary proceeding as a class action under FRCP 23(b)(1) was held not to constitute an abuse of discretion.

In re Cottrell, Case No. 88-5321 (6th Cir. June 5, 1989). This decision resolves the uncertainty created 6 years earlier when the Sixth Circuit issued its opinion in Baker v. Auger, 709 F.2d 1063 (6th Cir. 1983). In Baker, a three-judge panel of the Sixth Circuit held that nonassignable causes of action belonging to a debtor were not "property of the estate" under 11 U.S.C. § 541, applying a rationale based upon pre-Code law. In Cottrell, the Sixth Circuit overruled Baker and squarely held that a debtor's personal injury action, whether or not assignable under applicable state law, constitutes property of the estate to be administered by the trustee, unless properly exempted by the debtor.

Scrima v. The John DeVries Agency, Inc., Case No. K 88-303 (W.D. Mich. May 31, 1989). Prior to commencing his bankruptcy case, Joseph Scrima operated a shoe store and shoe repair business in a building owned by him. These business assets were insured by Transamerica Insurance Company as of the date on which he and his wife filed a joint Chapter 13 petition, viz., July 26, 1985. The debtors' failed to notify Transamerica of their bankruptcy filing and, on September 13, 1985, the debtors' case was converted to one under Chapter 11. On August 9, 1985, Transamerica informed the debtors that it was canceling the insurance policy effective September 11, 1985. On that date, the debtors obtained a replacement policy from Insurance Company of North America ("INA") which contained limits lower than those in the canceled Transamerica policy. Eleven days later, a former shoe store employee burned the store, destroying the structure and its contents. Ultimately, Joseph Scrima commenced an adversary proceeding against Transamerica, INA, and others to recover these losses. After trial was held in August, 1988, Bankruptcy Judge Laurence Howard dismissed Joseph Scrima's claims (and INA's cross-claims) against Transamerica on the ground that, even though Transamerica had violated the automatic stay in canceling the policy, Scrima had consented to and ratified this cancellation. On appeal, District Judge Robert Holmes Bell reversed the bankruptcy court on the grounds that (i) Transamerica's attempted cancellation was void ab initio; and (ii) Joseph Scrima lacked the necessary scienter to ratify or consent to this cancellation. According to Judge Bell, "[t]he facts of this case indicate that Scrima was not aware of his rights under the automatic stay .... Scrima's fundamental ignorance of the effect of the automatic stay on an insurer's cancellation of an insurance policy vitiated Scrima's consent or ratification by acquiescence."

Munn v. Michigan National Corp., Case No. 87-CV-74018-DT (E.D. Mich. May 30, 1989). District Judge Barbara Hackett was requested in this appeal to reverse the order of the bankruptcy court imposing sanctions on the plaintiffs debtors under Bankruptcy Rule 9011. Bankruptcy Judge Ray Reynolds Graves found that the plaintiffs had commenced an adversary proceeding against a bank for improper purposes and had withheld relevant facts from their counsel. Consequently, the bankruptcy court ordered the plaintiffs to pay the bank $87,566.33 for their reasonable expenses, attorney fees, and costs. District Judge Hackett affirmed this order upon a thorough review of the record below. Her opinion contains an extensive discussion of the case law decided developed under Rule 11 of the Federal Rules of Civil Procedure and its analog, Bankruptcy Rule 9011.

Deal v. Michigan Dairy Herd Improvement Ass'n, Inc., Adversary Proceeding No. 88-0274 (Bankr. W.D. Mich. June 22, 1989). This decision, rendered by Bankruptcy Judge James D. Gregg after trial, contains an extensive discussion of Michigan negligence law. This adversary proceeding was commenced by two debtors to recover damages allegedly caused by defendant's negligent acts that caused a malfunction of debtor's milking system. Judge Gregg awarded the debtors a damage award of $30,888.68 reduced by 50 percent due to their comparative negligence. This sixty-three page opinion addressing the intricacies of mastitis has been marked "Not for Publication" by Judge Gregg.

In re Coulston, 98 Bankr. 280 (Bankr. E.D. Mich. 1989). This decision, authored by Bankruptcy Judge Arthur Spector, discusses the requirements for eligibility to file a Chapter 12 petition contained in 11 U.S.C. §§ 101(17) and (20). As stated by Judge Spector, "[f]or a debtor to be adjudged eligible for such relief it must appear that more than 50 percent of the debtor's gross income for the year prior to the year in which the case is filed was derived from a 'farming operation' as defined in 11 U.S.C. § 101(20)." The Chapter 12 debtor before the court derived $27,000 as cash rental for farmland in the relevant year, i.e., 1987. The issue, answered in the affirmative by Judge Spector, was "whether [the debtor's] income from the leasing of tillable land constitutes income from a farming operation to allow him to qualify for Chapter 12 relief." In deciding this issue, Judge Spector adopted a "totality of the circumstances" approach and rejected the "mechanistic risk analysis approach." This latter test requires a debtor to assume the economic risk of farming in order to qualify for Chapter 12 relief. Judge Spector concluded that, under the "totality of circumstances" test, the debtor's rental income is "the fruit of a legitimate strategy to retain the farm for himself for purposes of his continuing to farm it, and, so, is derived from a farming operation."

Industrial Insurance Services, Inc. v. Zick, Adversary Proceeding No. 88-0955 (Bankr. E.D. Mich. May 30, 1989). Prior to David Zick's filing of his Chapter 7 petition, he was the named defendant in a state court action commenced by Industrial Insurance Services, Inc. ("IIS") alleging certain willful and malicious actions. Thereafter, this action was mediated and a mediation award of $600,000 in favor of IIS was accepted by both parties. This award was thereafter embodied in a judgment entered by the state court on August 31, 1988. Nine days later, Zick commenced his Chapter 7 case which was assigned to Bankruptcy Judge Graves for administration. Thereafter, IIS commenced an adversary proceeding requesting a determination that its $600,000 claim was nondischargeable on res judicata grounds and moved for partial summary judgment. In his opinion denying this motion, Judge Graves first noted that the $600,000 state court judgment was akin to a consent judgment. The entry of this judgment was "an administrative or ministerial act involving no exercise or judgment or discretion." Under Michigan law, collateral estoppel effect is not accorded to consent judgments unless the parties to the judgment intend to be bound on certain issues of fact and the judgment reflects that intention. Similar rules apply to nondischargeability proceedings in bankruptcy courts.

Applying these principles to the case before him, Judge Graves found that the state court judgment established the amount of IIS's unsecured claim but that the judgment could not be granted collateral estoppel effect on the question of nondischargeability. IIS was permitted to submit to the bankruptcy court "the state court record, the judgment, and extrinsic evidence to support" its claim of nondischargeability.

Laborers' Fringe Benefit Funds v. Kaltz, Adversary Proceeding No. 89-0028 (Bankr. E.D. Mich. May 30, 1989). This opinion, also authored by Judge Graves, addresses similar issues involved in the Zick case discussed above. The consent judgment involved in Kaltz was entered in a federal district court action and awarded the plaintiffs the sum of $109,025.31 plus interest. There were no statements contained in the judgment regarding fraud claims. After debtor commenced a Chapter 7 case, the plaintiffs in the state court action commenced an adversary proceeding seeking a determination of nondischargeability under 11 U.S.C. § 523(c). The debtor thereupon filed a motion for summary judgment, asserting that the plaintiffs were collaterally estopped by the earlier consent judgment from obtaining a judgment of nondischargeability. Judge Graves denied the debtor's motion, finding that there was no indication in the record "that the issues upon which plaintiffs base their claims of nondischargeability were litigated or determined in the prior federal court suits between the parties."

EDITOR'S NOTEBOOK

The Bankruptcy Court for the Eastern District of Michigan has recently made available to the public proposed amendments to the local bankruptcy rules. Copies of these amendments may be obtained at no cost from the Intake Section of the Clerks' Offices at Detroit, Bay City, and Flint. Copies may also be obtained by writing to the Bankruptcy Court Clerk, 1003 U.S. Courthouse, 231 West Lafayette Boulevard, Detroit, Michigan 48226. If ordering by mail, you must enclose a self-addressed, 9 x 12 envelope bearing $1.25 in postage. Written comments on these amendments must be received by the Clerk by no later than August 18, 1989. Public hearings on these amendments will be held as follows:

Flint and Bay City: August 11, 1989, at 2 p.m., in Bay City at the U.S. Bankruptcy Court, 1000 Washington Avenue, Room 301, Bay City, Michigan

Detroit: August 18, 1989, at 3 p.m., in Detroit at the U.S. Courthouse, 231 West Lafayette Boulevard, Room 115, Detroit, Michigan

On July 25 and 26, 1989, National Business Institute, Inc., is conducting a seminar entitled "Basic Bankruptcy in Michigan" in Lansing (July 25th) and Southfield (July 26th). The topics that will be addressed by the panel include the national and local bankruptcy rules, attorney fees, and bankruptcy ethics. For more information, please contact NBI at (715) 835-7909.

STEERING COMMITTEE MEETING MINUTES

A meeting was held on June 23, 1989, at noon at the Peninsular Club.

1. Colleen Olson and Jeffrey Hughes gave an update on the First Annual Bankruptcy Section Seminar scheduled for August 24-26, 1989:

    (a) The promotional brochures are printed and will be sent out on July 11, 1989.

    (b) To date, thirty-four members have preregistered.

    (c) To assume a room and attendance at the seminar, each applicant should immediately fill out an application.

2. Portraits of retired Bankruptcy Judges and Referees are finished and are in the process of being framed. James Engbers reported that the ceremony for the hanging of these portraits will be held this fall or late summer. Prior notice of this ceremony will be published in this newsletter and in the Grand Rapids Bar Association Newsletter. A 4 p.m. time was decided upon.

3. Tom Schouten indicated the Bankruptcy Appellate Panel survey will be circulated after District Judge Hillman and the other District Judges have been advised of and approved of further action.

4. The Bankruptcy Court is still working on the final drafts of the local rules and fee guidelines which will be printed in the Newsletter for public comment.

5. The next Steering Committee meeting will be held at the Peninsular Club on Friday, July 28, 1989, at noon.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan during the period from January 1, 1989, to June 30, 1989. These filings are compared to those made during that same period 1 year ago.

	1/1/89-6/30/89	1/1/88-6/30/88
Chapter 7	1,695	1,427
Chapter 11	54	57
Chapter 12	5	17
Chapter 13	604	567