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THE SECTION 1111(B) ELECTION (Part II)

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(This is a continuation of Judge Gregg's article which began last month. Unfortunately, because of editorial error, the paragraph intended to finish last month's edition was omitted from the newsletter. For continuity purposes, I have reprinted the preceding paragraph. The example referred to assumed real property worth $80,000, and underlying debt of $100,000.)

With respect to a possible future postconfirmation appreciation of collateral, the Code gives an undersecured creditor the opportunity for an election. The creditor may choose to be treated as a nonrecourse creditor and thereby waive its unsecured claim. § 1111(b)(1)(A)(i) and (b)(2). If the election under § 1111(b)(2) is timely made, FRBP 3014, the creditor is treated as fully secured, notwithstanding the secured-unsecured claim bifurcation under § 506(a).

In the example above, the undersecured creditor making the § 1111(b) election would hold a secured claim in the amount of the debt, i.e., $100,000, and no unsecured claim. After the election is made, the undersecured creditor would hold a lien in the amount of $100,000 on property worth only $80,000. Why wouldn't an undersecured creditor always make the election? The answer is in the treatment of such electing creditor's secured claim under chapter 11. Although the chapter 11 debtor must pay the entire debt amount under a confirmed plan, the value of the payments made must only equal the present value of the collateral. In the above example, the reorganized debtor would therefore pay $80,000, plus market rate interest thereon, during the loan repayment period. Total payments of principal and interest must equal $100,000.

On confirmation, the collateral vests in the debtor. § 1141(b). After confirmation, the debtor is therefore free to sell the property and must pay any outstanding secured indebtedness in accordance with the secured creditor's retained lien. The secured creditor must be given a lien under the confirmed plan to protect its property interest. § 1129(a)(7), 1129(b)(2)(A)(i)(I). Assume, once again, that the value of the collateral is $80,000 and the amount of the indebtedness is $100,000. Further assume that two years after confirmation the value of the collateral increases to approximately $90,000. Also assume that the reorganized debtor, postconfirmation, has made all requisite plan payments and has reduced the principal indebtedness secured by the collateral by $5,000. Finally assume that the debtor then sells the property and, after expenses of sale, nets $88,000. What is the proper division of the sale proceeds between the debtor and the secured creditor? This will depend upon whether the secured creditor made the § 1111(b) election or not.

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If no § 1111(b) election was made, the analysis to determine the distribution of the postconfirmation sale proceeds is as follows. The secured creditor held an allowed secured claim supported by a lien in the amount of $80,000. § 506(a). The lien principal amount, by reason of $5,000 in postconfirmation payments, has been reduced to $75,000. Therefore, the debtor is obligated to pay $75,000 cash to the secured creditor to satisfy the lien and the debtor would retain the remaining unencumbered proceeds of $13,000. Of course, the undersecured creditor will still receive distribution of its undersecured $20,000 claim in accordance with the plan provisions, without interest, most often at something far less than 100 cents on the dollar.

If the secured creditor made the § 1111(b) election, the analysis to determine the distribution of the postconfirmation sale proceeds mandates a different result. The secured creditor held an allowed secured claim supported by a lien in the amount of $100,000. §1111(b)(2). The lien principal amount, because of the $5,000 postconfirmation payments, has been reduced to $95,000. Therefore, the entire amount of the net sale proceeds of $88,000 must be paid to the secured creditor--the debtor retains no appreciated value. (In fact, absent consent by the secured creditor, the sale will not take place because the proceeds are insufficient to fully satisfy the secured a creditor's lien.) However, because the § 1111(b) election was made, the secured creditor receives no distribution under the plan as an unsecured creditor.

As can be readily seen by the above illustration, if the value of the collateral shall likely increase, or if the secured creditor believes the confirmation valuation of the property is erroneously low, the secured creditor would be prudent to make the § 1111(b) election, to preserve its right to receive any collateral appreciation or the differential between the court determined valuation and the higher correct value of the property. On the other hand, if the property is unlikely to appreciate or not perceived to be undervalued at confirmation, it is probably better not to make a § 1111(b) election because the undersecured creditor will not waive its right to its distribution as an unsecured creditor under the plan. In making a decision, another important factor is the percentage distribution to be paid to the unsecured creditors. If a meaningful distribution will be made, this would weigh against an undersecured creditor making the § 1111(b) election; contrariwise, if the unsecured creditor's distribution will be nominal, there is a greater incentive to make the election.

In a situation where the confirmation value of the collateral is heavily contested, i.e., there is a wide disparity between the debtor's and the undersecured creditor's belief as to the correct value, it is prudent for the undersecured creditor to obtain a binding determination of the collateral value before the time to make the election expires. FRBP 3014. In such an instance, the undersecured creditor is well-advised to file a motion for valuation. FRBP 3012. However, if the value is not heavily contested or the debtor and the creditor (and the unsecured creditors' committee) agree on the value, such a motion is not necessary.

It should be noted that three major exceptions exist to both the chapter 11 treatment of a nonrecourse secured debt as a recourse debt and the ability of an undersecured creditor to make an § 1111(b) election

First, if the undersecured creditor's property interest in collateral is "inconsequential", the § 1111(b) election may not be made. § 1111(b)(1)(B)(i). The meaning of "inconsequential" is not defined under the Bankruptcy Code. The author submits it must be determined on a case-by-case basis--one example would be where the undersecured creditor's interest in the collateral is only $100 but the debt is $ 100,000. In such an instance, the § 1111(b) election should be prohibited.

Second, if the property which secures the nonrecourse undersecured creditor's claim is sold under § 363 or is to be sold under the plan, the nonrecourse secured creditor will not be treated as holding a recourse claim. § 1111(b)(1)(A)(ii). Any unsecured deficiency claim would not be allowed or paid with a, class of unsecured creditors. Third, if the undersecured creditor holds a recourse debt, and the collateral is sold under § 363 or is to be sold under the plan, the election may not be made. § 1111(b)(1)(B)(ii).

Apparently, the rationale of prohibiting an § 1111(b) election if the property is to be sold, whether under § 363 preconfirmation, or postconfirmation in connection with the plan, may be twofold. First, the secured creditor may object to the sale or the confirmation of the plan which proposes the sale. Second, and perhaps more importantly, the secured creditor, in effect, has a right of "first refusal" with regard to any proposed sale. The creditor has the opportunity to "credit bid" at the sale to either take title to the property or to make certain that the proposed sale price is not too low. § 363(k).

Suggested general readings:

4 William L. Norton, Jr., Norton Bankruptcy Law & Practice 2d, § 89:1 to 89:7 (1993).

5 Collier on Bankruptcy, paragraph 1111.02[1]-[6] (Lawrence P. King, ed., 15th ed. 1993).

RECENT BANKRUPTCY DECISIONS

McPherson v Comerica Bank v McPherson, 93-C-70261-D (ED Mich, Judge Zatkoff, 12/8/93). McPherson was a shareholder and officer of an American Speedy Printing Center franchise in the Illinois/Indiana area. The franchise had a $1 million line of credit with Defendant Comerica Bank. The business could not meet the payment requirements. The Bank agreed to renew the line with the guarantee of the parent franchisor, American Speedy Printing Center (ASPC), and the joint guarantee of McPherson and his wife. At the time the guarantee of ASPC was given, it was a customer of the Bank.

The franchise eventually failed and was sold back to ASPC, which formally assumed the note. At that time, McPherson and his wife gave notice to the Bank that they were revoking their guarantees of the business indebtedness.

ASPC filed bankruptcy without paying the note. Mrs. McPherson filed suit against the Bank alleging a violation of the Equal Credit Opportunity Act (15 USC 1691 et seq). Specifically, she alleged that the Bank wrongfully required her signature on the guarantee in violation of Regulation B of the Act, which prohibits a lender from demanding the signature of a spouse on a credit instrument if the applicant is independently creditworthy.

McPherson claimed that the Bank owed him a duty to advise him of the financial difficulties of ASPC, which it allegedly knew of when it required his guarantee.

The McPhersons defended the Bank's collection action on the grounds of lack of consideration, failure to mitigate damages and contributory negligence. All parties filed motions for summary disposition.

Mrs. McPherson's claim of violation of the Equal Credit Opportunity Act was dismissed, because her financial statement of the husband relied on joint assets, so he was not independently creditworthy, under Regulation B. Her defense of failure of consideration was also dismissed and the Bank's motion for summary judgment against her was granted.

Additionally, the Court found that the Bank had no duty to advise McPherson of the financial condition of ASPC. He had a business relationship with ASPC that would have allowed him to ascertain its financial condition without the assistance of the Bank. Further, when he asked the Bank about ASPC, the Bank directly declined to discuss ASPC's circumstances. His interpretation of the Bank's silence as affirmation that nothing was wrong was not reasonable. The Court held that no jury could reasonable find justifiable reliance, so the Bank's motion for summary judgment was granted against the husband.

Comber Tool v General Motors and AC Delco, (ED Mich, Judge Edmonds, 12/21/93). General Motors through AC Delco, contracted with Dynaplast Corporation for the manufacture of an injection molding machine. Dynaplast subcontracted a part of the contract to Comber, without the knowledge of GM. Comber delivered its parts to Dynaplast, which filed Chapter 11 before it paid Comber. GM took possession of the Comber parts, which had a value in excess of the balance due to Comber.

Comber claimed that it held title to the goods and sued to recover them from GM, or for their value. GM argued that it held title.

The parts were delivered by Comber to Dynaplast on several different occasions, only to be returned to Comber for additional work. After the last meeting between Comber and Dynaplast, Comber agreed to pick up the goods again and make some changes. However, before it could pick the parts up, a receiver had been appointed.

Before it filed Chapter 11, Dynaplast had been financially supported by GM, which had a perfected lien against all of its inventory. Just prior to the filing, GM had taken possession of that inventory, including the Comber parts. It had also paid Dynaplast for the work done under the contract. Comber did not file a proof of claim in the Dynaplast case, but instead demanded payment from GM.

The Court held that the contract which determined title to the goods was the contract between Dynaplast and GM, formed prior to the Comber/Dynaplast agreement. That contract specifically provided that title to the goods rested in GM. Pursuant to Article 2, Section 401 of the UCC, parties to a contract for special goods can agree to pass title to the buyer in any manner and on any conditions agreed by the parties. Because of the express agreement of GM and Dynaplast, Comber's claim of title was not valid.

Comber's claim of quantum meruit recovery, was denied as well. Because GM had no expectation that Comber would have any part in the manufacturer of the goods, the Court declined to infer the quasi-contractual relationship necessary to a claim of quantum maruit. As previously stated,

GM held title to the goods by contract. Further, it had already paid Dynaplast in full for the goods before it filed under Chapter 11. GM notified the bankruptcy court of all its dealings with Dynaplast, in contrast to Comber, which made no attempt to collect from Dynaplast and never filed a claim with the bankruptcy estate.

Horvath v Oldford, File No. 93-70342, (ED Mich, Judge Cohn, 12/16/93). Horvath was one of two general partners in a limited Partnership. He, through a corporation he and the other general partner owned, purchased property on land contract, and subsequently assigned it to the limited partnership for a profit of approximately 25%. Horvath was to receive a commission of $80,000 on the sale.

The limited partners sued, claiming that the general partners' failure to disclose their expectation of profit from the transfer to the limited partnership constituted a breach of their fiduciary duty. The Oakland County Circuit Court granted partial summary judgment in favor of the limited partners, appointed a receiver for the partnership, and ordered the general partners to hold all benefits and profits derived from the transfer in trust. The Michigan Court of Appeals affirmed. (Band v Livonia Associates, 176 Mich App 95).

8 unexplained years later, the Oakland County Circuit Court entered judgment against Horvath in the amount of $189,555. On the same day the judgment was entered, Horvath filed Chapter 11. Oakland County brought an action to declare the judgment nondischargeable under 523(a)(4).

The Bankruptcy Court heard oral argument on the dischargeability issue and rendered an opinion without ever reviewing the record from the Circuit Court. Instead the Bankruptcy Court relied on the Court of Appeals' decision and held that opinion constituted collateral estoppel against the debtor.

The District Court reversed. It held that the Bankruptcy Court was required to review the Circuit Court record. Further, the District Court noted that there was no evidence at any level of defalcation on the part of Horvath. Instead, the Circuit Court had stated that it was not necessary to determine that there had been any receipt of money by Horvath, because "Profits are something that are realized in accounting terms and not necessarily must be received (sic)."

The District Court defined defalcation as including innocent and unintentional defaults resulting from a fiduciary's duty to make the proper payment of money coming into his possession. In re: Johnson, 691 F.2d 249 (6th Circuit 1982).

The case was remanded to the Bankruptcy Court for a determination of the merits of the claim of defalcation.

Cohen v Hagen, File No. 93-72062 (ED Mich, Judge Cohn, 12/8/93). Debtor/Defendant/Appellant Hagen appealed from a bankruptcy court decision holding his debt to Plaintiff Cohen to be nondischargeable. Cohen moved to dismiss on procedural ground. The District Court dismissed the appeal.

A trial was held in the Bankruptcy Court on Cohen's complaint to determine the dischargeability of Hagen's debt to him. The bankruptcy court held the debt to be nondischargeable, but denied Cohen's motion for actual attorney fees. Cohen then filed a motion for reconsideration. Hagen filed a response. Hagen then filed an appeal, before the Bankruptcy Court ruled on the motion for reconsideration. The order denying the motion for reconsideration was entered 35 days after the appeal was filed. Hagen did not file a new notice of appeal.

The District Court dismissed the appeal, holding that the judgment of the Bankruptcy Court was not final and ripe for appeal until the motion for reconsideration was disposed of, pursuant to FRBP 8002(b). After entry of the order denying the motion for reconsideration, Hagen had 10 days to file an appeal. His premature appeal did not preserve his rights. When he failed to refile after entry on the motion for reconsideration, the District Court was without jurisdiction to hear his case.

Resolution Trust Corp, as Receiver for Germantown Trust Savings Bank v Cheshire Management Co., File No. 92-6171, 1993 WL 504506 (CA6 December 10, 1993). In 1986, Defendant Cheshire Management (Cheshire) and Germantown Trust Savings Bank (Bank) entered into a contract. This contract required Cheshire to inject $1.4 million into a Houston apartment complex on which the Bank held a mortgage. In exchange, the Bank gave Cheshire an option to purchase 6000 shares of its stock for $100 per share from May 31, 1986 to May 1, 1988. Cheshire also had the right to sell this stock option back to the Bank for $300,000. The parties also agreed that the Bank would hold a right of first refusal on future "end loans" negotiated by Cheshire.

On May 1, 1988, Cheshire attempted to exercise this stock purchase option. The Bank refused to honor the agreement. Cheshire then filed suit to enforce the contract. In 1989, the Resolution Trust Corporation (RTC) became conservator for the Bank and substituted itself as defendant. In January of 1990, Cheshire received a district court judgment against RTC. RTC appealed. On May 17, 1990, during the pendency of the appeal, RTC was named receiver

for the Bank. On May 22, 1990, RTC published notice of its appointment as receiver for the Bank. On May 24, 1990, two days after RTC was appointed receiver, Cheshire recorded its district court judgment with the county giving it a judgment lien under state law. In April of 1991, the Court of Appeals affirmed this judgment.

RTC then filed a complaint seeking to have Cheshire's judgment lien invalidated. Cheshire argued that it had a properly recorded judgment. Alternatively, Cheshire claimed that it had a perfected security interest in a qualified financial contract (QFC) under the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) which RTC could not avoid. RTC argued that Cheshire's failure to record its judgment until after RTC's appointment as receiver, left Cheshire as an unsecured creditor, entitled to no more than its pro rata share of the receivership's assets. Also, RTC maintained that Cheshire possessed a judgment, not a QFC. Consequently, FIRREA's requirements for QFC's did not apply. The district court agreed with RTC, and granted it summary judgment and invalidated the lien.

The Court of Appeals affirmed this second district court decision. It found §1821(d)(13)(C) of FIRREA provides that "[no] attachment or execution may issue by any court upon assets in the possession of the receiver." Moreover, §1821(e)(8)(C) of FIRREA does not automatically elevate a holder of a QFC to the status of a secured creditor. Without resolving whether Cheshire possessed a QFC, this particular section applies only to transfers of assets by an institution prior to insolvency.

United States v Blanchard, File No. 92-1723 & 1724, 9 F3d 22 (CA6 1993). Defendant, Gerry E. Blanchard, pled guilty to bankruptcy fraud under 18 USC § 152. Blanchard was the former CEO of Kinross Mfg. Co. and concealed $118,000 in the corporate bankruptcy case. Blanchard received the entire benefit of this fraud and also diverted other amounts to his alleged paramour. Douglas W. Hillman, Senior District Judge for the Western District of Michigan, sentenced him to 24 months in jail and to pay fines of $6,500 and restitution of $118,000. On appeal, Defendant challenged the order for payment of fines and restitution, claiming an abuse of discretion since there was no evidence that he had "either the present ability or future ability to pay either."

The Court of Appeals affirmed the district court decision, finding that there was no abuse of discretion. Under 18 USC § 3664(a), the court must consider the amount of loss sustained by the victim, defendant's financial resources, financial needs, earning ability and such other factors the court deems appropriate. The trial court reviewed the presentence report which, inter alia, stated that: Blanchard had a very high I.Q.; had been a former congressional aide; earned more than $100,000 annually between 1984 and 1989; and his wife had a talent for generating earnings. The trial court was not required to make factual findings on the record regarding financial ability to pay. Nevertheless, it did consider the factors. Moreover, Defendant's indigence is not a bar to an order of restitution. Additionally, Defendant has the burden of showing that he was unable to pay the fines imposed by the district court. When Blanchard offered no proof of his future ability to pay, the district court had the duty to impose some fine. USSG §5E1.2(a).

Patton v Bearden, et al, File No. 92-6636, 8 F3d 343, (CA6 1993). Plaintiff Nicholas Patton developed a catfish breading mix and entered into an agreement with Anthony Pizzolato, giving him exclusive production and sale rights for the mix in exchange for royalty payments. Pizzolato in turn granted Richard, Robert and J.M. Bearden, individually and d/b/a Bearden Fish Farms (the "Beardens") a sublicense for producing and selling the mix. A dispute arose between these parties. The Beardens then stopped selling the mix. Patton and Pizzolato settled their dispute whereby Pizzolato assigned his rights back to Patton. Patton then filed suit against the Beardens, individually and d/b/a Bearden Fish Farms to recover unpaid royalties under the sublicense agreements.

The district court granted summary judgment in Patton's favor and against the Beardens. Subsequently, the Beardens filed a Notice of Bankruptcy that the Bearden Fish Farms partnership filed a Chapter 11 Petition. Accordingly, entry of judgment against the individual partners of the debtor partnership violated the automatic stay provisions of 11 USC § 362. The district court rejected this argument, since the automatic stay does not protect the partners of a partnership. The Beardens then appealed.

The Court of Appeals rejected all of the Beardens' arguments related to the contract and the granting of summary judgment for Patton. The Court also affirmed the district court decision regarding the automatic stay issue. Defendants' mere status as general partners does not entitle them to protection under 11 USC § 362(a)(1). Patton's action operates against individual assets of the partners, not partnership assets. The Court recognized that some courts have held that the debtor's stay may be extended to non-bankruptcy parties in "unusual circumstances" such as when debtor and the nonbankrupt party are closely related or the stay contributes to debtor's reorganization. A.H. Robbins Co. v Piccinin, 788 F2d 994 (CA4 1986). However, such extensions are usually

in the form of an injunction issued by the bankruptcy court after a hearing establishing the "unusual circumstances".

DLM Investments, Inc. v. Security Connecticut Life Ins. Co., Case No. 1:93-CV (W.D. Mich. Dec. 3, 1993). Judge McKeague affirmed the Order of Abstention and Lift of Stay issued by Judge Stevenson, holding that permissive abstention under 28 U.S.C.§ 1334(c)(1) was appropriate in this case and that the stay should be lifted to allow the state court actions to proceed.

The debtor, DLM Investments, Inc. filed an adversary proceeding against defendant Security Connecticut Life Insurance Co. seeking to recover past and future insurance commissions to which DLM claimed entitlement. The same insurance commissions were claimed by several other parties in two cases pending before Arizona courts. Both Security Connecticut and DLM were parties to the Arizona proceedings which were filed prior to DLM's bankruptcy filing. In response to the complaint, Security Connecticut indicated that it was prepared to pay out the disputed commissions, but requested that the bankruptcy court abstain so that the Arizona courts could determine who was entitled to the commissions. The bankruptcy court, concluding that DLM's action involved a non-core proceeding, abstained from rendering the decision as to DLM's right to the commissions and lifted the automatic stay so that the Arizona court cases could proceed to resolve the dispute over the commissions. DLM appealed.

On appeal, DLM argued that the bankruptcy court erred in determining that the action against Security Connecticut constituted a non-core proceeding under 28 U.S.C. § 157(b)(2) and that the bankruptcy court should not have abstained from determining who was entitled to the commissions. The Court reviewed Sixth Circuit law on core/non-core proceedings. Citing In re Wolverine Radio Co., 930 F.2d 1132, 1144 (6th Cir. 1991), the Court noted that "if the proceeding does not invoke a substantive right created by federal bankruptcy law and is one that could exist outside of the bankruptcy, then it is not a core-proceeding." The Court reasoned that DLM's action for the insurance commission did not hinge on a right created by federal bankruptcy law, but instead, the action was a independent contractual action for monies owed which could easily exist outside of DLM's bankruptcy proceedings. The Court held that the action was a "related proceeding under 28 U.S.C. § 157(c)(1) for the purposes of determining the issue of abstention.

After holding the mandatory abstention under 28 U.S.C. § 1334(c)(2) was not applicable in this case, the Court reviewed the case law interpreting permissive abstention under 28 U.S.C. § 1334(c)(1). The Court noted twelve factors which courts consider in determining whether to abstain under § 1334(c)(1). The Court held that the bankruptcy court properly abstained because: 1) the legal issues raised by the debtor were solely matters of state law; 2) the proceedings in Arizona had already commenced and were proceeding until the automatic stay was imposed; 3) that adjudication of the matter before the bankruptcy court would substantially burden the bankruptcy court's docket; 4) that DLM's action in bringing the matter to the Western District of Michigan suggests that forum shopping may be at issue; and 5) that all interested parties except Security Connecticut are Arizona citizens and are already parties to the Arizona litigation.

In re South Haven Marine, Remes v. A.D.D. Construction Co., Inc., Case No. 1:93-CV-921 (W.D. Mich. Dec. 6, 1993). Judge McKeague denied the trustee, Richard Remes' motion for leave to appeal an interlocutory order denying a motion for summary disposition.

The Trustee entered into a contract on behalf of the debtor to have certain improvements made on the debtor's real property by the defendant, A.D.D. Construction Co., Inc. A contract dispute arose before the improvements were completed. A.D.D. did not receive full payment and ceased performance before completion. A.D.D. filed a claim of construction lien against the property. The Trustee moved for partial summary disposition contending that A.D.D.'s lien was legally deficient and unenforceable. The bankruptcy court denied the Trustee's motion, and the Trustee moved for leave to appeal.

The Court cited the historic federal policy disfavoring piecemeal appeals and noted that the Trustee's motion failed to persuade the Court that an exception to the federal policy was warranted in this case. The Court noted that the Trustee's motion for leave to appeal was technically deficient because the Trustee failed to summarize the defendant's argument and identify the "specific 'controlling' question(s) of law to be presented on appeal." Furthermore, the appeal would not efficiently administer the case because A.D.D. had filed a counter-claim and a trial on the counter-claim would be necessary even if the Trustee's motion for partial summary disposition was granted. Finally, the Court noted that the bankruptcy court's denial of the Trustee's motion was not determinative of either parties' substantive rights because it did not touch the merits of the claims, but decided only that the claim should go to trial. The Court therefore, denied the Trustee's motion for leave to appeal.

In re Fishell, Fishell v. Slotow, Case No. 1:92-CV846 (W.D. Mich Dec. 15, 1993). Judge Gibson affirmed the bankruptcy court's order imposing sanctions on debtor's counsel pursuant to FRBP 901(a), but remanded the case for determination of the amount of the sanctions.

The debtors borrowed money from Robert Slotow. The obligation was secured by a mortgage on real property owned by the debtors. The debtors defaulted on the loan. Under the terms of an escrow holding agreement, Slotow placed a mortgage discharge in escrow and the debtors had placed an executed warranty deed in escrow. When the debtors did not pay the indebtedness by a certain date, the agent released the two documents to Slotow and Slotow recorded the warranty deed. In response, debtors filed n action against Slotow in the Eaton County Circuit Court seeking to cancel the warranty deed. Debtors alleged fraud, misrepresentation, lack of consideration, that the deed was in reality a mortgage, and that the interest on the loans was usurious. Thereafter, debtors filed a voluntary petition for bankruptcy. Debtors removed the action to the bankruptcy court. After investigation, the Chapter 7 trustee filed a motion to approve settlement. The debtors filed the only objection to the settlement. The bankruptcy court approved the settlement over the debtors' objections. The debtors filed an amended motion for rehearing and/or reconsideration which, after argument, the court denied. The bankruptcy court ordered debtors' attorney to pay the Slotow's counsel $1,000.00 and the Chapter 7 trustee $500.00 as sanctions for his violation of FRBP 9011(a).

The Court reviewed FRBP 9011 and the case law interpreting the same. The test for imposing sanctions under FRBP 9011(a) is whether the attorney's conduct is reasonable under the circumstances. The Court noted that the debtors' objection to the settlement was without merit, the hearing on the motion for rehearing and/or reconsideration was an unnecessary proceeding, the debtors had caused repeated delays in the adversary proceeding and their bankruptcy case, the debtors had given the bankruptcy court the impression that they did not want the action to go to trial, and the debtors' attorney did not present facts and/or evidence in connection with the rehearing motion which were not available at the original hearing. The Court held that the bankruptcy court's decision to impose sanctions was justifiable and that the court's rationale was well reasoned and thoughtful.

The Court also reviewed the factors that a court must consider in determining the amount of sanctions to award. The Court noted that a court must consider the amount necessary to deter the attorney from future violations, the amount the trustee and other interested parties were forced to spend because of the attorney's unreasonable conduct, the mitigating actions of opposing parties, and their attorney's ability to pay the sanctions. The Court remanded the case to the bankruptcy court because the record did not indicate that the judge considered these factors in determining the amount of the sanctions imposed.

Schilling v. Federal Home Loan Mortgage Corp., Case No. 1:93-CV-678 (W.D. Mich. Dec. 15, 1993). Judge Bell granted defendant's motion for summary disposition holding that plaintiff's arguments requesting that a foreclosure sale on their real property be set aside were unjustified and imposing sanctions against plaintiff.

Plaintiffs signed a promissory note and mortgage with regard to their real property. The mortgage was assigned to the defendant. Plaintiffs filed a Chapter 11 bankruptcy, but later received a discharge under Chapter 7. Following debtors' discharge, defendant sold plaintiffs' real property at foreclosure sale. Following the foreclosure sale, plaintiffs filed an action in Kent County Circuit Court seeking to have the foreclosure sale set aside and seeking a declaration that the mortgage was discharged. Defendants removed the action to the District Court and filed this motion for summary judgment.

Plaintiffs alleged that the mortgage was discharged in their bankruptcy proceeding, that the defendant filed to present the promissory note for collection, and, because the defendant, the Federal Home Loan Mortgage Corporation was not registered to do business in the State of Michigan, that the foreclosure sale should be set aside. The court held that a discharge only discharges a debtor's dischargeable debts which did not include the mortgage. Noting that liens past through bankruptcy and can be foreclosed following the close of the bankruptcy case, the debtors' discharge in this case in no way affected the defendant's rights with respect to the mortgage. Further, because the action was not on the promissory note, the presentment of the note was irrelevant. Finally, the Court noted that the Federal Home Loan Mortgage Corporation is authorized to conduct its business with regard to any qualification or similar statute in any state.

Defendant requested that sanctions be imposed against plaintiffs and their counsel under FRBP 11. The Court held that plaintiffs' attorney breached his duty to modify the complaint under Rule 11 to bring it into accord with the requirement that the complaint be legally tenable. Noting that a reasonable inquiry of the existing law would clearly have disclosed to plaintiffs' attorney that none of his claims were legally tenable, the Court further found that plaintiffs' pleadings exhibited other deficiencies that the Court found to

be unreasonable, including citation of statutes that were not even remotely related to the asserted proposition and frivolous arguments. The Court imposed sanctions, requiring plaintiffs' attorney to pay defendant's attorney's fees incurred after the date of removal to the District Court.

In re Michigan-Wisconsin Transportation, Case No. ST 91-83338 (Bankr. W.D. Mich. Dec. 9, 1993). Judge Stevenson interpreted 11 U.S.C. § 1167 in light of the Trustee, Donald Cassling's objection to priority of the claim filed by Transportation Communications International Union, C & O System Board ("TCU"), on behalf of certain employees of the debtor and held that certain vacation and wage claims of the debtor's employees were not entitled to administrative priority.

TCU is the exclusive bargaining representative for debtor's current and former clerical and related employees. On behalf of several of the employees, TCU filed claims based on pre-petition wages, sick and vacation pay. The claim sought priority status under 11 U.S.C. §§ 507(a)(1),(3) and (4).

The trustee objected to TCU's claim arguing that § 507(3) limits claims to $2,000.00 per individual earned within the 90 days preceding bankruptcy. Because TCU's proof of claim did not identify the amounts per individual or the time frame within which the amounts were earned, TCU had not established priority under §507(a)(3). The trustee also argued that certain portions of the claim were duplicative of employees' claims, and that the trustee could not reconcile TCU's claim with the debtor's records. TCU argued that because the collective bargaining agreement at issue in this case was the kind identified in 11 U.S.C. § 1167, the agreement was entitled to as great or greater protection as afforded to collective bargaining agreements under § 1113. Section 1113 provides that the trustee must make all payments under the collective bargaining agreement until it is rejected notwithstanding § 503(b). Because collective bargaining agreements governed by § 1113 are entitled to administrative expense status, TCU concluded that the same should be true for claims arising out of collective bargaining agreements governed by § 1167.

The Court analyzed whether TCU's claim was eligible for priority under §§ 507(a)(1), (3) and (4). First, the Court noted that none of the claims asserted came under § 507(a)(4). Second, the Court agreed with the trustee and held that to the extent the claim asserts priority under § 507(a)(3), that insufficient facts were stated on the face of the claim to determine the amount entitled to priority, and therefore, the claim was disallowed as it related to the priority under that subsection.

Finally, the Court analyzed whether the claims were entitled to priority under 11 U.S.C. § 507(a)(1). The court distinguished between acceptance and rejection of an executory contract and the priority of claims and administrative expenses. The court noted that acceptance or rejection has to do with a debtor's ongoing obligation to perform a contract post-petition and is governed by 11 U.S.C. § 365. When an executory contract is rejected, the non-debtor party to a contract claim is entitled to damages based upon the debtor's statutorily decreed pre-petition breach of contract. In contrast, priority and administrative expense status are entirely separate matters. Claims entitled to first priority, administrative payments are normally post-petition costs which are necessary to sustain the debtor's business. Both § 1113 and 1167 address the issue of acceptance or rejection of executory contracts and both are exceptions to the general rule set forth in § 365 which apply in the context of collective bargaining agreements. TCU used this similarity to equate the two sections. The court distinguished that the issue is not the assumption or rejection of the collective bargaining agreement, but the priority of the claim. Specifically, § 1113 mandates that the trustee comply with that section notwithstanding any other provisions of the Bankruptcy Code. In contrast, § 1167 contains override language only with respect to § 365. Therefore, § 1113(f) explicitly incorporates protections for the bargaining agreement itself, while § 1167 protects only the wages and working conditions which are attended to the collective bargaining agreement.

The Court reviewed the legislative history of §§ 1113 and 1167, noting that if Congress intended employees who were covered by collective bargaining agreements subject to § 1167 to have broader rights, Congress would have provided for the same in § 1171. Therefore, based on the plain language of § 1167 and legislative history of that section, the Court concluded that congress did not intend to extend the priority given to employees under § 507(a)(3) with the passage of § 1167.

Finally, the Court noted that the trustee did not provide any evidence as to its dispute with the amount of the claim, and therefore, he did not satisfy his burden of proof, the burden of persuasion was not shifted to the creditor and the trustee's objection as to the amount was overruled. The Court, therefore, allowed TCU's claim, in its entirety, as a general unsecured claim.

In re Square Real Estate, Inc., Leitch v. Marjorie M. Jelsema Ten Year Irrevocable Trust Dated Jan. 2, 1982 and

Currently Trusted by Jack Jelsema, Case No. HG 90-80909 (Bankr. W.D. Mich. Jan. 10, 1994). Judge Howard applied the Seventh Circuit's analysis in Deprizio and held that the one year preference period did not apply in this case because the defendants did not receive transfers which benefitted an inside creditor.

Robert Steed, a trustee of two trusts and President of Square Real Estate Company, coordinated an agreement between both of the trusts and Square under which the trusts advanced funds totalling $200,000.00 to be used by Square for various investment ventures. Steed was eventually removed as trustee from both trusts and the trusts demanded repayment of the amounts advanced to Square. Square paid a total of approximately $420,000.00 to the trusts. Thereafter, Square filed bankruptcy.

Square's Chapter 7 trustee filed complaints against the trusts seeking to recover the payments as preferences. The payments were made within one year of their bankruptcy filing and therefore, the trustee asserted that the trusts received the payments for the benefit of Steed, an insider creditor. The trustee asserted that the payments made to the trusts within one year of the bankruptcy were preferences because Steed, an insider, was a creditor of Square for his contingent liability to the trusts. The case came before the Court on cross motions for summary judgment.

Relying on the Sixth Circuit's intent to follow Levitt v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Const. Co.), 874 F.2d 1186 (7th Cir. 1989) as expressed in Ray v. City Bank and Trust Co. In re C.L. Cartage Co., Inc.), 899 F.2d 1490 (6th Cir. 1990) and Harrison v. Brent Towing Co., Inc. In re H & S Transp. Co., Inc.), 939 F.2d 355 (6th Cir. 1991), the Court analyzed the facts of this case under the analysis in the Deprizio. The Court discussed the Deprizio analysis at length, detailing three types of preferential transfers to non-insiders made for the benefit of insider creditors. However, because Steed never guarantied Square's debt to the trusts, the only issue before the Court was whether Steed, an insider, was a creditor of the debtor.

The Court first examined whether Steed had breached his fiduciary duty to the trusts, and whether that breach would have made Steed a creditor of their debtor. The Court held that Steed may have breached his duties as a trustee, and in Michigan, a trustee is personally liable for trust losses if they are caused by the trustee's breach of trust. However, the Court noted that Steed would not hold a claim against Square for the breach of his own fiduciary duty as a trustee and there was no evidence that Steed had an express contract with Square for indemnification. Because Steed did not have a right to indemnification based on common law, implied or express contract, the Court held that Steed was not a creditor to Square.

The trustee's second argument, contrary to his first argument, asserted that the trusts had waived any claim of self-dealing or conflict of interest because Steed was selected as a trustee for the purpose of investing in Square, and therefore, Steed acted in a manner that the trusts desired. The Court noted, however, that if Steed did not breach his fiduciary duty, there would be no reason whatsoever for steed to pay anything to the trusts. Because the Trustee had not shown that Steed had any liability to the trusts which would have been satisfied by the transfer, Steed was not a creditor of the trust.

The Bankruptcy Court held that Steed was not a creditor of the debtor and therefore, the 90 day recovery period applied. Because the transfers were prior to the 90 days before the bankruptcy filing, summary judgment was granted in favor of the defendants.

EDITOR'S NOTEBOOK

I'm still trying to learn how this editing process really works. Hopefully, I'll learn how to do this sooner or later.

The Michigan State Bar Ethics Committee has issued an opinion dealing with bankruptcy lawyers. The syllabus reads as follows:

> "A bankruptcy adversary proceeding is within the scope of a lawyer's representation of a bankruptcy debtor client unless the lawyer's representation agreement with the client unambiguously excludes the adversary proceeding.
>
> "If a lawyer knows that information provided by a bankruptcy client was false, and the client refuses to correct the false information, the lawyer must rectify the false information with the bankruptcy court."

A full copy of the opinion can be obtained through the Ethics Committee; the opinion is RI-184.

Judge Rhodes has issued an opinion in a single-asset chapter 11 case sanctioning the Debtor's attorneys

approximately $25,000.00 for pursuing a bad faith filing. It is not reported in this edition of the newsletter, because it is very recent; Judge Rhodes may not release it, pending the status of a likely appeal.

The Supreme Court has denied certiorari in two bankruptcy cases, one dealing with the interplay between federal and state courts on abstention, and the other dealing with whether a bankruptcy court violated due process by issuing an order for payment on a judgment before the debtor could file a reply brief regarding the applicable interest rate. On this latter issue, Larry Ver Merris reports that federal judgment interest rates can be obtained by calling (202) 273-2168.

Legal Definition -- De Minimus A roast given in honor of Mickey Mouse's girlfriend.

STEERING COMMITTEE MINUTES

A meeting of the Steering Committee of the Bankruptcy Section of the Federal Bar Association of the Western District of Michigan was held on February 18, 1994 at the Peninsular Club in Grand Rapids. Present were John Arndts (for Bob Wright), Miri Goldman (for Denise Twinney), Dean Rietberg (for Dan Casamatta), Bob Sawdy, Peter Teholiz, Pat Mears, Tom Sarb, Gordon Toering (for Tim Hillegonds), Janet Thomas, and Mary Hamlin (for Steve Rayman).

1. Seminar. Mary Hamlin reported that the hotel has been confirmed and all of the seminar rooms have been reserved. Additionally, all four of the outside speakers have committed to attending. Topics are still being developed, although they should be finalized within the next month. Miri Goldman reported that the social activities committee was still considering several options, including a winery tour. Again, these items would be finalized within the month.

2. FRCP 26. John Arndts reported that a letter had been sent to Judge Howard and copied to the other judges, expressing the belief of the Steering Committee that the Bankruptcy Court should opt out of the mandatory disclosure of discovery required by the amended rule.

3. Presentations. Pat Mears brought up the topic of a presentation to the Steering Committee by a local bank regarding DIP financing. It was decided that if a bank, or banks, wish to put on such a presentation, they should coordinate it so that it was opened to all members of the Western District bar, and that a member of the Steering Committee could serve as a moderator. Pat Mears also brought up the idea of having District Court Judge Bell give a short presentation to the Steering Committee regarding bankruptcy appeals.

4. Other Business. The Committee discussed the recent decision of Judge Rhodes in the Big Rapids case regarding sanctions against a bankruptcy firm for a bad faith filing of a single-asset chapter 11 case.

5. March Meeting. The next meeting of the Steering Committee is scheduled for Friday, March 18, 1994 at the Peninsular Club in Grand Rapids.

LOCAL BANKRUPTCY ORDERS

On February 28, 1994, the Bankruptcy Court issued General Order, which reads as follows:

> "Whereas, the Federal Rules of Civil Procedure have been amended and those amendments have now taken effect, and
>
> Whereas, it appears to this Court that amendments to Rules 16(b) and 26(a)(1), (d) and (f) are not appropriate to either contested matters or to adversary proceedings before a bankruptcy court, and
>
> Whereas, these provisions of the rules explicitly permit courts to opt out of the requirements by local rule or order,
>
> NOW, THEREFORE, IT IS ORDERED that absent an order making these rules applicable to a specific case, Sections 16(b) and 26(a)(1), (d) and (f) of the Federal Rules of Civil Procedure shall not apply to either contested matters or adversary proceedings which are now pending or will be filed in the future."

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 (Lower Peninsula) during the period from January 1 through January 31, 1994. These filings are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	January 1994	Percent Increase (Decrease)	January 1993	Percent Increase (Decrease)	January 1992
Chapter 7	278	(0.6%)	311	(28.8%)	437
Chapter 11	6	(40%)	10	0%	10
Chapter 12	0	(100%)	5	66.7%	3
Chapter 13	110	(5.2%)	116	(21.1%)	147
	394	(14.7%)	462	(22.6%)	597

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