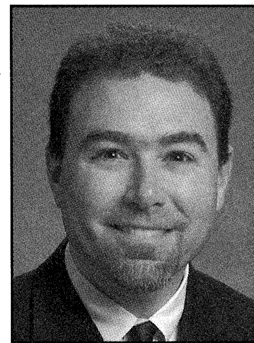
Test Your Knowledge: Recent Developments in Insolvency Law

Paul J. Pascuzzi and Thomas Phinney



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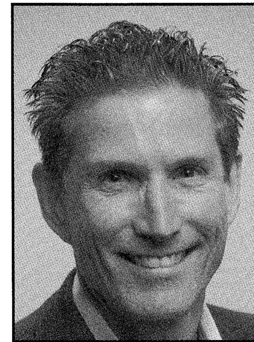

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Welcome to the third annual edition of our article covering developments in bankruptcy law. This article comes from a program we present for the Bankruptcy and Commercial Law Section of the Sacramento County Bar Association. Once again, we invite you to test your knowledge of recent developments in the area of insolvency law. Unless otherwise noted, all references are to the Bankruptcy Code. We provide a summary of the facts and issues in each case and then ask you to choose the answer(s) that reflect(s) the holding of the court. There may be more than one correct answer. We also provide a short commentary on each holding. Check the end of this article for information on how to access 1.0 self-study credits.

1. Exemption for Inherited IRA: *Clark v. Rameker*, 573 U.S. ___, 134 S. Ct. 2242 (June 12, 2014)

This case involves whether an IRA that is inherited from a parent is exempt under the Bankruptcy Code exemptions. Section 522(b)(3)(C) allows a debtor to exempt retirement funds to the extent those funds are in a fund or account that is exempt from taxation under certain provisions of the Internal Revenue Code, which would include an IRA. Is an inherited IRA exempt under section 522(b)(3)(C)?

In *Clark v. Rameker*, Heidi Heffron-Clark inherited an individual retirement account ("IRA") worth roughly $450,000 from her mother's estate. Heffron-Clark and her husband ("Debtors") filed bankruptcy in October 2010 and sought to exclude the $300,000 in funds remaining in the IRA as exempt under section 522(b)(3)(C). The chapter 7 trustee and unsecured creditors objected to the claimed exemption on the ground that the funds in the inherited IRA were not "retirement funds" within the meaning of the statute.

The bankruptcy court disallowed the debtors' claimed exemption and held that the inherited retirement funds must be held for the current owner's retirement in order to qualify as an exempt retirement fund under section 522(b)(3)(C). The district court reversed and held that the exemption covers any account containing funds originally accumulated for retirement purposes. The Seventh Circuit Court of Appeals reversed the district court and disallowed the exemption, holding that the rules for inherited IRAs, unlike the rules for non-inherited IRAs, require the owner to withdraw the funds in the account (either within five years of the original owner's death or through minimum annual distributions), so inherited IRAs "represent an opportunity for current consumption, not a fund of retirement savings."

The Supreme Court:

A. Affirmed, but remanded for a determination of whether the debtors were going to use the funds in the account on a vacation home or sports car immediately after their bankruptcy proceedings are complete as alleged by the trustee and the creditors.

B. Reversed, holding that inherited IRAs can be treated as an exempt "retirement fund" under section 522, because there is no difference between an inherited IRA and an IRA that is not inherited.

C. Reversed and remanded for a determination of whether the funds in the inherited IRA were reasonably necessary to pay for the debtors' retirement.

D. Affirmed the seventh circuit's decision, holding that the funds in an inherited IRA are not set aside for the debtor's retirement and thus are not "retirement funds" under the exemption in section 522(b)(3)(C).

Explanation of *Clark v. Rameker*: IRA inherited from parent is not exempt under section 522(b)(3)(C).

The answer is D. The Court examined three legal characteristics of inherited IRAs in determining whether the funds are objectively set aside for the purpose of retirement. First, unlike traditional IRAs, the holder of an inherited IRA is prohibited from investing additional money in the account. Second, the holder of an inherited IRA is required to take minimum annual distributions every year, no matter how many years they are from retirement. Finally, unlike traditional IRAs, the holder of an inherited IRA may withdraw the entire balance of the account at any time and for any reason without penalty.

Based on these characteristics, the Court held that inherited IRAs cannot be treated as an exempt "retirement fund" under section 522. The Court reasoned that if an individual were to be "allowed to exempt any inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete." The Court held that this would frustrate the balance between ensuring creditor recoveries while protecting the debtor's essential needs during their retirement years and enabling a "fresh start."

While the Supreme Court's opinion dealt with an IRA inherited by a child from a parent, the Court noted that IRAs inherited by spouses may be treated differently. In particular, the Court noted the distinction between an IRA inherited from a parent and an IRA inherited from a spouse. Unlike an IRA inherited from a parent, when the heir to an inherited IRA is the owner's spouse, the spouse "may 'roll over' the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA" subject to the applicable rules.

A California debtor in bankruptcy may claim a retirement fund exemption under either the California state exemption statutes or section 522(b)(3). Most of the decisions interpreting the California statutes appear to exclude inherited IRAs as exempt under the California statutes because: (1) they are not a "similar plan or contract on account of illness, disability, death, age, or length of service" and/or (2) the funds are not used primarily for retirement purposes. (*See Diamond v. Trawick*, 497 B.R. 572 (Bankr. C.D. Cal. 2013) and *In re Greenfield*, 289 B.R. 146, 150 (Bankr. S.D. Cal. 2003).) These cases focus on the specific words in the state statutes.

2. Reasonableness of Bankruptcy Trustee Fees Tied to Distributions to Unsecured Creditors: *In re Scoggins*, 517 B.R. 206 (Bankr. E.D. Cal. 2014)

"Reasonable" compensation for bankruptcy trustees is something of a term of art. Trustees' efforts generate money to pay creditors. But, since they are paid ahead of creditors, their fees also have the effect of reducing payments to creditors. Section 330(a)(7), enacted in 2005, provides that "in determining the amount of reasonable compensation to be awarded to a trustee, the court ***shall* treat such compensation as a commission**, based upon section 326 [commonly referred to as "the cap"]."[1] Section 330(a)(7) has created a puzzle, since, among other things, section 326 and other portions of section 330 still mandate that the court should only allow "reasonable" compensation.

In *In re Salgado-Nava*, 473 B.R. 911 (BAP 9th Cir. 2012), the bankruptcy court awarded "reasonable" compensation of $854 to a chapter 7 trustee, which was a reduction of the trustee's request to be paid $1,315.41 as its section 326 "commission" amount. The Bankruptcy Appellate Panel reversed the bankruptcy court and held that, absent "**extraordinary circumstances**, chapter 7, 12 and 13 trustee fees should be *presumed reasonable* if they are requested at the statutory ['commission'] rate." (*Id.* at 921.)

In *Scoggins*, the bankruptcy court combined four cases where the chapter 7 trustees sought, with support from the United States Trustee, their full "commission" based upon section 326. Three of the cases involved the sale of a residence with a "carve-out" of sale proceeds agreed to by the secured creditors, and the last was a successful business

case. Fees in these kinds of cases tend to be much higher, because the trustee is making distributions to secured creditors and to creditors doing business with the trustee. The court in *Scoggins* focused on the type of case and the size of the "commission" relative to the distribution to unsecured creditors, summarized as follows:

Case Name	Requested Compensation Trustee's § 326 "commission"	Anticipated Distribution To Unsecured Creditors
Scoggins	$16,000	$8,572 (5%)
Ruelas	$9,000	$5,784 (32%)
Popescu	$36,500	$20,100 (priority claims)
Dry Mix	$59,915	$498,000 (47%)

The court evaluated the trustee compensation requests, which in the first three cases exceeded the distribution to unsecured creditors. The court's decision was joined by all of the judges of the Eastern District. The holding of the opinion is also now a General Order (No. 14-05, December 11, 2014).

Which of the following are true of the court's holding?

1. The court held that the trustee fees in the consolidated cases that exceeded the amounts remaining for unsecured creditors were "unreasonably disproportionate," and, hence, not "reasonable" for purposes of section 330(a)(1)(A).
2. The court reduced the fees requested by the trustees to equal the amounts that would be distributed to unsecured claims.
3. The court held that chapter 7 trustee fee applications must be detailed and supported by time records and a narrative statement of services in the following categories of cases:
   (1) requests for fees in excess of $10,000 (the "top 5%"of all fee applications);
   (2) all cases, such as in *Scoggins*, in which the trustee seeks fees exceeding the amount remaining for unsecured claims (including priority and general unsecured claims);
   (3) all cases involving "carve-outs" and "short sales;" and
   (4) all cases where the trustee operates a business.

Explanation of *In re Scoggins*.

All of the above are true. The court explained that a trustee fee that exceeds the distribution to unsecured creditors is "unreasonably disproportionate" and that this circumstance can be considered "extraordinary" within the meaning of *Salgado-Nava*, justifying departure from the award of a straight commission. The court relied in part on *In re KVN Corp., Inc.*, 514 B.R. 1 (BAP 9th Cir. 2014), which held that a distribution to unsecured priority and general claims that is less than the trustee's fee is disproportionate, is not "meaningful," and presents an "extraordinary circumstance."

The court in *Scoggins* acknowledged that the $60 statutory fee earned by chapter 7 trustees in a typical "no asset" chapter 7 case was low, and that even the $60 fee was not earned in "fee waiver" cases where the court authorized an impecunious debtor to file bankruptcy without paying a filing fee. But a low fee or no fee in other cases was not properly a factor in favor of allowing straight commissions in asset cases. Interestingly, the court in *Scoggins* found support for disallowing a portion of the requested "commission" by comparing publicly available information on annual income of local chapter 7 trustees, many of whom earned more than standing chapter 13 trustees.

3. Bankruptcy Court Jurisdiction: *Executive Benefits Ins. Agency v. Arkison*, 573 U.S. ___, 134 S. Ct. 2165 (June 9, 2014)

In 2011, the U.S. Supreme Court upset the bankruptcy court landscape by holding that, as Article I courts, bankruptcy courts do not have the constitutional authority to enter final judgments in certain matters, even though Congress attempted to grant the bankruptcy courts such authority. Bankruptcy enthusiasts wondered whether express or implied consent could cure the problem. The *Executive Benefits* case presented the Court with the opportunity to answer the query. Did the Court deliver?

An insolvent insurance agency transferred its business operations to a successor corporation and then closed its doors. After the company filed bankruptcy, the chapter 7 trustee filed an action against the successor entity (Executive Benefits Ins. Agency) seeking, among other things, to recover the asset

transfers as fraudulent conveyances. The trustee moved for summary judgment, and the bankruptcy court granted the motion. Executive Benefits appealed to the district court, which reviewed the decision *de novo* and affirmed.

On appeal to the Ninth Circuit, the defendants objected for the first time to the bankruptcy court's jurisdiction to hear and determine the state law fraudulent transfer claims, based on *Stern v. Marshall*, 564 U.S. 2 (2011). The Supreme Court had decided the *Stern* case after Executive Benefits had filed its opening brief in the appeal.

Stern held that bankruptcy courts cannot enter a final judgment in certain matters statutorily-designated as "core" under 28 U.S.C. sections 157(b)(1) & (2), because the bankruptcy courts are not Article III courts. A bankruptcy litigant has a constitutional right to have certain matters heard by an Article III court. *Stern* held that Congress may not withdraw from Article III courts "any matter which, from its nature, is the subject of a suit at the common law, or in equity, or in admiralty." In *Stern*, the Court held that Article III prevents bankruptcy courts from entering final judgment on claims that seek only to "augment" the bankruptcy estate and would otherwise exist without regard to any bankruptcy proceeding.

In light of the *Stern* holding, Executive Benefits moved to dismiss the appeal on grounds that the bankruptcy court lacked subject matter jurisdiction and the Ninth Circuit lacked jurisdiction over the appeal. In response, the trustee argued that Executive Benefits had consented to the bankruptcy court's jurisdiction to enter a final judgment in non-core matters as permitted by section 157(c)(2), which provides that the district court may refer a proceeding related to a case under the Bankruptcy Code to a bankruptcy court with the consent of the parties.

The Ninth Circuit held that consent could be, and was, implied and need not be express. The court also found that the district court's *de novo* review was consistent with section 157(c)(1), which permits a district court to refer any cases or proceedings under the Bankruptcy Code to bankruptcy courts for the district. The Supreme Court granted Executive Benefits' petition for certiorari.

The Supreme Court:

A. Assumed that the subject claims were "*Stern*" claims; that is, claims denominated as "core" under section 157(b) that, under *Stern*, could not be finally decided by the bankruptcy court.
B. Concluded that the procedure under section 157(c)(1) for a bankruptcy court issuing proposed findings and conclusions for the district court's *de novo* review in non-core matters is not expressly authorized for *Stern* "core" matters.
C. Held that *Stern* matters not governed by the "core" provisions of section 157(b) are in effect non-core and thus are subject to section 157(c)(1).
D. Found that Executive Benefits received the appropriate *de novo* review when the district court applied the *de novo* standard applicable to review of grants of summary judgment.
E. All of the above.

Explanation of *Executive Benefits Ins. Agency v. Arkison*: Express or Implied Consent Satisfies *Stern* in the 9th Circuit

The correct answer is E. The Supreme Court reiterated that as the result of *Stern*, the bankruptcy courts do not have jurisdiction to hear and determine state law fraudulent transfer claims, even though those claims are "core" claims under 28 U.S.C. § 157(b). The Court acknowledged that this situation creates a statutory gap. But the Court did not agree that this "gap" created an insolvable problem, since the Bankruptcy Code contains a "severability" provision. Thus, the Court ruled that the statute permits *Stern* claims to proceed as non-core within the meaning of section 157(c).

In this particular case, that is exactly what happened: the bankruptcy court's ruling was reviewed *de novo* by the district court, thus following the substance of the ruling in *Stern*.

The Court expressly declined to reach the issue of consent to jurisdiction, one of the grounds articulated by the Ninth Circuit. However, the consent issue was squarely raised in another case before the Supreme Court, called *Wellness Int'l Network, Ltd. v. Sharif*. In the Court's majority opinion issued May 26, 2015, the Court held that Article III is not violated when the parties knowingly and voluntarily consent to adjudication by a bankruptcy judge. Thus, the Ninth Circuit's ruling in *Executive Benefits* was correct.

4. Can a Dishonest Debtor's Exemptions Be Surcharged? *Law v. Siegel*, 571 U.S. ___, 134 S. Ct. 1188 (March 4, 2014)

Chapter 7 debtor Stephen Law ("Debtor") claimed a $75,000 state law homestead exemption in his house, which

was worth $375,000. The house was subject to a first and second deed of trust in the amount of $150,000 each, so it appeared there was no equity in the property. The chapter 7 trustee, however, sued to avoid the second deed of trust as fraudulent. The second deed of trust holder, Lili Lin of Artesia, California, stipulated that the lien was a sham and to the invalidation of the lien. However, Lili Lin of China then appeared, through various attorneys, to say she was the real Lili Lin, and that the lien was valid. After years of litigation with the second Lili Lin (and $500,000 in litigation expenses by the trustee), the bankruptcy court concluded that the second deed of trust was a fiction and a fraudulent plan by the Debtor to shield from the trustee the Debtor's equity in the property.

Based on the Debtor's fraud, the trustee moved to "surcharge" the Debtor's $75,000 homestead exemption to defray the trustee's attorney's fees. The bankruptcy court granted the trustee's motion, based upon section 105, and the Bankruptcy Appellate Panel and the Ninth Circuit affirmed, citing *Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004) (allowing surcharge to compensate the estate for the actual monetary costs caused by the debtor's misconduct, and to protect the integrity of the bankruptcy process).

The Court:

A. Reversed. The bankruptcy court may not exercise either its statutory power under section 105(a), or its inherent equitable powers, in contravention of Debtor's homestead exemption rights set forth in section 522, which: (1) allow the Debtor to claim a California homestead exemption, and (2) provide that such exemption is not liable for the payment of administrative expenses of the estate (section 522(k)).

B. Affirmed. The bankruptcy court may exercise its inherent equitable powers to surcharge a Debtor's homestead exemption rights set forth in section 522.

C. Reversed. A surcharge in this case would have been allowable if the trustee had timely objected to the Debtor's claimed homestead exemption. Since he did not, the exemption became final prior to the imposition of the surcharge, citing *Taylor v. Freeland & Kronz*, 503 U.S. 638, 643-44 (1992).

Explanation of *Law v. Siegel*.

A is true; B and C are false. In a unanimous opinion written by Justice Scalia, the Court explained that section 522's "meticulous...enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exceptions [such as an equitable surcharge]." The Court acknowledged that the inability to surcharge exemptions may result in inequitable outcomes in cases such as this one, but held that Congress already balanced the interests of debtors and creditors in section 522, and the courts cannot alter the statute's balance. The Court further explained that a bankruptcy court may issue sanctions under Rule 11, may deny the debtor's discharge, and may have sanctioning power under section 105 and its inherent powers, but it has no power under federal law to surcharge an exemption claimed under section 522. Note that there is some limited authority for the proposition that state law may allow a surcharge of state-created exemptions. See *In re Denson*, 195 F. 857, 858 (N.D. Ala. 1912); *Cowan v. Burchfield*, 180 F. 614, 619 (N.D. Ala. 1910); *In re Ansley Bros.*, 153 F. 983, 984 (E.D.N.C. 1907). But federal law provides no authority for bankruptcy courts to deny an exemption on a ground not specified in the Bankruptcy Code.

B is false. The Court held that a court's equitable powers, like its powers under section 105, could not override the provisions of section 522. C is also false. It is true that the bankruptcy trustee in this case failed to timely object to the exemption, but the Court held that even if he had timely objected, this still would not have provided grounds for surcharging an exemption.

5. Recovery of Post-Petition Interest: *In re SW Boston Hotel Venture, LLC*, 748 F.3d 393 (1st Cir. 2014)

Section 506(b) of the Bankruptcy Code allows a creditor that is secured by collateral worth more than the debt (i.e., oversecured) to add to the debt post-petition interest, attorney's fees, and other charges provided for in the loan documents. This case involves the question of when post-petition interest begins to accrue for an oversecured creditor.

A lender held a first priority mortgage on a hotel and related properties. A few months after the borrower's chapter 11 filing, the lender moved for relief from the automatic stay. The debtor successfully argued that the creditor was oversecured, so the lender's motion for relief from stay was denied.

Less than a year later, the hotel property was sold. The oversecured lender filed a motion under section

506(b) to recover post-petition interest accruing during the pendency of the bankruptcy case at the default rate set forth in the loan documents. The bankruptcy court granted the lender's motion, allowing interest at the default rate, but ruled that post-petition interest began to accrue only as of the date of the sale of the property, not from the petition date. On appeal, the First Circuit Bankruptcy Appellate Panel ("First Circuit BAP") reversed on that point, holding that the lender was entitled to post-petition interest at the default rate from the petition date. The debtor appealed to the First Circuit Court of Appeals.

The First Circuit:

A. Affirmed, because the bankruptcy court had earlier found that the creditor was oversecured at the time it moved for relief from the automatic stay, so that finding was binding upon the bankruptcy court when considering the creditor's entitlement to post-petition interest.

B. Reversed, because the language of section 506 permits a flexible approach to the date for determining whether a creditor is oversecured, and there was no reason for the First Circuit BAP to disturb the bankruptcy court's ruling.

C. Affirmed, because under principles of judicial estoppel, if the debtor was able to persuade the court at the outset of the case that the creditor was substantially oversecured at that time, the debtor was prohibited from arguing that postpetition interest should not be awarded.

D. Affirmed, because section 506(a)(2) specifies the date of the filing of the petition as the measuring date for valuing personal property, so Congress must have intended the petition date as the measuring date for any other property.

Explanation of *In re SW Boston Hotel Venture, LLC*: Section 506 Permits a Flexible Approach to the Date for Determining Whether a Creditor is Oversecured

The correct answer is B. The court held that when viewed as a whole, the language of section 506 permits a flexible approach to the date for determining whether a creditor is oversecured. The court noted that although section 506(b) does not provide a specific measuring date, an exception to the rule contained in section 506(a)(2) for personal property does specify the date of the filing of the petition as the measuring date. The fact that Congress mandated particular measuring dates in the exception applicable to personal property without mandating a particular measuring date in the general rule suggests that Congress intended flexibility.

As to the fact that the bankruptcy court had found that the lender was oversecured early in the case at the time it moved for relief from the automatic stay, the court said: "[A] valuation made for one purpose at one point in a bankruptcy proceeding has no binding effect on valuations performed for other purposes at other points in the proceeding."

It should be noted that the particular facts in the case appear to have played a part in the flexible approach ruling and the First Circuit's decision not to disturb the bankruptcy court's ruling. The lender had liens on multiple parcels of real property, parts of the collateral were sold before others, and the debtor was making improvements to the property at different times. Ultimately, the bankruptcy court ruled that a sale is a better determination of the value of the property than the one made by the court in connection with the relief from stay motion and that the facts showed that the increase in value occurred around the time of the sale, rather than that the value had been there since the petition date.

Bottom line: a flexible approach to valuation in bankruptcy cases. A decision from the Ninth Circuit Bankruptcy Appellate Panel uses the sale date, and not the petition date, as the date for determining whether the creditor is oversecured. *Takisaki v. Alpine Group, Inc. (In re Alpine Group, Inc.)*, 151 B.R. 931, 935-36 (BAP 9th Cir. 1993).

6. Pleading "Consent" and Attorney's Fees in Bankruptcy Court: Bankruptcy Rule 7008 (General Rules of Pleading)

Federal Rule of Bankruptcy Procedure ("FRBP") 7008 was recently amended in two important ways. *Prior to its recent amendment* effective December 1, 2014, FRBP 7008 provided:

> (a) Rule 8 Federal Rules of Civil Procedure applies in adversary proceedings. The allegation of jurisdiction required by Rule 8(a) shall also contain a reference to the name, number, and chapter of the case under the Code to which the adversary proceeding relates and to the district and division where the case under the Code is pending. In an

adversary proceeding before a bankruptcy court, the complaint, counterclaim, cross-claim, or third-party complaint shall contain a statement that the proceeding is core or non-core, and, if non-core, that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy court.

(b) Attorney's fees. A request for an award of attorney's fees shall be pleaded as a claim in a complaint, cross-claim, third-party complaint, answer, or reply as may be appropriate.

1. Effective December 1, 2014, FRBP 7008(a) (end of second sentence) was amended. Is it true or false that FRBP 7008(a) was amended to *delete* the requirement of a statement that the proceeding is core or non-core?

2. FRBP 7008(b) was also amended. Is it true or false that it was amended to provide that a demand for attorney's fees can also be included in a pretrial conference statement?

Explanation of Amendment to Bankruptcy Rule 7008.

The first answer is true. Former subdivision (a) of FRBP 7008(a) was amended to *remove* the requirement that the pleader state whether the proceeding is core or non-core. The pleader is still required to state whether the party does or does not consent to the entry of final orders or judgment by the bankruptcy court. The change was driven by the U.S. Supreme Court holding in *Stern v. Marshall*, 564 U.S. 2, 131 S. Ct. 2594 (2011), which held that some proceedings that satisfy the statutory definition of core proceedings in 28 U.S.C. § 157(b)(2) nevertheless must be determined by an Article III court and are beyond the constitutional power of a bankruptcy judge to finally adjudicate. Thus, the amended rule is simplified to eliminate the requirement to distinguish between core and non-core matters, since this distinction may not be meaningful. Instead, the pleader is required only to make a statement regarding consent, regardless of whether or not a proceeding is termed core or non-core.

As mentioned above, the Supreme Court ruled in *Wellness Int'l Network, Ltd. v. Sharif* that parties *may* consent to the bankruptcy court's rendering of a final judgment in a matter in which it otherwise lacks the constitutional authority to do so under *Stern v. Marshall*. The Court further held that consent may be implied as well as express, though implied consent must nevertheless be "knowing and voluntary." Note that Rule 7012(b) has been amended to require a similar statement regarding consent in a responsive pleading.

No. 2 is false. FRBP 7008(b) was amended to entirely delete subdivision (b), which requires attorney's fees to be pled as a claim. This (former) requirement differed from the practice under the Federal Rules of Civil Procedure, and was viewed as potentially creating a trap for the unwary.

Under the prior FRBP 7008(b), the general understanding was that attorney's fees had to be demanded in a claim for relief, not just in the prayer. (*See In re Odom*, 113 B.R. 623, 625 (Bankr. C.D. Cal. 1990) ("Although plead with specificity, Plaintiffs' request for fees is in the form of a prayer only. Such a request is deemed insufficient under Rule 7008(b).").) (*See also In re Frazer*, 466 B.R. 107, 118 (Bankr. S.D. Tex. 2012) (rejecting a party's claim for attorneys' fees, reasoning that "[i]t is insufficient for a party to solely demand attorney's fees in the prayer for relief" and because "the Plaintiffs failed to assert a claim for attorney's fees in their complaint...the Plaintiffs are not entitled to recover the attorney's fees that they have incurred for the prosecution of this adversary proceeding").) Other cases sometimes approached the former rule in a relaxed manner, and treated the pleadings as amended to conform to evidence at trial. (*DiSalvo*, 221 B.R. 769 (BAP 9th Cir. 1998).)

With the deletion of the requirement to plead a claim for attorney's fees, the procedures for seeking an award of attorney's fees are now set out in Rule 7054(b)(2), which makes applicable most of the provisions of Federal Rule of Civil Procedure ("FRCP") 54(d)(2). As specified by FRCP 54(d)(2)(A) and (B), a claim for attorney's fees must be made by a motion filed no later than 14 days after entry of the judgment unless the governing substantive law requires those fees to be proved at trial as an element of damages. When fees are an element of damages, such as when the terms of a contract provide for the recovery of fees incurred prior to the adversary proceeding, the claim for attorney fees still needs be made as part of the pleadings.

7. Post-petition Inheritance as Property of a Chapter 13 Bankruptcy Estate: *Dale v. Maney (In re Dale)*, 505 B.R. 8 (BAP 9th Cir. 2014)

Section 541(a)(5) of the Bankruptcy Code, applicable to filings under all chapters, provides that property of the estate includes any property acquired by the debtor up to 180 days after the petition date by bequest, devise or inheritance.

Section 1306(a), applicable to chapter 13 cases only, provides that property of a chapter 13 estate also includes all property the debtor acquires after the petition date and before the case is closed, dismissed, or converted. This case involves the question of whether the time limitation in section 541(a)(5) trumps section 1306(a) or vice versa.

Debtors Robert and Kathy Dale filed their chapter 13 petition in late 2011. In August of 2012, more than 180 days after the petition date but before confirmation of the chapter 13 plan, the husband's mother passed away, leaving him an inheritance of about $30,000.

The debtors disclosed the inheritance to the bankruptcy court in late 2012, and the chapter 13 trustee demanded the debtors turn over the money for distribution to their creditors. Less than a month after his turnover demand, the chapter 13 trustee sought dismissal of the chapter 13 case because the debtors were delinquent on payments under their proposed plan. The debtors filed a motion to halt their plan payments, and proposed funding their remaining plan payments from what was left of the inheritance, about $10,000. The chapter 13 trustee filed an amended motion to dismiss, alleging that the debtors failed to turn over the nonexempt inheritance proceeds and were still delinquent on their plan payments.

The bankruptcy court held that an inheritance received by a chapter 13 debtor before the case is closed, dismissed, or converted becomes property of the bankruptcy estate pursuant to section 1306(a). The bankruptcy court ordered the debtors to either turn over the balance of the inheritance to the chapter 13 trustee for distribution to creditors, or amend their plan to provide for a direct distribution of the funds. The debtors appealed to the Ninth Circuit Bankruptcy Appellate Panel ("Ninth Circuit BAP").

The Ninth Circuit BAP:

A. Reversed, holding that section 541(a)(5) imposes a 180-day limit on property acquired by a debtor by inheritance, and, since the debtors acquired the inheritance after the 180-day period, the inheritance did not need to be used to fund the chapter 13 plan.
B. Reversed, holding that even though section 1306(a) expands property of a chapter 13 estate, the time limitation in section 541(a)(5) governs over the more general language of section 1306(a).
C. Affirmed, holding that the language in section 1306(a) expands the 180-day time period in section 541(a)(5) for chapter 13 cases.
D. Reversed, declining to follow the majority of courts interpreting the application of section 1306(a) with respect to post-petition inheritances in chapter 13.

Explanation of *Dale v. Maney (In re Dale)*: Section 1306(a) Expands the 180-Day Time Period in Section 541(a)(5) for Chapter 13 Cases

The correct answer is C. The decision hinges on a reconciliation of Bankruptcy Code sections 541(a)(5) and 1306(a). Section 541(a)(5) imposes a 180-day limit on property acquired by inheritance by a debtor after the petition was filed. Property acquired by inheritance within 180 days after the petition is filed is included in the bankruptcy estate property if such property would have been property of the estate if the debtor had owned it at the time he filed the petition. Section 1306(a) says that for purposes of chapter 13 cases, property of the estate includes all property that the debtor acquires after commencement of the case but before the case is closed, dismissed, or converted.

The debtors argued that an inheritance received by a chapter 13 debtor more than 180 days after the petition date is not bankruptcy estate property, because subsection 1306(a) only expands the definition of estate property enumerated by subsection 541(a), but does not change subsection 541(a)'s 180-day limit on after-acquired property. The debtors argued that husband's inheritance—received during the pendency of the chapter 13 case but outside subsection 541(a)(5)'s 180-day limit—was not property of the estate.

The Ninth Circuit BAP disagreed. The Ninth Circuit BAP agreed with the Fourth Circuit Court of Appeals' decision in *Carroll v. Logan*, 735 F.3d 147, 150 (4th Cir. 2013), which held that the temporal language in section 1306(a) expanded the 180-day time period in section 541(a)(5) for chapter 13 cases. The Ninth Circuit BAP noted that the *Carroll* decision "is consistent with the great weight of authority interpreting the application of section 1306(a)(1) with respect to postpetition inheritances in chapter 13, explicitly considering the temporal exclusion included in section 541(a)(5)."

Thus, the Ninth Circuit BAP affirmed the bankruptcy court's ruling, holding that inheritances received by chapter 13 debtors more than 180 days after the petition date but before the chapter 13 case is closed, dismissed, or converted are included as estate property. The Ninth Circuit

BAP joins a long list of courts that have held subsection 1306(a) supersedes subsection 541(a)'s treatment of after-acquired property in chapter 13 cases. While the Ninth Circuit Court of Appeals has not addressed this issue, this holding may suggest it would reach a similar conclusion.

8. Chapter 7 Lien Stripping: *Bank of America v. Caulkett*, 575 U.S. ____ 135 S.Ct. 1995 (June 1, 2015)

In two different cases (combined for appeal), chapter 7 debtors made motions to strip off a wholly-unsecured 2nd deed of trust on their residences. The motions were based on sections 506(a) & 506(d). Section 506(a) bifurcates an undersecured claim into two claims: one is a secured claim to the extent of the value of the creditor's interest in the collateral that secures the claim; the other is an unsecured claim to the extent of any deficiency between the amount of the claim and the value of the collateral. Section 506(d) in turn provides, "To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void . . ."

The bankruptcy court granted the debtors' motions to "strip off" the liens, and the district court and 11th Circuit affirmed. This set up a Circuit split - the Fourth, Sixth, and Seventh Circuits have held that a chapter 7 debtor cannot strip off a wholly unsecured junior lien.

The United States Supreme Court:

1. Reversed. Wholly unsecured junior mortgages constitute "allowed secured claims" and are therefore not subject to being stripped off by chapter 7 debtors in bankruptcy.
2. Affirmed. Under the plain meaning of sections 506(a) and 506(d), the unsecured portion of a lien is not "an allowed secured claim," and may be stripped down.
3. Reversed. The Court's decision was controlled by *Dewsnup v. Timm*, 502 U.S. 410 (1992), which held that section 506(d) cannot be used by a chapter 7 debtor to "strip down" the undersecured portion of a lien.

Explanation of *Caulkett* Holding.

No. 1 is the correct holding of the Court. No. 3 is also correct. The Court held that its decision was controlled by *Dewsnup v. Timm*, 502 U.S. 410 (1992). That case held that section 506(d) cannot be used by a chapter 7 debtor to "strip down" the undersecured portion of a lien. In *Dewsnup*, the Court interpreted "an allowed secured claim" as used in section 506(d) to mean a claim that is (1) allowed and (2) secured by a lien, and thus ruled that a strip down of the lien was impermissible under section 506. *Dewsnup* did not address the question whether the same rule would apply to bar the "strip off" of a wholly unsecured lien. The Court in *Caulkett* did address the question, and said the answer is the same: no.

No. 2 is not correct, but, strikingly, the Court expressed sympathy with this view. At the oral argument stage, several Justices voiced their displeasure with the *Dewsnup* decision. The *Caulkett* opinion states that the more natural reading of the statute would be to allow stripping-off of unsecured liens, were it not for the *Dewsnup* precedent. *Caulkett* contains a single footnote that states, with citation, that *Dewsnup* had been the "target of criticism." At several points in the opinion, the Court reiterated that the debtors had not asked the Court to overrule *Dewsnup*. Justice Scalia stated at oral argument that he still believed his dissent in *Dewsnup* was "correct," and Justice Kagan agreed. The Court was unwilling to overrule prior precedent without an express request from one of the litigants, but if there had been such a request, the result may well have been different.

9. Non-Dischargeability of Taxes: *Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662 (9th Cir. 2014)

Section 523(a)(1)(C) provides that a tax debt is non-dischargeable if the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax. This case presents the question of what is necessary to establish that a debtor "willfully attempted" to evade or defeat the tax debt.

The debtor in this case, Hawkins, was the founder of Electronic Arts ("EA"), one of the Silicon Valley's most successful computer-games companies. In the mid-1990s, Hawkins began to sell off his EA stock to fund a second company, 3DO. Around that time, Hawkins' tax advisors advised him to invest in two complex offshore investments designed to create large losses to offset capital gains. 3DO was not a success, and ultimately filed bankruptcy. In 2001, the Internal Revenue Service ("IRS") began investigating the tax shelter transactions and started an audit of Hawkins' taxes. In 2005, the IRS and the California Franchise Tax Board ("FTB") assessed $36 million in taxes, penalties, and interest. Hawkins was unable to pay the tax debt, so he filed chapter 11.

A plan of reorganization was negotiated with the IRS and the FTB, which was approved by the bankruptcy court (i.e., confirmed) without objection. Under the plan, the taxing authorities together received over $19 million. However, under the plan, the taxing authorities had not waived their right to assert that the remaining taxes were non-dischargeable. After confirmation, the debtors sued the IRS and FTB to determine the dischargeability of the remaining taxes. The bankruptcy court discounted or entirely rejected all of the taxing authorities' claims other than that Hawkins had continued to live in a "luxurious" fashion while knowing that the taxing authorities were going to assess additional taxes. The bankruptcy court held that paying expenses in excess of income while not paying known taxes amounted to a "willful attempt to evade or defeat" the taxes under section 523(a)(1)(C), and, thus, that the remaining unpaid taxes were not discharged. The district court affirmed, holding expressly that specific intent to evade or defeat the tax was not required for section 523(a)(1)(C) to apply.

The Ninth Circuit:

A. Affirmed, holding that Congress intended that the dischargeability of taxes owed to the federal government was to be interpreted in favor of non-dischargeability, because the government needs the money.
B. Affirmed, following cases in other circuits that hold that taxes can be excepted from discharge under section 523(a)(1)(C) even where no particular action is taken with the intent to evade or defeat the tax.
C. Affirmed, holding that a "willful" attempt to evade or defeat taxes requires only a willful act (choosing not to pay the taxes), such as not paying the taxes while living in a "luxurious" fashion.
D. Reversed, holding that "willful" requires that the debtor take action with the specific intent to evade or defeat the taxes.
E. All of the above, except D.

Explanation of *Hawkins v. Franchise Tax Bd. of California*: Specific Intent Must be Shown to Establish "Willful" Requirement for Non-Dischargeability of Taxes

The correct answer is D. The court noted that the word "willful" can have different meanings depending on the context, so the court first looked to the structure of the statute and the policies of the bankruptcy court as a whole.

The first two categories of non-dischargeable taxes in section 523(a)(1) impose liability where intent is not considered, but the last section—the one at issue here—does not. Instead the statute groups "willfully . . . evade or defeat such tax" with filing a "fraudulent return," and proving the filing of a "fraudulent return" clearly requires showing specific intent. It follows, the court reasoned, that proving a debtor "willfully" attempted to evade a tax must also require showing intent.

The Ninth Circuit also considered the identical language in section 7201 of the Internal Revenue Code, which describes felonious action and clearly requires specific intent. The court also noted the general policy in bankruptcy law of reading exceptions to discharge narrowly. As a result, the court reversed because the lower courts applied the wrong, more lenient standard. The court remanded the case to apply the correct standard.

10. Chapter 7 Debtor's Attorney's Obligation to Represent the Debtor: *In re Seare*, 515 B.R. 599 (BAP 9th Cir. 2014).

Attorneys representing chapter 7 debtors typically exclude from the engagement certain types of potential proceedings, such as nondischargeability proceedings. This case explores when and how attorneys may "unbundle" their obligations to represent the debtor. In this case, Wayne Seare ("Seare") sued his employer (a hospital) for employment discrimination. During the litigation, Seare admitted that he had embellished evidence to bolster his discrimination claim. The court found that Seare had committed a "fraud upon the court," and sanctioned Seare by ordering him to pay the employer attorneys' fees in the amount of $67,430.58 ("Judgment").

Seare engaged bankruptcy counsel and filed a chapter 7 petition. Seare said he explained to the bankruptcy attorney the fraud finding behind the Judgment; the attorney said he understood the debt was a medical debt and that Seare did not explain the circumstances. The 19-page bankruptcy retainer agreement, which Seare signed, provided that the attorney would represent Seare in his chapter 7 case for $1,999, excluding any non-dischargeability proceedings, which would require an additional fee.

The hospital creditor filed a non-dischargeability complaint against Seare. The attorney declined to represent

Seare and referred him to other counsel. The bankruptcy court issued an Order to Show Cause ("OSC") why the attorney should not be sanctioned for violating the Nevada Rules of Professional Conduct ("NRPC") for failing to represent Seare in the adversary proceeding. After an evidentiary hearing, the court sanctioned the attorney for impermissibly limiting the scope of his representation of Seare in violation of various Nevada state ethics rules and of sections 526(a), 528(a) & 707(b)(4)(C). The court ordered the attorney to return the attorney's fees, the costs of filing, and the credit check fee. The order also required the attorney to "provide a copy of the Sanctions Opinion to potential adversary clients whose case [the attorney] declines for the next two years."

On appeal, the Ninth Circuit BAP affirmed the bankruptcy court's order on which of the following grounds:

A. The attorney violated section 526(a)(1) for his failure to perform a service he informed the debtor that he would provide in connection with his bankruptcy case by flatly refusing to represent the client in the adversary proceeding when his fee agreement said he would do so for an additional fee.

B. The attorney failed to comply with section 526(a)(3) because he did not inform the debtor about the risks associated with an adversary proceeding he was nearly certain to face once he filed for bankruptcy.

C. The attorney violated section 528(a) because he failed to sign the retainer agreement.

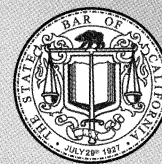
D. The attorney violated section 707(b)(4)(C) because he did not perform a reasonable investigation into the circumstances that gave rise to the petition.

E. The Ninth Circuit BAP affirmed the monetary sanctions but remanded for further findings to justify the extraordinary sanction of requiring the attorney to provide the sanctions order to all prospective adversary clients for two years.

Explanation of *In re Seare*.

The correct answer is that the Ninth Circuit BAP affirmed the bankruptcy court's order on all of these grounds. Answer E is partially incorrect, in that there was no remand for further findings. The Ninth Circuit BAP concluded that a qualitative analysis of each debtor's case should be done at the intake to ensure that a debtor's reasonable goals and needs are met and, in this case, that calculus was not performed. In a detailed concurring opinion, Judge Jury made clear that consumer bankruptcy attorneys may unbundle their services in Nevada, particularly excluding adversary proceedings from the representation. The concurring opinion made clear that unbundling representation in a bankruptcy case from representation in an adversary proceeding is prohibited by neither state ethical standards nor the Bankruptcy Code. However, unbundling needs to comply with the rules of ethics and the Bankruptcy Code.

Note that this case follows the general rule that when there is a dispute between the attorney and the client as to what was said or transpired, the attorney will lose unless there is proper documentation to independently verify the attorney's position. In this case, the attorney needed to undertake additional minimal investigation, such as a review of the state court's records or questioning Seare after the meeting of creditors, at which meeting the hospital had requested the debtor stipulate that the debt was nondischargeable.



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Endnotes

1 The "cap" provides a formula to calculate a trustee's maximum commission. 11 U.S.C. § 326 ("Limitation on compensation of trustee") provides:

> (a) In a case under chapter 7 or 11, the court may allow reasonable compensation under section 330 of this title of the trustee for the trustee's services, payable after the trustee renders such services, not to exceed 25 percent on the first $5,000 or less, 10 percent on any amount in excess of $5,000 but not in excess of $50,000, 5 percent on any amount in excess of $50,000 but not in excess of $1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of $1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.

For example, if the trustee distributes $50,000, the cap is $5,750.