Bankruptcy Bulletin
A Publication of the Minnesota State Bar Association Bankruptcy Section

March 2006

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The United States Supreme Court Rules That States May Be Sued In Bankruptcy Proceedings

In *Central Virginia Community College et al. v. Katz*, 546 U.S. ___ (2006), the United States Supreme Court ruled that a bankruptcy trustee's proceeding to set aside a debtor's preferential transfers to state agencies is not barred by the states' sovereign immunity defense.

The Bankruptcy Clause in Article I, Section 8, Clause 4 of the U.S. Constitution provides that Congress shall have the power to establish "uniform laws on the subject of Bankruptcies throughout the United States." In *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004), the Supreme Court, without reaching the question of whether the Bankruptcy Clause gives Congress the authority to abrogate states' immunity from private suits, upheld the application of the Bankruptcy Code to proceedings initiated by a debtor against a state agency to determine the dischargeability of a student loan debt.

Here, a bankruptcy trustee commenced an avoidance action pursuant to 11 U.S.C. §§ 547(b) and 550 against four public educational institutions in the State of Virginia to recover funds paid by a debtor who operated bookstores in Virginia. Virginia asserted state sovereign immunity as a defense to the trustee's preferential transfer claims. The trustee argued that state sovereign immunity does not protect Virginia from the avoidance actions. The 6th Circuit Court of Appeals ruled in favor of the trustee and Virginia appealed.

The other forty-nine states filed friend-of-the-court briefs in support of Virginia's position. They warned of possible effects on state finances if they could be sued like other creditors and had to defend against such lawsuits in courts around the country. However, the Supreme Court held that the states gave up sovereign immunity protection in bankruptcy cases when they adopted the U.S. Constitution and its overriding Bankruptcy Clause. The Supreme Court noted that there was general agreement at the Constitutional Convention on the importance of authorizing a uniform federal response to the problems and injustices that a wildly divergent and uncoordinated insolvency and bankruptcy law could create in the country.

Because of its holding, the Court stated that it did not need to consider the question left open by *Hood*: whether the attempt by Congress to abrogate the states' sovereign immunity through Bankruptcy Code §106(a) was valid. It is also to interesting to note that the Supreme Court's decision in *Katz* was perhaps one of its last where Justice O'Connor's "swing vote" proved pivotal. *Katz* was a 5 to 4 decision with Justice O'Connor siding with the majority. The dissent was authored by Justice Thomas, who was joined by Chief Justice Roberts and Justices Scalia and Kennedy.

"Negative Notice" Is Sufficient Notice For The Bankruptcy Courts To Issue Orders Without The Need To Hold Hearings

In *Roberts v. Pierce (In re Pierce),* No. 05-1095 (8th Cir., Jan. 25, 2006), the Eighth Circuit Court of Appeals upheld a bankruptcy court's use of "negative notice" as a means of providing notice to a creditor of a claim objection.

The Debtor filed a Chapter 13 petition and objected to a creditor's proof of claim. The Debtor served a negative notice on the

creditor, which stated that if the creditor did not respond and request a hearing within thirty days, the court could enter an order without further hearing. The creditor did not respond nor did he request a hearing. The bankruptcy court, without holding an evidentiary hearing, issued an amended order granting in part and disallowing in part the creditor's claim. The creditor appealed and the district court affirmed, finding that Federal Rule of Bankruptcy Procedure 9007 specifically granted the bankruptcy court the discretion to set the particularities of notice procedures. The creditor then appealed to the Eighth Circuit Court of Appeals.

The Eighth Circuit held that, while FRBP 9007 may give bankruptcy courts the discretion to adopt negative notices, such notice is directly authorized by Bankruptcy Code §§ 102 and 502. Section 502(b) provides that if a claim is objected to, then the bankruptcy court shall determine the claim amount "after notice and hearing." Bankruptcy Code § 502(b). Section 102 defines "after notice and a hearing" to allow an act without an actual hearing provided that proper notice is given and a hearing is not timely requested by a party in interest. Thus, an actual hearing is not necessary, and the creditor here did not deny that he had received the negative notice.

Eighth Circuit Agrees Rule 9011 Violated, But Overturns Award Of Sanctions

In *Briggs v. Labarge (In re Phillips)*, 433 F.3d 1068 (8th Cir. 2006), the Chapter 13 trustee sought imposition of Rule 9011 sanctions against attorney Ross Briggs ("Briggs") for filing a bankruptcy petition without the Debtor's consent. The bankruptcy court granted the trustee's motion and sanctioned Briggs. The BAP affirmed, and Briggs appealed to the Eighth Circuit Court of Appeals which affirmed the bankruptcy court's finding that Rule 9011 was violated, but struck the award of sanctions.

The Debtor retained Critique Services ("Critique") to file a Chapter 13 bankruptcy on her behalf. This case was filed, but later dismissed because the Critique attorney assigned to the case did not comply with several of the bankruptcy rules. The Debtor remained concerned about her case and an upcoming foreclosure sale pending against her home, and she frequently contacted Critique to inquire about the status. Critique hired Briggs and assigned him to the Debtor's case.

Without meeting or speaking with the Debtor, or obtaining her signature, Briggs proceeded to electronically file a second Chapter 13 bankruptcy for her. He used an incorrect address on the petition and thus the Debtor, unaware that a second petition had been filed, did not attend any of the required hearings as she did not receive notice. As such, the case was dismissed for her repeated failure to appear in bankruptcy court. Unaware of the second filing, the Debtor retained other counsel who filed a third Chapter 13 bankruptcy petition on her behalf. A creditor moved to dismiss this filing on the basis of "bad faith" as this was her third petition.

The Trustee filed a motion for sanctions against Briggs, alleging that he had violated Bankruptcy Rule 9011 by filing a bankruptcy petition for the Debtor without meeting with her or obtaining her signature. The bankruptcy court concluded that the Debtor did not authorize Briggs to file a bankruptcy petition and that there was no original voluntary petition bearing the Debtor's signature for the second bankruptcy case. The court found that these acts violated Bankruptcy Rule 9011, and that

sanctions were warranted. The court ordered Briggs to return all funds paid by the Debtor to Critique for her first bankruptcy petition (before Briggs was hired by Critique), to pay a fine of $750 to the court, to pay the trustee's attorney fees and the court further referred the matter for possible criminal prosecution and disbarment.

The Eighth Circuit agreed that Briggs violated Rule 9011, holding that Rule 9011 requires that the attorney make a reasonable inquiry into whether there is a factual and legal basis for a claim before filing. The court found that Briggs' reliance on the older signatures in the file, his general knowledge that the Debtor seemed to want some action taken and knowledge of the impending home foreclosure did not constitute a reasonable inquiry. The court concluded that, without the personal authorization of the client, and especially without her verification that the facts in the petition were correct, Briggs did not make a reasonable inquiry before filing the bankruptcy petition.

However, the Court of Appeals noted that a violation of Rule 9011 does not necessarily require the exaction of sanctions. The court recognized Briggs' seeming good intentions and found that the bankruptcy court improperly sanctioned Briggs for the sins of the entire Critique law firm, rather than for his individual conduct. The court found "even more abusive" the referral for possible criminal prosecution. The Court of Appeals concluded that the sanctions imposed by the bankruptcy court were heavy-handed and an abuse of discretion and thus struck the sanctions in their entirety.

The Eighth Circuit Court Of Appeals Examines Jurisdictional Issues Where Reference Is Withdrawn To Adjudicate A Claim Objection

In *United States v. Gurley*, No. 04-2627 (8th Cir., Jan. 20, 2006), Debtor, the owner and operator of two hazardous waste sites, the Edmondson and West Memphis sites, was found liable under the Comprehensive Environmental Response, Compensation, and Liability Act for over $1.7 million, plus pre-judgment interest to the United States. The district court also granted the United States declaratory judgment for all future response costs associated with the Edmondson site. The Debtor subsequently filed for Chapter 7 bankruptcy. The United States filed a proof of claim. The claim included the amount of the district court judgment, interest, post-judgment response costs pursuant to the declaratory judgment, and response costs related to the West Memphis site. The Debtor filed an objection to the claim and then moved to withdraw the reference and remove the contested matter to district court.

After the matter was removed, the United States moved for summary judgment on the Edmondson site based on the prior declaratory judgment and for summary judgment on the West Memphis site. The United States was granted partial summary judgment on its proof of claim and the issues regarding the response costs for the Edmondson site pursuant to the declaratory judgment and the response costs for the West Memphis site were set for trial. At trial, the Debtor argued that the United States had failed to serve him with a complaint on the matter and that he had been denied his right to answer. The district court rejected the argument and entered judgment in favor of the United States, setting the matter on for a bench trial to determine the

amount of response costs. At the bench trial, the Debtor failed to make any arguments regarding the calculation of interest and the court awarded the United States almost $14 million in response costs, plus interest, for the Edmondson site and $7 million in response costs, plus interest, for the West Memphis site. With respect to the accrual of interest the court held that the United States was entitled to interest from the later of (i) the payment demand date, or (ii) the date of expenditures. The Debtor then moved to alter or amend the judgment, challenging the interest accrual date ordered by the court. Holding that new arguments could not be raised for the first time in a motion to alter or amend judgment, the court denied the Debtor's motion.

On appeal, the Debtor claimed that the district court lacked subject matter jurisdiction and personal jurisdiction because the United States had failed to serve him with a complaint. The United States argued that the district court had jurisdiction to adjudicate the Debtor's objection to the proof of claim pursuant to 28 U.S.C. § 1334(b). This section provides that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11."

Agreeing with the United States, the Eighth Circuit Court of Appeals stated that, although district courts may refer bankruptcy cases to bankruptcy courts, when resolution of a matter concerns both title 11 and federal laws affecting interstate commerce, upon timely motion of a party the district court shall withdraw reference. 28 U.S.C. § 157(d). Withdrawing the reference and returning adjudication of a proof of claim to the district court does not affect the subject matter jurisdiction that a district court is already granted under 28 U.S.C. § 1334(b).

In response to the Debtor's claim that the district court lacked personal jurisdiction, the court stated that, by filing a proof of claim, the United States participated in the bankruptcy proceeding to share in the Debtor's assets held *in rem* by the bankruptcy trustee. Because this was an *in rem* proceeding, the court held that the district court did not need personal jurisdiction over the Debtor. The court also noted that the adjudication of a proof of claim is subject to the Federal Rules of Bankruptcy Procedure, which do not require the United States to serve a complaint.

Finally, the appellate court addressed the Debtor's claim that the district court incorrectly calculated interest and that the district court's judgment constituted issue preclusion and equitable estoppel as to the start date for the accrual of interest. After failing to find any reference to these issues, in the record, by the Debtor prior to the Debtor's motion to alter or amend judgment, the court held that the district court did not abuse its discretion in denying the Debtor's motion for reconsideration. The court eloquently quoted from *United States v. Dunkel*, 927 F.2d 955, 956 (7th Cir. 1991), as follows: "Judges are not like pigs, hunting for truffles buried in brief."

Debtor's Status As A "Farmer" Is An Affirmative Defense To An Involuntary Petition Filing That Is Waived If Not Timely Raised

U.S. Bank v. Young (In re George L. Young and Prof. Bus. Servs., Inc.), No. 05-6013WM (B.A.P. 8th Cir., Jan. 12, 2006), involved a farmer who initially consented to the involuntary petition filing, but later

asserted lack of subject matter jurisdiction as a defense in an adversary proceeding.

George L. Young ("Young") owned and operated Professional Business Services, Inc. ("PBS" and together with Young, the "Debtors"). Several creditors filed an involuntary Chapter 7 bankruptcy proceeding against the Debtors. The Debtors filed an answer claiming that, although they were both farmers, they consented to the bankruptcy court's entry of an order for relief. After the bankruptcy court entered the order for relief, the Debtors attempted to convert to a Chapter 11 proceeding based on the argument that, because the Debtors were farmers, the bankruptcy court did not have subject matter jurisdiction over the involuntary Chapter 7 case. The Debtors' motion to convert was denied.

During the bankruptcy proceeding, Young entered into a plea agreement pleading guilty to obtaining credit by fraud from several creditors. The creditors then filed adversary proceedings against Young to except the debts from discharge under 11 U.S.C. § 523. The creditors moved for summary judgment on the ground that the plea agreement collaterally estopped Young from arguing that he did not incur the debts by way of fraud. Young responded by asserting that the court did not have subject matter jurisdiction over the involuntary Chapter 7 case and therefore it did not have jurisdiction over the adversary proceeding. Young did not challenge the collateral estoppel argument raised by the creditors. The bankruptcy court again rejected Young's jurisdictional argument and granted summary judgment in favor of the creditors.

On appeal, Young challenged three separate orders on the grounds that the court lacked subject matter jurisdiction: (i) the initial order for relief in the Chapter 7 bankruptcy case; (ii) the order denying the Debtors' motion to convert to a case under Chapter 11; and (iii) the order granting the creditors' motions for summary judgment in the adversary proceedings. The BAP found the first two orders to be "final" orders for the purposes of filing timely appeals. In order for the appellate court to have jurisdiction over the appeals from these orders, Young would have had to file notices of appeal within 10 days after the orders were entered, which he failed to do. Thus, the BAP did not have subject matter jurisdiction over the appeals from the first two orders. In regards to the third order, Young argued that because he was a farmer, the bankruptcy court lacked subject matter jurisdiction in the involuntary Chapter 7 bankruptcy case pursuant to 11 U.S.C. § 303(a). The BAP held that a debtor's status as a farmer is an affirmative defense to an involuntary petition as a bankruptcy court's jurisdiction is conferred by 28 U.S.C. §§ 157 and 1334, not 11 U.S.C. § 303(a). Young voluntarily consented to the bankruptcy court entering an order for relief in the involuntary Chapter 7 case even though he may have been a farmer within the meaning of the Bankruptcy Code. Thus, he waived this defense.

The Portion Of A Debtor's Federal Tax Refunds Attributable To The Child Tax Credit Is Property Of The Estate

In *Law v. Stover* (*In re Law*), No. 05-6034WM (B.A.P. 8th Cir., Jan. 26, 2006) and *Brouse v. Stover* (*In re Brouse*), No. 05-6037WM (B.A.P. 8th Cir., Jan. 26, 2006), the Debtors each took the position that the portion of their federal tax refunds attributable to the child tax credit is not property of the bankruptcy estate. They therefore subtracted those amounts from their refunds before calculating the amount

to be turned over to the bankruptcy trustee. The trustee filed an objection against each of the Debtors and the bankruptcy court sustained the trustee's objection in each case. The Debtors appealed the decisions to the BAP, which considered the cases in a joint opinion.

The child tax credit ("CTC") was enacted in 1997 to give parents of dependent children a financial break. It allows parents with an adjusted gross income below a threshold amount to claim a $1,000 tax credit for each child under the age of 17. The credit is reduced to zero on a graduating scale for families whose income is below the threshold amount. The credit is refundable to the taxpayer to the extent it exceeds tax liability.

Under Missouri Law, tax refunds arising from an overpayment of taxes, or from the federal earned income credit, are properties of the estate and are not considered exempt. Despite the Debtors' arguments to the contrary, the BAP did not find the CTC to be distinguishable from the federal earned income credit. The court had little trouble in finding that the CTC does not constitute exempt property. It simply noted that because the CTC was a contingent interest of the Debtors on the petition date, it became property of the estate upon filing in accordance with 11 U.S.C. § 541(a)(1) (property of the estate includes contingent interests in future payments).