

# Bankruptcy Bulletin

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**The 8<sup>th</sup> Circuit B.A.P. Questions  
Jurisdiction in Case Involving Probate  
Matter**

In *Litzinger v. Estate of Litzinger (In re Litzinger)*, No. 04-6059 (8<sup>th</sup> Cir. B.A.P., March 15, 2005), the B.A.P. questioned whether a matter involving the distribution and allocation of a probate estate's assets is properly heard before the Bankruptcy Court.

The parties were involved in a dispute regarding who owned certain property of a decedent's estate. One of the beneficiaries of the decedent's estate was married at the time he distributed certain funds from the decedent's estate to himself and to his wife. Shortly before the couple filed for divorce, the wife withdrew a large amount of money from the couple's joint account which can be traced to the decedent's estate funds. After the divorce, the wife filed for bankruptcy protection, and the decedent's estate representative filed a proof of claim against the wife for the funds she had withdrawn.

The Bankruptcy Court allowed the estate's claim, and the wife appealed. Upon review, the B.A.P. determined that it was unclear whether the case fell within the probate exception to the bankruptcy court's jurisdiction. There is a two pronged test for determining whether a bankruptcy court has jurisdiction or if a matter is subject to the probate exception. First, the bankruptcy court must consider whether it is being asked to directly probate a will or administer an estate. Second, the bankruptcy court must consider whether entertaining the action causes it to "interfere with the probate proceedings or assume general jurisdiction of the probate or control of property in the custody of state court." The B.A.P. noted that a determination of interference can be made by looking at whether the federal court: (1) interferes with the probate proceedings; (2) assumes general jurisdiction of the probate; or (3) asserts control of property in the state court's

custody. After setting forth this analysis, the B.A.P. remanded the proceeding to the Bankruptcy Court to determine whether this exception applies and, if so, to refer the matter to the state court for final resolution.

**8<sup>th</sup> Circuit Affirms Minnesota Homestead  
Exemption Has Extraterritorial Effect**

In *Drenttel v. Carter (In re Drenttel)*, No. 04-2335 (8<sup>th</sup> Cir. March 31, 2005), the Eighth Circuit Court of Appeals upheld the B.A.P.'s decision that a Minnesota homestead exemption can apply to a home of the debtor located in Arizona. (See September issue of the *Bankruptcy Bulletin* for the summary of the B.A.P.'s decision). The 8<sup>th</sup> Circuit agreed with the B.A.P.'s decision citing to Minnesota's strong public policy of construing the homestead exemption liberally in favor of the debtor.

The trustee argued that the Court should apply Minnesota's choice of law provisions in determining whether to allow the application of the Minnesota homestead exemption for a home outside of Minnesota. The Eighth Circuit declined to interpret the phrase "the law that is applicable" as the whole of Minnesota state law, including the choice of law provisions. 11 U.S.C. § 522(b)(2)(A). Instead, the Court said that only Minnesota's exemption laws were meant to be encompassed in 11 U.S.C. § 522(b)(2)(A). Furthermore, the Eighth Circuit felt that it was important to note that the debtors, who were domiciled for the majority of the 180 days prior to filing their bankruptcy petition in Minnesota, were limited in selecting either the federal or Minnesota exemptions. The Eighth Circuit noted that requiring debtors to choose a particular state's exemption law to where they had just relocated would actually exacerbate the danger of forum shopping.

### **B.A.P. Distinguishes Break-Up Fee and Expense Claim**

In *AgriProcessors, Inc. v. Fokkena (In Re Tama Beef Packing, Inc.)*, No. 04-6039 (8<sup>th</sup> Circuit B.A.P., March 14, 2005) the Eighth Circuit Bankruptcy Appellate Panel reversed a lower court order limiting AgriProcessors' administrative expense claim for expenses as an unsuccessful sale bidder.

AgriProcessor was a "stalking horse bidder" for an unexpired lease held by the panel trustee. AgriProcessors and the trustee entered into an agreement whereby if AgriProcessors were not the ultimate purchaser, AgriProcessors would be entitled to submit an administrative claim of not more than \$50,000 for its costs and expenses associated with the transaction.

AgriProcessors was not the successful bidder. The Bankruptcy Court held that as a result, AgriProcessors was entitled to a "breakup fee" of \$4,896 representing 3.2% of the \$153,000 purchase price ultimately paid for the lease. AgriProcessors appealed that ruling.

The Bankruptcy Appellate Panel held that, depending on the circumstances of a transaction, an unsuccessful stalking horse bidder may seek reimbursement of its actual expenses or it may seek a breakup fee which is designed to compensate the unsuccessful bidder for the risk and costs incurred in advancing the competitive bidding process. Breakup fees are usually limited to one to four percent of the purchase price. The only cap for actual fees and expenses incurred, however, is that they satisfy the requirements of section 503(b). In this case, AgriProcessors incurred fees and expenses of \$45,014.99. Because AgriProcessors was not seeking a breakup fee, but was instead seeking its actual fees and expenses as agreed to by the trustee, the Bankruptcy Appellate Panel reversed the lower court, holding that AgriProcessors was entitled to the higher amount.

### **Mandatory Abstention Applied Under 28 U.S.C. § 1334(c)(2)**

In *St. Paul Fire & Marine Ins. Co., v. A.P.I., Inc.*, No. 05-139 (D. Minn., March 23, 2005), the District Court considered mandatory abstention under 28 U.S.C. § 1334(c)(2). The case concerned defendant/counterclaimant/third-party plaintiff (debtor) API's motion to abstain and remand. The action commenced when St. Paul Fire sought declaratory relief, in state court, as to the nature and extent of insurance coverage available to (debtor) API for asbestos-related claims. API filed for relief under Chapter 11 and, after Judge Kishel lifted the automatic stay, one of the third-party defendants, CNA, removed the case to the U.S. District Court pursuant to 28 U.S.C. § 1452(a). API then filed its motion to abstain and remand. St. Paul Fire did not respond, but several of the third-party defendant insurers did.

The District Court noted that the claims of both API and the insurers were based on state law and both sought declaratory relief. The primary issue for all parties concerned the insurance coverage available to API for asbestos-related injuries. API submitted a prepackaged bankruptcy plan that proposed a funded trust and channeling injunction pursuant to 11 U.S.C. § 524(g). Two of the insurers objected to the plan. API asserted that its plan did not depend on insurance funding of the trust for its success because API itself was funding the \$40 million of the trust and if API prevailed on the state law issues, the trust funds available for creditors would simply increase based upon the funds received from the insurers.

The District Court maintained that removal of a state court case to federal court is permitted under 28 U.S.C. § 1452 if the federal court has jurisdiction under 28 U.S.C. § 1334. Under section 1334, federal courts have original jurisdiction over

bankruptcy cases under title 11, and original but concurrent jurisdiction over cases arising under title 11 (core proceedings) or “related to” cases under title 11. A proceeding is related to bankruptcy if it meets the “conceivable effect” test: the outcome could alter the debtor’s rights, liabilities, options or actions or in any way could impact the handling and administration of the bankruptcy estate. Here, the parties agreed that the insurance coverage dispute was a related proceeding and, thus, the District Court had original but concurrent jurisdiction with the state court pursuant to § 1334. API argued that mandatory or discretionary abstention under 28 U.S.C. § 1334(c)(1)-(2) applied or, alternatively, that the court should remand the proceeding pursuant to 28 U.S.C. § 1452.

The District Court’s inquiry began and ended with mandatory abstention. Mandatory abstention applies in related proceedings where the only basis for federal jurisdiction is section 1334 and where the case can be “timely adjudicated” in state court. As to jurisdiction, the insurers argued that the federal court also had jurisdiction based upon the alleged diversity of the parties. Although acknowledging that complete diversity did not exist between all the parties (both API and St. Paul Fire were Minnesota corporations), the insurers asserted that the court could sever St. Paul Fire’s action against API and remand only that claim to state court. The insurers based this assertion on § 1452(a)’s language concerning the removal of “claims or causes of action.” Therefore, the insurers argued, that the court must analyze diversity jurisdiction as to each claim or cause of action. Stating that no authority was cited for this proposition and, further, that CNA had removed not just the third-party, non-St. Paul Fire, claims, but the entire state court action, complete diversity must exist and it did not. The insurers were also unable to demonstrate that the matter could not be timely adjudicated in state court because:

(i) the funding of the plan’s trust was not dependent on insurance coverage funds; and (ii) the state court proceeding had been pending for two years and was scheduled for trial in November 2005.

Accordingly, the District Court found that mandatory abstention under 28 U.S.C. § 1334(c)(2) applied. The motion was granted and the court ordered that the proceeding be remanded to state court.

### **Debtor’s 1040 Forms Constitute Tax Returns Under 11 U.S.C. § 523**

In *Colson v. U.S.A. (In re Colsen)*, No. 04-6042 (B.A.P. 8th Cir., March 25, 2005), the Eighth Circuit B.A.P. held that a 1040 form constitutes a tax return for purposes of determining when taxes are assessed and discharged under section 523.

In this case, the debtor failed to timely file income tax returns for the years 1992 through 1996. The IRS notified debtor of these deficiencies and advised debtor of his right to seek a redetermination of these deficiencies with the United States Tax Court. The debtor did not respond to the notice or seek a redetermination in Tax Court. The IRS subsequently assessed taxes, interest, and penalties against the debtor for tax years 1992 through 1996. After the assessment, the debtor prepared and filed 1040 Forms for tax years 1992 through 1996. The IRS examined the 1040 Forms and authorized partial abatements of the taxes and interest previously assessed.

The debtor filed for relief under Chapter 7 of the Bankruptcy Code and subsequently initiated an adversary proceeding to determine the dischargeability of his income tax liabilities. The debtor argued they were assessed more than 3 years ago and, thus, discharged. The United States filed a motion for summary judgment essentially arguing that the assessed tax liabilities for tax years 1992 through 1996 did not qualify as tax returns under 11 U.S.C. § 523 (a)(1)(B)(i) and that, therefore,

no return was filed and the taxes were excepted from discharge. The Court denied the motion and held that the tax liabilities were discharged. The issue before the B.A.P. was whether the debtor's 1040 Forms filed after the IRS had assessed the tax liabilities qualified as returns for purposes of dischargeability under 11 U.S.C. § 523 (a)(1)(B)(i). The B.A.P. held that the 1040 Forms filed by the debtor after the IRS had assessed the debtor's tax liabilities qualified as returns pursuant to Section 523 (a)(1)(B)(i) of the Bankruptcy Code, and that, therefore, the debtor's tax liabilities were over 3 years old and discharged.

#### **Attorney's Retainer Secures Payment of Pre-Petition Services**

In *Fiegan Law Firm, P.C. v. Fokema (In re On-Line Services Ltd.)*, 2005 WL 600361 (8<sup>th</sup> Cir. B.A.P. 2005) the United States Bankruptcy Appellate Panel for the Eighth Circuit held that a debtor's retainer held by the debtor's attorney is property of the bankruptcy estate and that the attorney may not be paid by the estate from the retainer for post-petition legal services, absent an appointment by the trustee's counsel. However, the attorney becomes a secured creditor as to services rendered pre-petition, and the attorney is entitled to be paid for reasonable pre-petition fees and expenses from the retainer.

On December 8, 2003, the debtor retained Fiegan Law Firm ("Fiegan") to file a chapter 7 bankruptcy petition and paid a \$9,000 retainer to Fiegan. Fiegan subsequently filed the bankruptcy case first drawing down \$547.50 from the trust account and applying it to pre-petition services. At filing, Fiegan disclosed that it accepted a retainer in the amount of \$8,791 plus the filing fee of \$209.

After a trustee was appointed, Fiegan continued to perform legal services for the debtor and to draw down on the retainer. The UST filed a motion for the court to

examine compensation paid to Fiegan. Fiegan demonstrated it had provided \$6,977.77 of legal services to the debtor consisting of \$3,693.27 in pre-petition fees and expenses and \$2,284.50 in post-petition fees and expenses. The Bankruptcy Court held that the \$8,452.50 remaining in Fiegan's trust account on the date of filing was property of the estate, and directed Fiegan to turn that amount over to the trustee. The Bankruptcy Court further held that the reasonable value of the pre-petition services was \$2,380.00, but that only \$547.50, which had been paid pre-petition, could be paid from the retainer. The Court, therefore, held that the balance of the allowed pre-petition services, \$1,946.77, could not be paid from estate assets and denied Fiegan's application for fees and expenses incurred post-petition.

The B.A.P. concluded there were four issues before it to decide. The first was whether the unapplied \$8,452.50 of the retainer became an asset of the bankruptcy estate. The second was whether Fiegan had a lien on the retainer to secure pre-petition work for which he had not been paid at the time the petition was filed. The third was whether Fiegan had any claim against estate funds for post-petition services. The fourth was the reasonable value of the services provided.

The B.A.P. stated that the three part test described in *Snyder v. DeWoskin (In re Mahendra)*, 131 F.3d 730, 755 (8<sup>th</sup> Cir. 1997) *cert. denied*, 523 U.S.1107, 118 S.Ct. 1678, 140 L.Ed.2d 815 (1998) was determinative of whether a debtor's interest becomes part of the estate. That test is: (1) does the item at issue constitute property under Section 541(a)(1); (2) does state law defined the interest in property; and (3) did the debtor have the property interest at the time of the filing. The letter agreement between Fiegan and On-Line provided that the retainer fees were to be held in Fiegan's trust account, to be drawn upon at billing, and that if trust funds were insufficient, the

client was responsible for payment of the bill. The agreement also provided that any funds remaining in the trust account at the end of the case would either be turned over to the UST, or refunded to the debtor.

The B.A.P. held that the Bankruptcy Court properly applied the three part test and concluded that the unearned portion of the retainer was an asset of the estate.

Second, the B.A.P. concluded that the security retainer did secure payment of pre-petition services performed but unpaid. The B.A.P. stated, "By taking a retainer – even though it is considered a security retainer – a professional becomes a secured creditor, and hence has a claim on the retained funds prior to any administrative claim." The B.A.P. held, therefore, that the Bankruptcy Court erred in holding that the allowed pre-petition fees and expenses were not payable out of the retainer.

In holding that Fiegan did not have a claim against the bankruptcy estate for post-petition services, the B.A.P. cited *Lamie v. United States Trustee*, 540 U.S. 526, 124 S.Ct. 1023 (2004) stating "The United States Supreme Court held that Section 330(a)(1) of the code does not authorize compensation awards to debtor's attorneys from estate funds, unless such attorneys have been employed by the trustee with approval of the court." Fiegan was not so employed by the trustee. The B.A.P. therefore affirmed the Bankruptcy Court decision on this issue.

Finally, as to the reasonableness of the pre-petition fees, the Bankruptcy Court held it would not compensate Fiegan for pre-petition work involving communications with creditors or with its client, for reviewing pleadings, motions, and communications, unless such actions were shown to be of benefit to the estate. As to pre-petition fees, Section 329 of the Bankruptcy Code allows the court to determine the reasonable value of such services. In reviewing the reasonableness of fees awarded to debtor's counsel for pre-petition work, the issue is not benefit to the

estate, but reasonable value of the services provided to the debtor. Therefore, the B.A.P. held that the Bankruptcy Court applied the wrong standard as to pre-petition services, and remanded for determination of the reasonableness of Fiegan's fees under section 329 of the Code.

### **Court Holds Interest in 403 Plan Not Excluded from Estate**

In *In re Wendt*, No. 04-33329 (Bankr. D. Minn., March 3, 2005) (C.J. Kishel), the Bankruptcy Court held that in an individual's chapter 7 case, the debtors' claim of exemption in certain funds held in a "403(b) thrift account" is not excluded from the bankruptcy estate under current 11 U.S.C. § 541(c)(2). However, under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 as recently enacted, the amendments to 11 U.S.C. § 541(b)(7) provide that amounts withheld from wages by an employer or received from an employee for or on account of the contribution to tax deferred annuities under I.R.C. § 403(b) are now excluded from the estate. Further, any interest in such a plan is exempt under 11 U.S.C. § 522. Those provisions are effective in six months.

### **State Court Judgment for Alienation of Affections Establish Willfulness But Not Malice**

In *Osborne v. Stage (In re Stage)*, 321 B. R. 486 (8<sup>th</sup> Cir. B.A.P. 2005) the United States Bankruptcy Appellate Panel for the Eighth Circuit held that the elements of the intentional tort of alienation of affections found in the creditor's judgment established willfulness, but not malice, as required by 11 U.S.C. § 523(a)(6).

On July 28, 1999, judgment was entered in favor of Gail Osborn in the amount of \$50,000.00 against debtor Cynthia Marie Stage for alienating the

affections of Osborn's husband from Osborn. On March 25, 2004, the debtor filed a chapter 7 petition in the Eastern District of Missouri. On June 22, 2004, Osborn filed a complaint to determine the dischargeability of her debt claiming the judgment she received in state court was excepted from Stage's discharge under Section 523(a)(6). Osborn further claimed that Stage was collaterally estopped from contesting the issue of willful and malicious injury because the issues had been litigated and determined in state court. On August 10, 2004, Stage made a motion to dismiss based on two theories. First, she claimed the issues of whether Stage's actions were willful and malicious for the purpose of section 523(a)(6) had not been adjudicated in state court and, therefore, collateral estoppel did not apply. Second, she argued that the case should be dismissed for failure to state a claim upon which relief could be granted as Missouri no longer recognized the cause of action for alienation of affections.

On August 24, 2004, the Bankruptcy Court denied Stage's motion to dismiss. On September 7, 2004, Osborn filed a motion for summary judgment based on collateral estoppel. The Bankruptcy Court granted Osborn's motion for summary judgment concluding collateral estoppel applied and that the judgment for alienation of affections in state court established that Stage willfully and maliciously injured Osborn. The Court also held that Missouri's abolishment of the intentional tort of alienation of affections did not affect Osborn's judgment.

The B.A.P. agreed with the Bankruptcy Court that the abolishment of the tort of alienation of affections did not affect the validity of the prior judgment nor bar Osborn from seeking determination of its dischargeability. However, as to the issue of collateral estoppel the B.A.P. stated that in the Eighth Circuit the terms "willful" and "malice" are two distinct elements, each

of which must be shown to establish an exception to discharge. The Bankruptcy Code at 11 U.S.C. § 523(a)(6) reads in pertinent part: "A discharge . . . does not discharge an individual debtor for any debt . . . for willful and malice injury by the debtor to another entity or the property of another entity." The B.A.P. concluded that "willful" indicates that an exception to discharge requires a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury. Thus, willfulness means that the defendant intended the injury.

The B.A.P. further stated that in the Eighth Circuit, an injury is malicious when the debtor intended to harm the creditor at least in the sense that the debtor's tortious conduct was certain or almost certain to cause harm. The Court concluded that the malice element is satisfied if, in committing the intentional tort, the perpetrator intending the resulting harm, or the harm was substantially certain or nearly certain to result.

Applying these definitions to the alienation of affections, the Bankruptcy Court found that Osborn need not prove willfulness or maliciousness because both had already been established by the state court judgment. The B.A.P. agreed as to willfulness, but disagreed as to maliciousness. The jury instructions only instructed the jury as to finding that the Stage intentionally damaged Osborn. The instructions did not address maliciousness. Therefore, maliciousness was not established by the state court judgment. The B.A.P. reversed the Bankruptcy Court grant of summary judgment, stating, "To prevail, Osborn must prove that Stage's actions were targeted at her, i.e. that Stage intended to harm her." Accordingly, the case was remanded on the issue of malice.

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