

# BANKRUPTCY IN THE SEVENTH CIRCUIT: 1994

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This Survey covers a period of slightly less than twelve months: December 1, 1993 to October 31, 1994. As in previous years, it reviews only a few of the Seventh Circuit's bankruptcy decisions. It also assesses the impact of The Bankruptcy Reform Act of 1994 on existing Seventh Circuit authority.

## I. CLAIMS AND ADMINISTRATIVE POWERS

*In re Udell*<sup>1</sup> is one of the most interesting cases to come before the Seventh Circuit in recent years. It examines the status of a covenant not to compete when the promisor is involved in bankruptcy proceedings. At both the trial and appellate levels, the written opinions address important issues of bankruptcy policy. The final disposition of this case is likely to attract attention from other circuits.

The facts in *In re Udell* are not unusual. Udell, while an employee at Carpetland, had signed a covenant not to compete. Later, he resigned and began doing business within the area covered by the covenant. Carpetland, seeking to enforce his promise, obtained a preliminary injunction from a state court. Udell then filed for bankruptcy under Chapter 13. This filing resulted in an automatic stay of the preliminary injunction, so Udell continued to operate his store. When Carpetland sought relief from the stay so that it could obtain a permanent injunction, Udell countered with a proposal to reject the covenant pursuant to section 365 of the Bankruptcy Code.<sup>2</sup> The bankruptcy court faced two primary issues: the enforceability of the promise not to compete following rejection, and the question of whether Carpetland had a claim in Udell's bankruptcy. Relief from the stay would not be appropriate if rejection vitiated the covenant or if Carpetland's right to equitable relief was a dischargeable claim.

More than twenty years ago, Professor Vern Countryman published an article on executory contracts in the *Minnesota Law Review*.<sup>3</sup> Until recently, this article has set the terms of the debate concerning the status of such contracts when a promisor is adjudicated a bankrupt. Under a traditional analysis, to escape from the noncompete obligation, the promisor would be required to establish that the employment contract was still executory. If successful, the promisor could then argue that rejection invalidated the noncompete obligation.<sup>4</sup> Recently, this traditional approach has come under attack.<sup>5</sup> The trial court

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1. 18 F.3d 403 (7th Cir. 1994).

2. *In re Udell*, 149 B.R. 898, 901 (Bankr. N.D. Ind. 1992).

3. Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439 (1973) and 479 (1974).

4. *In re Rovine*, 6 B.R. 661 (Bankr. W.D. Tenn. 1980).

5. See, e.g., Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

opinion by Judge Grant acknowledges the changes occurring in executory contract jurisprudence:

Carpetland first argues that the employment agreement between it and the debtor, which contains the covenant not to compete, is no longer "executory" and, therefore, cannot be rejected. Debtor argues that the agreement is still "executory" and all the obligations included within it are avoided upon rejection.

Recently, persuasive scholarly analysis of executory contracts and bankruptcy has argued that the search for "executoriness" as a precondition to rejection is misplaced. Professors Andrew and Westbrook both emphasize that rejection should be conceived as nothing more than the estate's business decision not to perform an obligation of the debtor, in the same fashion that a party to any contract always has the option either to perform or to breach an obligation and to accept the consequences of that decision. Thus, courts should not place the focus of rejecting executory contracts upon whether or not rejection is an available option but, instead, upon the consequences of rejection, as between creditor and the estate, and the effect of any discharge the debtor might ultimately obtain upon the rejected obligation.

One fundamental error identified by Professors Westbrook and Andrew is the notion that rejection in some way destroys the existence of the contract and allows the debtor to act as though it never existed. They emphasize that the rejection of an executory contract is not an avoiding power and does not operate to rescind or otherwise destroy the contract and the rights and obligations it contains. Instead, rejection constitutes nothing more than a pre-petition breach of the contract. . . .

This court, as have others before it, agrees with Westbrook and Andrew's approach to executory contracts. Accordingly, the court need not decide whether or not the contract between the debtor and Carpetland is "executory" or whether or not the debtor can reject it. Indeed, for the purposes of this decision, we assume that it is and that the debtor can do so. In either event, the resulting analysis is exactly the same. If the debtor cannot reject the contract, the issue before the court turns upon the effect of the debtor's potential Chapter 13 discharge upon the obligation represented by the covenant not to compete. In the same fashion, since rejection is not an avoiding power and does not operate to destroy, rescind, or nullify the rejected obligation, after rejection the question before the court becomes one of whether or not the debtor's potential Chapter 13 discharge will encompass the rejected restrictive covenant.<sup>6</sup>

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6. *In re Udell*, 149 B.R. at 901-02 (Bankr. N.D. Ind. 1992) (citations omitted). See articles cited *supra* note 5. It is interesting to note that another Seventh Circuit executory contract/rejection decision during the Survey period relies upon the traditional analysis. In *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994), the debtor attempted to reject a recorded reciprocal, restrictive land covenant. This attempt was unsuccessful, in part because the court concluded that the covenant was not an executory contract. *Id.* at 298.

Judge Grant next considered whether Carpetland's right to an injunction was a "claim" under the Bankruptcy Code.<sup>7</sup> Under 11 U.S.C. § 101(5)(B), a right to equitable relief is a "claim" if the breach of a contractual duty "gives rise to a right to payment." Finding that Indiana law did not give Carpetland a right to damages as an alternative to the equitable relief, Judge Grant concluded that Carpetland did not have a claim.<sup>8</sup> Accordingly, the potential Chapter 13 discharge did not affect Carpetland's right to equitable relief. Judge Grant, therefore, granted the request for relief from stay because "the potential harm to Carpetland by continuing the stay outweighed the potential harm to the debtor which may flow from terminating it."<sup>9</sup>

District Court Judge William Lee agreed with Judge Grant's executory contract analysis. However, he reversed because he concluded that damages were available as compensation for the breach that was being enjoined.<sup>10</sup>

In the Seventh Circuit Court of Appeals, Udell and Carpetland offered differing constructions of the term "claim." Udell was admittedly liable in damages under Indiana law for any injury suffered prior to issuance of the preliminary state court injunction. He argued that this liability was sufficient to constitute a claim since the act of breach (competition), in addition to creating a right to equitable relief, created a right to payment for breach of performance.<sup>11</sup> Carpetland argued that a claim, as defined in the statute, existed only if the damage award were an alternative to the injunctive relief.<sup>12</sup> The court accepted this narrower reading of 11 U.S.C. § 101(5)(B). Since it also concluded that Indiana law did not provide an alternative damage remedy in this situation, it agreed with Judge Grant's conclusion that no claim existed.<sup>13</sup>

As Judge Flaum noted in his concurring opinion, reaching this conclusion depended on abandoning the plain meaning rule and reading the statute as if it required that such breach give rise to "an *alternative* right to payment."<sup>14</sup> Nonetheless, he agreed that it was appropriate to take some interpretative liberties with the statutory language:

To appreciate the patent absurdity of implementing the plain text of [s]ection 101(5)(B) one must keep in mind that this is a bankruptcy statute. If, following the plain language, an injunction may be stayed in bankruptcy anytime the underlying breach of contract or law also happens to give rise to money damages, the real-world results would be ludicrous. If we were to apply the plain text of [section] 101(5)(B) to individuals restrained by court orders—e.g. trespassers, polluters, stalkers, batterers—theoretically, simply by filing bankruptcy, the violator could escape from any restraining order prompted by a

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7. *In re Udell*, 149 B.R. at 903.

8. *Id.* at 906.

9. *Id.* at 907.

10. *Udell v. Standard Carpetland*, 149 B.R. 909 (N.D. Ind. 1993). The contract contained a liquidated damages clause that Judge Lee believed applied to both past and prospective breaches of the employment contract.

11. *In re Udell*, 18 F.3d 403, 406 (7th Cir. 1994).

12. *Id.*

13. *Id.* at 407.

14. *Id.* See *supra* text accompanying notes 7-8.

breach that also gave rise to an award of money damages. Certainly the parade of horrors is extensive, and I need not belabor it further. Since the text of [section] 101(5)(B) presents one of those extremely unique circumstances of patent absurdity, we may turn to the purpose, context and policy of [section] 101(5)(B) to supplement its plain language.<sup>15</sup>

I do not agree that a discharge affecting the legal liability of “trespassers, polluters, stalkers, batterers” is “ludicrous.” Bankruptcy involves discharge, and the facts in *In re Udell* present important questions of discharge policy that merited debate.<sup>16</sup> Unfortunately, only Judge Flaum’s concurring opinion even recognizes the substantial impact of the decision on the rehabilitative relief available in bankruptcy.

Having concluded that Carpetland’s claim was not discharged, the Seventh Circuit, nonetheless, remanded the case to the bankruptcy court:

It does not necessarily follow that Carpetland is entitled to relief from the stay, however. The automatic stay prescribed by the Bankruptcy Code applies to “judgment[s] obtained before the commencement of the case under this title,” whether or not the judgment arises out of a “claim.” Though the bankruptcy court correctly held that Carpetland’s right to an injunction is not a claim, the court was required to also consider (1) the prejudice to the debtor or the bankruptcy estate from allowing the non-bankruptcy litigation to continue; (2) the relative hardship to the debtor and to the party seeking relief; and (3) the creditor’s probability of prevailing on the merits in the litigation, before it could lift the automatic stay. Udell argued before the district court that the bankruptcy court abused its discretion by not giving sufficient consideration to his inability to get a “fresh start,” or to the unequal treatment of other creditors which will result from the lifting of the stay. The district court reversed the bankruptcy court on other grounds without considering this remaining issue. Because we reverse the district court’s decision, we remand this case to the district court for a determination of whether the bankruptcy court abused its discretion by granting Carpetland relief from the automatic stay.<sup>17</sup>

This disposition makes absolutely no sense. Rehabilitation through bankruptcy is achieved through a discharge. However, the bankruptcy discharge only bars the enforcement of “claims.”<sup>18</sup> Non-claims, as well as non-dischargeable claims, are not affected by the rehabilitation process. Since it believed that no claim existed, the Seventh Circuit should have affirmed the action of the trial court in granting relief from stay.

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15. *Id.* at 412 (Flaum, J., concurring).

16. Under the court’s reading of Indiana case law, Udell’s obligation to refrain from future competition can never be discharged.

17. *In re Udell*, 18 F.3d at 410 (citing 11 U.S.C. § 362(a)(2) (1988) & *In re Fernstrom Storage & Van Co.*, 938 F.2d 731, 735 (7th Cir. 1991)).

18. A discharge prevents the collection of any (discharged) debts. 11 U.S.C. § 524(a)(2) (1988 & Supp. 1994). A debt is a liability on a claim. 11 U.S.C. § 101(12) (Supp. 1994). If the debt arising from the breach is discharged, the covenant not to compete should not be enforceable because it interferes with the debtor’s fresh start. 2 DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 122-27 (1993).

There is a further, more fundamental, flaw in this opinion. The court's premise that Indiana law does not create an alternative right to payment is incorrect.<sup>19</sup> Under generally accepted principles of contract law, Udell's breach created a right to damages for losses arising prior to issuance of the preliminary injunction, and a right to either a permanent injunction or damages for the losses that would be sustained if Carpetland did not pursue the equitable remedy. In other words, Carpetland had a retrospective damage claim and, if it chose not to insist on injunctive relief, it also had a claim for prospective damages. The latter was truly alternative to its equitable rights.

In the absence of any controlling Indiana authority, the court of appeals relied on the well-recognized rule stated in *The Restatement (Second) of Contracts*:<sup>20</sup> "Specific performance or an injunction may be granted to enforce a duty even though there is a provision for liquidated damages for breach of that duty."<sup>21</sup> This section of the *Restatement*, however, does not support the proposition that damages are not an alternative to equitable relief. Rather, the rule it states prevents the party in breach from defeating the innocent party's request for equitable relief by asserting that the liquidated damages clause provides an adequate legal remedy. Notwithstanding that provision, Carpetland had the option of foregoing equitable relief and claiming damages if the competition continued. As the *Restatement (Second) of Contracts* states: "Every breach of contract gives the injured party a right to damages against the party in breach . . . . Although a judgment awarding a sum of money as damages is the most common judicial remedy for breach of contract, other remedies, including equitable relief in the form of specific performance or an injunction, may be also available."<sup>22</sup> Carpetland had an alternative damage remedy, and its right to equitable relief was a claim. The court's opinion ignores this distinction between the retrospective (cumulative) damage claim and the prospective (alternative) damage claim. Ultimately, of course, it does not matter which construction of the statute prevails. Under either reading, Udell has a claim.<sup>23</sup>

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19. None of the authorities cited in the majority opinion support the proposition that Carpetland does not have an alternative right to damages if it chooses to forego injunctive relief. *Duckwall v. Rees*, 86 N.E.2d 460 (Ind. App. 1949) decided that the language in a contract for the sale of real estate clearly indicated that only damages, not equitable relief, was the appropriate remedy following breach by the vendor. *Seach v. Richards, Dieterle & Co.*, 439 N.E.2d 208 (Ind. Ct. App. 1982) merely holds that an innocent party is entitled to both retrospective damages and an injunction to prevent future harm. The Seventh Circuit's citation of this case for the proposition that "an injunction and an award of liquidated damages are cumulative and not alternative," *In re Udell*, 18 F.3d at 409, demonstrates that the court is not aware of the fact that an innocent party who chooses to pursue a damage claim alone is also entitled to the alternative remedy of damages to compensate for future harms. *Hahn v. Drees, Perugini & Co.*, 581 N.E.2d 457 (Ind. Ct. App. 1991) reaches the same conclusion as *Seach*. *Rajski v. Tezich*, 514 N.E.2d 347 (Ind. Ct. App. 1987) merely affirms an award of equitable relief while reversing enforcement of an invalid liquidated damages clause.

20. *In re Udell*, 18 F.3d at 409; see RESTATEMENT (SECOND) OF CONTRACTS § 361 (1981).

21. RESTATEMENT (SECOND) OF CONTRACTS § 361.

22. *Id.* at § 346 cmt. a.

23. The court's mistake concerning Carpetland's rights under Indiana law clearly affected the outcome of the appeal. As it noted in a footnote, if the parties had intended that a liquidated damages provision "replace the right to specific performance . . . . Carpetland's right to an injunction would undoubtedly be a 'claim.'" *In re Udell*, 18 F.3d at 409 n.4.

Unless other courts recognize this error, *Udell* may unduly restrict the availability of rehabilitation through bankruptcy.

## II. DISCHARGE

*Hiatt v. Indiana State Student Assistance Commission*<sup>24</sup> is another decision likely to attract attention outside the Seventh Circuit. It is the first court of appeals decision determining when the nondischargeability period for educational loans begins following a consolidation agreement with a new lender. The news for student borrowers is not good; the nondischargeability clock is reset. This is done even when no new credit (above the amount required for consolidation) is involved.

Although the court invokes the plain meaning rule to justify the result,<sup>25</sup> the language in 11 U.S.C. § 523(a)(8) is far from clear. The statute restricts discharge of educational debt within a stated period of time from when "such loan first became due."<sup>26</sup> The term "such loan" can be taken as a reference to either the original loan or the consolidation loan.

As a matter of policy, this result is probably inevitable given the current structure of the student loan program. Unless the clock is restarted when the consolidation loan is made, it will become increasingly difficult, and eventually impossible, for student borrowers to refinance their education loans. Thus, student borrowers who consolidate their obligations waive some of the protection provided by a bankruptcy discharge. The result is similar to the consequence of an unwise reaffirmation, although the consequences of a bad decision in this context last for only seven years.

This is the second consecutive year in which the Seventh Circuit has issued an important educational loan opinion. Last year, the court adopted a narrow interpretation of the "undue hardship" requirement for immediate dischargeability.<sup>27</sup> At that time, I observed that the court was requiring "[s]omething akin to abject and permanent misery."<sup>28</sup> While the issue this year is different, the misery continues.

## III. CHAPTER 12/13 PROCEEDINGS

Three interesting decisions involving rehabilitation proceedings for debtors with regular income were handed down during the Survey period. In *In re Fortney*,<sup>29</sup> the debtor proposed a three-year Chapter 12 plan. This plan amortized a real estate mortgage over a twenty-year period. It also proposed to pay a secured tax claim in the three years covered by the plan. The trustee argued that the tax claim should also be paid over a period greater than three years.<sup>30</sup> Accepting the trustee's argument would have increased

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24. 36 F.3d 21 (7th Cir. 1994).

25. *Id.* at 23.

26. *Id.* (citing 11 U.S.C. § 523(a)(8) (1988 & Supp. 1994)). During the initial repayment period, discharge is available only upon a showing of "undue hardship." 11 U.S.C. § 523(a)(8).

27. *In re Roberson*, 999 F.2d 1132 (7th Cir. 1993).

28. Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1993*, 27 IND. L. REV. 761, 765 (1994).

29. 36 F.3d 701 (7th Cir. 1994).

30. *Id.* at 705.

the disposable income which § 1225(b) requires be distributed to unsecured claims during the term of the plan. The lower court's rejection of this argument was affirmed.<sup>31</sup>

The decision in *In re Fortney* is very sensible. The trustee was, in effect, claiming that the disposable income requirement was not satisfied. In the simplest circumstances, it is often difficult to decide whether this requirement has been met. It is best to confront this issue directly by asking whether projected income is adequate and living expenses are excessive.

A second decision, *In re Witkowski*,<sup>32</sup> sends a very strong signal that "pot" plans will be preferred to "defined percentage" plans. In a pot or "base" plan,<sup>33</sup> the debtor proposes to pay a set amount to creditors. The actual percentage payout on unsecured claims is determined by the number of claims filed. In a percentage plan, creditors receive the same payout percentage regardless of the amount of claims that are filed. If less than the anticipated amount of claims are filed, a windfall to the debtor is possible. This is what happened in *In re Witkowski*. The debtor proposed to pay ten percent to creditors over a forty-seven-month term.<sup>34</sup> When all his creditors failed to file proofs of claim, the Chapter 13 trustee moved to deprive the debtor of any benefit by modifying the plan pursuant to 11 U.S.C. § 1329(a).<sup>35</sup> The proposed modification increased the payout to participating creditors to nineteen percent, over the same forty-seven-month term.<sup>36</sup> Debtor argued that the trustee's request should be denied because both § 1329<sup>37</sup> and the common law doctrine of res judicata require a showing of changed circumstances as a condition of modification.<sup>38</sup> Neither argument was successful.

Although *In re Witkowski* does not hold that percentage plans can never be confirmed, a highly critical footnote questions the legality of such plans:

A percentage plan, by its very nature, does not seem to constitute a plan by which the debtor will contribute all disposable income to the plan because the debtor may retain a portion of disposable income if fewer than anticipated claims are filed. Rather, to fulfill the disposable income requirement, it would seem that any surplus of funds must be funneled into the plan, not returned to the debtor.<sup>39</sup>

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31. *Id.* at 707.

32. 16 F.3d 739 (7th Cir. 1994).

33. For a description of various types of plans, see 2 KEITH LUNDIN, CHAPTER 13 BANKRUPTCY § 4.84 (1994).

34. *In re Witkowski*, 16 F.3d at 741.

35. *Id.*

36. *Id.*

37. There is nothing in § 1329 that prohibits modification. However, there is an argument against modification based on language in 11 U.S.C. § 1327(a) (1988) providing that "[t]he provisions of a confirmed plan bind the debtor and each creditor." The plan in *In re Witkowski* had been confirmed. The Seventh Circuit has twice been unwilling to allow challenges to the provisions of a confirmed plan when a subsequent objection comes from a secured claim holder. See *In re Chappell*, 984 F.2d 775 (7th Cir. 1993); *In re Pence*, 905 F.2d 1107 (7th Cir. 1990).

38. *In re Witkowski*, 16 F.3d at 741.

39. *Id.*

*In re Escobedo*<sup>40</sup> is the final interesting rehabilitation decision. It concerns a confirmed Chapter 13 plan which proposed to pay a certain amount to creditors during the life of the plan. The stipulated sum was insufficient to satisfy the requirement of 11 U.S.C. § 1322(a)(2) that priority claims be paid in full. Indeed, the plan did not even state any treatment for priority claims other than administrative expenses. However, these defects were not noticed prior to confirmation, which occurred without objection from any creditor. The shortfall was apparently discovered when amended proofs of priority tax claims were filed. These claims were allowed, but the debtor never modified her plan. Then, almost five years after confirmation and two years after the last plan payment, the trustee moved to dismiss pursuant to 11 U.S.C. § 1307. The bankruptcy court granted this motion.<sup>41</sup> The Seventh Circuit affirmed, rejecting the debtor's argument that the language of 11 U.S.C. § 1327(a) ("the provisions of a confirmed plan bind . . . each creditor") and the doctrine of *res judicata* preclude a post-confirmation challenge to the treatment of priority tax claims.<sup>42</sup>

This case exposes a weakness in the Chapter 13 process. Rapid confirmation is desirable so that payments to creditors can commence at an early date.<sup>43</sup> However, confirmation before completion of the claim allowance process creates the possibility for conflict between the plan provision and the allowed claim. "Problems arise because the Bankruptcy Code describes two parallel processes that inevitably interact and overlap at confirmation in a Chapter 13 case."<sup>44</sup>

Twice in recent years, the Seventh Circuit has applied the principal of *res judicata* to resolve the conflict between the confirmation process and the claims allowance process. In both *In re Pence*<sup>45</sup> and *In re Chappell*,<sup>46</sup> the court refused to allow post-confirmation challenges to the plan treatment of a secured claim. The opinion in *In re Escobedo*<sup>47</sup> reaches a different conclusion without citing *In re Pence*. *In re Chappell* is distinguished on the ground that it "involved the non-mandatory code provisions (the 'permissive' plan provisions of § 1322(b)) rather than the mandatory plan provisions of § 1322(a)(2)."<sup>48</sup>

This distinction between mandatory and permissive confirmation requirements is illusory. All of the plan requirements in 11 U.S.C. § 1322 are mandatory in the sense that compliance is a requirement for confirmation if the plan addresses a situation to which the requirement is applicable. None can be ignored. But only the requirements of § 1322(a)

40. *In re Escobedo*, 28 F.3d 34 (7th Cir. 1994).

41. *Id.*

42. *Id.* at 35. The debtor relied primarily on *In re Szostek*, 886 F.2d 1405 (3rd Cir. 1989), a leading authority for the proposition that the bankruptcy court has discretion to confirm a plan that does not meet all confirmation requirements. The Ninth Circuit has recently refused to follow *In re Szostek*. See *In re Barnes*, 32 F.3d 405 (9th Cir. 1994).

43. Funds turned over to the trustee cannot be disbursed until the plan is confirmed. 11 U.S.C. § 1326(a)(2) (1988).

44. LUNDIN, *supra* note 33, at § 6.10.

45. 905 F.2d 1107 (7th Cir. 1990).

46. 984 F.2d 775 (7th Cir. 1993).

47. 28 F.3d 34.

48. *Id.* at 34 n.1.

will be applicable to every plan. Those in § 1322(b) may or may not apply to a specific plan depending upon the needs of the debtor.

Prior to this decision, the Seventh Circuit had been a leader among the minority of courts willing to give preclusive effect to a confirmed Chapter 13 plan.<sup>49</sup> *In re Escobedo* is inconsistent with prior authority. Its sanction of dismissal pursuant to 11 U.S.C. § 1307 is likely to lead to more litigation.<sup>50</sup>

#### IV. CHAPTER 11 PROCEEDINGS

Section 1122(a) of title 11 of the United States Code permits claims to be placed in the same class by a reorganizing debtor only if they are "substantially similar" to other claims in the same class.<sup>51</sup> The statute, however, does not provide clear guidance as to when similar claims may be placed in different classes. A debtor may want to split similar claims into separate classes in order to satisfy the requirement of 11 U.S.C. § 1129(a)(10) that at least one impaired class accept the plan.<sup>52</sup> If the debtor enjoyed unlimited power to create classes of claims, the requirement of one accepting class could too easily be satisfied.

One leading decision, *In re Greystone III Joint Venture*,<sup>53</sup> would allow separate classification as long as it is not done for the purpose of obtaining the approval of an impaired class.<sup>54</sup> However, the *In re Greystone* court refused to approve separate classification for a deficiency claim created by § 1111(b).<sup>55</sup> It believed the separate classification was an attempt to secure approval of the Chapter 11 plan by gerrymandering classes.<sup>56</sup>

*In re Woodbrook Associates*<sup>57</sup> takes a different view of this classification problem. Observing that "we cannot accept the proposition implicit in *Greystone* that separate classification of a § 1111(b) claim is nearly conclusive evidence of a debtor's intent to gerrymander,"<sup>58</sup> the court found such "significant disparities" between the § 1111(b) claim and general unsecured claims that separate classification was required.<sup>59</sup> *In re Woodbrook*

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49. LUNDIN, *supra* note 33, at § 6.13.

50. Here is a possible scenario. Debtor, barred from obtaining a Chapter 7 discharge, files under Chapter 13. The plan eventually fails after Debtor has made substantial payments to Creditors. Debtor applies for a § 1328(b) discharge. Creditor counters with a Motion to Dismiss under § 1307 arguing that the plan should never have been confirmed because the requirement of § 1322(a)(1) was (in retrospect) not satisfied. If *Escobedo* is followed, the Motion to Dismiss may be granted.

51. 11 U.S.C. § 1122(a) (1988).

52. 11 U.S.C. § 1129(a)(10) (1988).

53. 995 F.2d 1274 (5th Cir. 1991).

54. *Id.* at 1279.

55. *Id.*

56. *Id.*

57. 19 F.3d 312 (7th Cir. 1994).

58. *Id.* at 318.

59. *Id.* at 319-20. The court also refused to decide whether the "new value precept" survived adoption of the new bankruptcy code. *Id.*

thus makes it somewhat easier to secure confirmation of a single asset bankruptcy in this circuit.<sup>60</sup>

#### V. PROCEDURE

*Zerand-Bernal Group, Inc. v. Cox*<sup>61</sup> is the final noteworthy decision. In *Zerand*, the bankruptcy court had approved a sale of the debtor's assets free and clear of all claims. The bankruptcy court reserved jurisdiction to enforce the agreement, as proposed in the reorganization plan. Several years later, Cox commenced a products liability suit against the purchaser of the debtor's assets for injuries caused by a machine sold to him by the debtor prior to the bankruptcy sale. The defendant in this action then applied to the bankruptcy court for an injunction preventing Cox from proceeding with the products liability litigation. The bankruptcy court decided that it lacked jurisdiction to enjoin Cox's action. The Court of Appeals affirmed the dismissal.<sup>62</sup>

Judge Posner's opinion rejects arguments that bankruptcy jurisdiction exists either because the equitable action is related to the bankruptcy proceeding or arises under the bankruptcy statute.<sup>63</sup>

As for the argument that the existence of federal jurisdiction would encourage purchasers to participate at bankruptcy sales, Judge Posner was unimpressed:

We said that the federal interest is tenuous, not that it is nonexistent. *Zerand* points out that the price received in a bankruptcy sale will be lower if a court is free to disregard a condition in the sale agreement enjoining claims against the purchaser based on the [seller's] misconduct. If the condition is invalid the purchaser will be buying a pig in a poke, never knowing when its seller's customers may come out of the woodwork and bring suit against it under some theory of successor liability. This possibility will depress the price of the bankrupt's assets, to the prejudice of creditors. All this is true, but proves too much. It implies, what no one believes, that by virtue of the arising-under jurisdiction a bankruptcy court enjoys a blanket power to enjoin all future lawsuits against a buyer at a bankruptcy sale in order to maximize the sale price: more, that the court could in effect immunize such buyers from all state and federal laws that might reduce the value of the assets bought from the bankrupt; in effect, that it could discharge the debts of nondebtors (like *Zerand*) as well as of debtors even if the creditors did not consent; that it could allow the parties to bankruptcy sales to extinguish the rights of third parties, here future tort claimants, without notice to them or (as notice might well be infeasible) any consideration of their interests. If the court could do all these nice things the result would indeed be to make the property of bankrupts more valuable than other property—more valuable to the creditors, of course, but also to the debtor's shareholders and managers to the extent that the strategic position of the debtor

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60. See generally Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1 (1994).

61. 23 F.3d 159 (7th Cir. 1994).

62. *Id.* at 164.

63. *Id.* at 162-63.

in possession in a reorganization enables the debtor's owners and managers to benefit from bankruptcy. But the result would not only be harm to third parties, such as the Coxes, but also a further incentive to enter bankruptcy for reasons that have nothing to do with the purposes of bankruptcy law.<sup>64</sup>

As this quotation indicates, it is difficult to discuss the jurisdictional issue without discussing the merits of issuing an injunction. In any event, the consequence of the decision is clear. It lessens the finality ordinarily associated with bankruptcy sales.<sup>65</sup>

## VI. THE BANKRUPTCY REFORM ACT OF 1994

The Bankruptcy Reform Act of 1994<sup>66</sup> was signed into law by President Clinton on October 22, 1994. This statute reverses the effect of several Seventh Circuit decisions. Bankruptcy judges may now hold jury trials under certain circumstances;<sup>67</sup> and, liens protecting marital obligations can no longer be avoided under 11 U.S.C. § 522(f)(1).<sup>68</sup> The two most dramatic changes involve the decisions in *Levit v. Ingersoll Rand Financial Corp.*<sup>69</sup> and *In re Lybrook*.<sup>70</sup>

In *Levit*, the trustee was allowed to recover a preferential transfer occurring more than ninety days before bankruptcy from a non-insider creditor when the transfer benefitted an insider. Although two other courts of appeal reached the same conclusion,<sup>71</sup> this line of decisions provoked a storm of protest from the commercial lending community. H.R. 5116 only permits recovery from the insider in this situation.<sup>72</sup>

*In re Lybrook*,<sup>73</sup> discussed in this Survey two years<sup>74</sup> ago, decided that an inherited asset must be included in the bankruptcy estate upon conversion from Chapter 13 to Chapter 7 even though the assets were inherited more than 180 days after the petition was filed. The Seventh Circuit was clearly concerned about the possibility of opportunistic inter-chapter movement. When *In re Lybrook* was decided, I suggested that it might be

64. *Id.* at 163 (citing *In re American Hardwoods, Inc.*, 885 F.2d 621, 624 (9th Cir. 1989)).

65. One commentator has called *Zerand* "a dramatic decision with far ranging impact." Martin Klein, *Bankruptcy Sales, Caveat Emptor*, N.Y.L.J., Sept. 8, 1994, § 1, at 5.

66. Pub L. No. 103-394, 108 Stat. 4106 [hereinafter H.R. 5116].

67. Section 112 of H.R. 5116 overrules *In re Grabill Corp.*, 967 F.2d 1152 (7th Cir. 1992).

68. *In re Sanderfoot*, 899 F.2d 598 (7th Cir. 1990). This decision, criticized in Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1989-1990*, 24 IND. L. REV. 551 (1991), was reversed by the Supreme Court in *Farrey v. Sanderfoot*, 500 U.S. 291 (1991). After *Farrey*, there were still some situations in which § 522(f)(1) could be used to avoid a judicial lien protecting marital obligations. This avoidance is no longer possible. Section 304 of H.R. 5116 prohibits use of § 522(f) when alimony, maintenance and support obligations are involved.

69. 874 F.2d 1186 (7th Cir. 1989).

70. 951 F.2d 136 (7th Cir. 1991).

71. *In re C-L Cartage Co.*, 899 F.2d 1490 (6th Cir. 1990); *In re Robinson Bros. Drilling*, 892 F.2d 850 (10th Cir. 1989).

72. H.R. 5116 § 202.

73. 951 F.2d 136 (7th Cir. 1991).

74. Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1992*, 26 IND. L. REV. 749, 757-58 (1993).

better to deal directly with opportunistic conversion rather than always including the asset in the converted estate.<sup>75</sup> The new legislation uses this approach. Ordinarily, property inherited more than 180 days after the Chapter 13 petition will not be part of the estate. However, if the conversion is in bad faith, all post-petition, pre-conversion property is included in the post-conversion bankruptcy estate.<sup>76</sup>

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75. I suggested that dismissal was the appropriate response to a bad faith conversion request. Then all post-petition property would be part of the subsequent (if any) proceeding.

76. H.R. 5116 § 311.