

Bankruptcy in the Seventh Circuit: 1991

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During the period covered by this survey,¹ the Seventh Circuit decided more than fifty bankruptcy appeals. I have included only opinions of more than passing interest in this review of the court's work, including one district court opinion which treats matters of particular interest to Indiana bankruptcy practitioners.

I. POWERS OF AVOIDANCE

Two separate provisions of the Bankruptcy Code authorize avoidance of fraudulent transfers. Section 544(b) vests the trustee with rights created by state law in favor of creditors holding unsecured claims.² Section 548 is a federal fraudulent conveyance statute which is only available to the bankruptcy trustee.³ In *Jones v. Atchison*,⁴ the Seventh Circuit held that a debtor's pre-bankruptcy renunciation of a testamentary gift cannot be set aside under section 548.⁵ Neither the trial judge nor the appellate court addressed the merits. Arguably, renunciation by an insolvent heir is a fraud on creditors.⁶ Each court in the *Atchison* case decided, however, that the relation back effect of the disclaimer retroactively eliminated the transfer and eliminated any need to discuss possible prejudice to creditors.⁷

The renunciation in *Atchison* occurred less than three months before the debtor's bankruptcy and was initially challenged under both section 544(b) and section 548. The bankruptcy judge decided that state law failed to create any cause of action which could be passed along to the trustee via section 544(b).⁸ This interpretation of state law was clearly

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1. See Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1989-1990*, 24 IND. L. REV. 551 (1991) (covering a period which concluded on August 31, 1990). This survey covers cases decided during the balance of 1990 and all of 1991. Cases decided during 1991 are included only if the opinions appeared in the West advance sheets on or before December 30, 1991 (947 F.2d No. 3).

2. 11 U.S.C. § 544(b) (1988).

3. 11 U.S.C. § 548 (1988 & Supp. II 1990).

4. *In re Atchison*, 925 F.2d 209 (7th Cir.), cert. denied, 112 S. Ct. 178 (1991).

5. *Id.* at 212.

6. See Adam J. Hirsch, *The Problem of the Insolvent Heir*, 74 CORNELL L. REV. 587, 610-26 (1989).

7. *Atchison*, 925 F.2d at 211-12.

8. *Jones v. Atchison (In re Atchison)*, 101 B.R. 556, 557 (Bankr. S.D. Ill. 1989).

correct. The Illinois Probate Act does not allow creditors of a disclaiming party to challenge the renunciation absent special circumstances not present in the facts of this case.⁹ This part of the lower court's ruling was not challenged on appeal.¹⁰ Only the section 548 claim came before the Seventh Circuit.

In affirming the decision of the bankruptcy court, Judge Will offered an unsatisfactory justification for dismissing the challenge based solely upon federal law. He reasoned that because a *valid* disclaimer had the effect of preventing the debtor from acquiring any interest in the disclaimed property, the debtor never had any interest in property which could be the subject of a transfer.¹¹ After the disclaimer, no transfer had occurred because there was nothing to transfer. Thus, there was nothing which could be avoided under section 548. Such circular reasoning is often encountered in litigation involving disclaimers of testamentary gifts.¹² The retroactive effect of a disclaimer is offered as the justification for concluding that no transfer exists. Once one assumes that no transfer exists, the validity of the disclaimer which produces the retroactive effect is assumed and cannot be debated.

Judge Will reasoned that Illinois law controlled the interpretation of section 548. Relying on *Butner v. United States*¹³ he observed, "Absent a federal provision to the contrary, a debtor's interest in property is determined by applicable state law."¹⁴ No one doubts that Illinois is free to fashion its laws of testate and intestate succession in a way that prejudices the interests of the disclaimant's creditors, but the Illinois choice is not necessarily one which should control the interpretation of section 548. A line of cases beginning with *Durrett v. Washington National Insurance Co.*¹⁵ has held that section 548, as federal law, can be used to avoid a transfer which is beyond the reach of nonbankruptcy fraudulent conveyance law. The Seventh Circuit has endorsed the general principle announced in *Durrett*.¹⁶ Thus, the exercise of a power of disclaimer could be viewed as a transfer under section 101(50)¹⁷ of the

9. *Id.*

10. *In re Atchison*, 925 F.2d 209, 210 n.2 (7th Cir), *cert. denied*, 112 S. Ct. 178 (1991).

11. *Id.* at 211.

12. See Hirsch, *supra* note 6, at 593-95, 601.

13. 440 U.S. 48 (1979).

14. *Atchison*, 925 F.2d at 210.

15. 621 F.2d 201 (5th Cir. 1980).

16. *Bundles v. Baker (In re Bundles)*, 856 F.2d 815, 822-23 (7th Cir. 1988) (mortgage foreclosure in compliance with state law may be avoided under § 548). This and similar applications of § 548 are criticized in THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 148-50 (1986).

17. 11 U.S.C. § 101(50) (Supp. II 1990).

Code, regardless of the Illinois view. The appropriate relationship between the law of testate and intestate succession and the law of fraudulent conveyances is not well articulated in judicial decisions. There are good arguments for both favoring and opposing the application of fraudulent transfer concepts to testamentary disclaimers.¹⁸ This problem deserved a more extensive and thoughtful consideration than was received in the *Atchison* opinion.¹⁹

Finally, and this may be the most disturbing aspect of this case, the Seventh Circuit failed to acknowledge and discuss cases, including one bankruptcy decision from the Central District of Illinois,²⁰ which conclude that post-petition disclaimers of inheritance violate section 549.²¹ If the relation back doctrine fails to negate the existence of a transfer when section 549 is invoked, why not apply the same analysis to pre-petition disclaimers? Further confusing the situation is the fact that in another disclaimer case, out of the Southern District of Illinois, the trustee was successful in avoiding a disclaimer under section 549.²² *Atchison* is cited and distinguished.²³ Sooner or later, the Seventh Circuit will be forced to clarify its position on disclaimers.

II. CLAIMS

Equitable considerations continue to play a prominent role in the Seventh Circuit's disposition of claim disputes.²⁴ This year the court, in

18. See Hirsch, *supra* note 6, at 610-26.

19. Two cases condemning prebankruptcy disclaimers were dismissed in one sentence in *Atchison*: "Cases cited by the trustee to the contrary are unpersuasive because they fail to give full application to the relation back doctrine under applicable state laws." *In re Atchison*, 925 F.2d 209, 211 (7th Cir.), *cert. denied*, 112 S. Ct. 178 (1991).

20. *Geekie V. Watson (In re Watson)*, 65 B.R. 9, 12 (Bankr. C.D. Ill. 1986).

21. *Cornelius v. Cornell (In re Cornell)*, 95 B.R. 219, 222 (Bankr. W.D. Okla. 1989); *McGraw v. Betz (In re Betz)*, 84 B.R. 470, 472 (Bankr. N.D. Ohio 1987); *Flanigan v. Lewis (In re Lewis)*, 45 B.R. 27, 30 (Bankr. W.D. Mo. 1984).

22. *Williams v. Chenoweth (In re Chenoweth)*, 132 B.R. 161, 166 (Bankr. S.D. Ill. 1991).

23. *Id.* at 164. Judge Meyers, who decided *Chenoweth*, also wrote the lower court opinion in *Atchison*. In *Chenoweth*, he relied on the reasoning contained in his opinion in *Atchison* to justify a different result when the disclaimer occurs post-petition. "The 'entitled to acquire' language of § 541(a)(5)(A) results in a much broader definition of property of the estate for testamentary interests arising after bankruptcy and manifests Congress' intent to capture such interests for . . . the bankruptcy estate. As such § 541(a)(5)(A) overrides the applicable state law of disclaimer. . . ." *Id.* This attempt to articulate a distinction between § 548 litigation and § 549 litigation was unpersuasive when he authored his opinion in *Atchison* and remains so in *Chenoweth*. The relation back theory of the Seventh Circuit involves an interpretation of "transfer" as that term is defined in § 101(50). The term is common to both § 548 and § 549. Judge Meyers's reasoning ignores the *Atchison* rationale that whatever the debtor owned retroactively disappeared when the disclaimer took place.

24. There were three equitable subordination decisions last year. See Boshkoff, *supra* note 1, at 556-60.

In re Unroe,²⁵ relied heavily on section 105 to excuse several mistakes made by the IRS with reference to a tax claim in a Chapter 13 proceeding.²⁶

Unroe's Statement of Affairs and Plan indicated total priority tax debts of \$15,000 for the 1982 and 1983 tax years. However, the IRS's proof of claim, filed before the bar date, covered only 1982 taxes. After the bar date, the IRS filed a second proof of claim for 1985 taxes which it styled as an amendment to the previous claim for 1982 taxes. It made no attempt to obtain an extension of the time for filing as authorized by Bankruptcy Rule 3002(c)(1). Almost one year later, it filed a third proof of claim (the second tardy filing), changing the date in the second proof of claim (the first tardy filing) to 1983. The debtor's objections to the late filed claim were rejected by the bankruptcy court on two grounds either: (1) the late filed claim for 1983 (1985) taxes related back to the timely proof of claim for 1982 taxes pursuant to Federal Rule of Civil Procedure 15(c)²⁷ or (2) the bankruptcy court was vested with an equitable power to accept the late claim.²⁸

Partially agreeing with this reasoning, the Seventh Circuit affirmed.²⁹ It first rejected the relation back justification. Federal Rule of Civil Procedure 15(c) was not adequate to rescue the late claim because there was no nexus between the two claims.³⁰ "Separate years imply separate tax claims. . . ."³¹ Nonetheless, the bankruptcy court's acceptance of the late claim was an appropriate exercise of the equitable power conferred by section 105.³²

25. 937 F.2d 346 (7th Cir. 1991).

26. *Id.* at 349-50.

27. FED. R. CIV. P. 15(c) (relation back of amendments) is applicable in adversary proceedings and contested matters. *See* BANK. R. 7015, 9014. A disputed claim is in the latter category. *Unroe*, 937 F.2d at 349.

28. *Unroe*, 937 F.2d at 348.

29. *Id.* at 351.

30. FED. R. CIV. P. 15(c) permits relation back when the amendment relates to the same "conduct, transaction, or occurrence."

31. *In re Unroe*, 937 F.2d 346, 349 (7th Cir. 1991).

32. *Id.* at 349-51. Collier notes two interpretative approaches, narrow and broad, to § 105. 2 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 105.01[3] (Lawrence P. King ed., 15th ed. 1991). *Unroe* clearly fits in the latter category. Collier describes the approaches as follows:

The cases and commentary reflect two general schools of thought regarding the breadth of section 105. The first recognizes that certain goals of the Bankruptcy Code are implied but not stated in the statutory language and views section 105 as granting the bankruptcy courts authority to fill the gaps left by the statutory language. The other approach is that section 105 is not a broad writ, and should be narrowly construed.

Regardless of the view adopted, it should be universally recognized that

This result is somewhat surprising in light of prior Seventh Circuit authority. In *Wilkins v. Simon Brothers, Inc.*,³³ the court refused to excuse a late filing.³⁴ However, the *Unroe* court seized on language in *Wilkins* to justify the result it reached. *Wilkins* had suggested that an exception to the strict enforcement of time limits could be made if the late claim was regarded as an amendment of an earlier and timely informal claim.³⁵ The *Unroe* court reasoned that the timely filed 1982 claim was fair warning of the IRS's intent to present claims covering subsequent tax years and warranted the exercise of equitable discretion.³⁶ This reasoning is rather curious when one remembers that the court had previously found no nexus between the timely and late filings for purposes of relation back under Federal Rule of Civil Procedure 15(c).

Unroe raises more questions than it answers. Consider the following possible lines of inquiry:

1. The IRS claim was allowed even though the agency offered absolutely no explanation for its late filing. The *Wilkins* court, on the other hand, refused to excuse a late filing even though there was a plausible explanation for the delay—a mix-up which occurred during the relocation of the creditor counsel's office.³⁷ Arguably, *Wilkins* presents a more sympathetic case for relief. Are we to assume that the delinquent creditor is better off with silence than an admission of fault? How can a court determine that the delinquent creditor is entitled to equitable relief when it does not understand how the mix-up occurred?

2. Are governmental creditors more likely to benefit from exercise of the bankruptcy court's inherent power than nongovernmental claimants? Possibly. Bankruptcy Rule 3002(c)(1) permits an extension of the time for filing claims by governmental units. Relating that rule to late claims, the *Unroe* court observed that "a bankruptcy court's power to extend the bar date implies a corresponding power to permit late claims."³⁸

3. What is to be made of the *Unroe* court's following observation concerning completely new claims? "We leave for another case the

the power granted to the bankruptcy courts under section 105 is not limitless and should not be employed as a panacea for all ills confronted in the bankruptcy case. Section 105 does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code or mandates of other state and federal statutes.

Id. (footnotes omitted).

33. 731 F.2d 462 (7th Cir. 1984).

34. *Id.* at 464.

35. *Id.* The *Wilkins* case was remanded for further findings as to whether the creditor's conduct was sufficient "to constitute a de facto informal filing." *Id.* at 465.

36. *In re Unroe*, 937 F.2d 346, 350 (7th Cir. 1991).

37. *Wilkins*, 731 F.2d at 464.

38. *Unroe*, 937 F.2d at 350.

question whether a judge in equity could permit an entirely new claim filed out of time. *Wilkins* appears to rule out this possibility, but we have not had the benefit of briefs or argument on the issue.”³⁹ This quotation suggests a sympathy with further exercise of the bankruptcy court’s power to grant equitable relief. Clearly, the decision in *Unroe* invites tardy claimants to petition for relief from the time constraints contained in Bankruptcy Rule 3002(c).

Unroe is not the only unusual claim decision. The IRS won a second questionable victory in litigation arising out of serial Chapter 11 filings. Two years ago, the Seventh Circuit, in *Fruehauf Corp. v. Jartran, Inc.*,⁴⁰ decided that Chapter 22 bankruptcies⁴¹ were permissible⁴² and then went on to hold that an administrative claim arising during the initial filing did not automatically retain that status in the second Chapter 11 case.⁴³ The court stated, “To receive an administrative priority in *Jartran II*, Fruehauf must demonstrate its claims relative to *Jartran II*; an administrative priority in *Jartran I* does not translate to an administrative priority in *Jartran II*.”⁴⁴

The Seventh Circuit, in *In re Official Committee of Unsecured Creditors of White Farm Equipment Co.*,⁴⁵ refused to treat priority tax claims in the same fashion that *Jartran* had treated priority administrative claims. The plan in the initial bankruptcy provided for payment of priority tax claims over a six year period as required by section 1129(a)(9)(c).⁴⁶ When the second Chapter 11 case was filed, the creditor’s committee argued that the tax claim was no longer entitled to priority status. Relying on the language of section 1141(d), the committee asserted that the treatment provided in the confirmed plan had been substituted for the original priority claim. The Seventh Circuit disagreed, stating:

By this reasoning, all debts incorporated in the reorganization plan lose their old priority status and are instead transformed into mere contractual obligations. . . . As the Committee concedes, administrative claims are intimately tied to a single bank-

39. *Id.*

40. *In re Jartran, Inc.*, 886 F.2d 859 (7th Cir. 1989).

41. A “Chapter 22” bankruptcy is two successive Chapter 11 proceedings. Recently, the Supreme Court, in *Johnson v. Home State Bank*, 111 S. Ct. 2150, 2156 (1991), refused to prohibit serial filings absent a finding of bad faith. *Johnson* was a Chapter 20 (7 + 13) proceeding.

42. *Jartran*, 886 F.2d at 866-67.

43. *Id.* at 870-71.

44. *Id.* at 870.

45. 943 F.2d 752 (7th Cir. 1991), *cert. denied*, 60 U.S.L.W. 3481 (U.S. Mar. 9, 1992).

46. *Id.* at 754.

ruptcy estate in a manner that is completely different from the trust fund tax claims at issue here. Absent a clear signal from Congress, therefore, we are reluctant to adopt the Committee's broad reading of *Jartran* and extend its holding so far beyond its unique facts.⁴⁷

Perhaps the decision in *White Farm* simply reflects some newly discovered doubts about the wisdom of permitting Chapter 22 cases and is an attempt to restrict the application of the *Jartran* decision. In any event, priority claimants are now in an enviable position, as they may choose either to continue with the treatment provided by the plan or revert to their original status.⁴⁸ Other parties to the confirmed plan are not so fortunate. Absent modification or revocation of the plan, they remain bound to the treatment provided in the original plan of reorganization, even though their affirmative votes may have been influenced by the treatment of the priority claimants.

III. PROCEDURE

Matters of procedure continue to be a major concern of appellate courts. The Seventh Circuit is no exception. Although some procedural wrangling should be expected under even the best of circumstances, bankruptcy procedural disputes often appear to be unnecessary and wasteful. Some of the complexity encountered in bankruptcy litigation can be blamed on congressional unwillingness to create a simple court structure following the decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*⁴⁹ A second complicating factor is the division of adjudicatory responsibility in bankruptcy matters between state and federal forums, a division which long predated *Marathon*.⁵⁰ *Diamond Mortgage Corp. v. Sugar*⁵¹ demonstrates how both these complicating factors can interact in the context of a procedural question often encountered by first year law students: Is the forum entitled to exercise personal jurisdiction over an absent defendant?

47. *Id.* at 757.

48. The *White Farm* court held that the IRS could claim a priority status in the second bankruptcy only if it was still, as an original matter, entitled to priority at that time. *Id.*

49. 458 U.S. 50 (1982) (Section 1471 of the Bankruptcy Act, which grants jurisdiction to bankruptcy judges, violates Article III of the Constitution because judicial power of the United States must be exercised by judges with life tenure and protection against salary diminution.).

50. STEPHEN E. SNYDER & LAWRENCE PONOROFF, COMMERCIAL BANKRUPTCY LITIGATION § 2.01 (1991).

51. 913 F.2d 1233 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 968 (1991).

Diamond Mortgage was a malpractice action brought by a Chapter 11 debtor in possession against its former attorneys. The plaintiff, whose bankruptcy was pending in the Bankruptcy Court for the Northern District of Illinois, commenced this action in the district court for the same district and claimed that personal jurisdiction over the defendants was obtained by service of process in Michigan pursuant to Bankruptcy Rule 7004(d), which authorizes nationwide service of process. The district court accepted the magistrate's recommendation for dismissal of the litigation on the ground that Bankruptcy Rule 7004(d) was not applicable to this controversy.

The Seventh Circuit reversed.⁵² It first decided that the malpractice was related to the bankruptcy because its resolution would affect the pool of assets available for distribution to creditors.⁵³ Having identified a nexus with bankruptcy, the court then decided that the bankruptcy rules, including the provision for nationwide service of process, applied irrespective of the decisionmaker.⁵⁴ Thus, the fact that the malpractice action had not been referred to the bankruptcy judge,⁵⁵ a possible post-*Marathon* disposition, had no effect on the applicability of the bankruptcy rules. This result is quite sensible.

It would seem anomalous to limit nationwide service of process to only those adversary proceedings which are heard in the bankruptcy court. To do so would cause personal jurisdiction to hinge upon whether the district court has withdrawn its reference to the bankruptcy court. Such a limitation would give the plaintiff in an adversary case before a bankruptcy court a more extensive ability to serve defendants than a plaintiff in an identical adversary case before the district court. This result hardly seems justifiable.⁵⁶

It was then necessary to determine whether Bankruptcy Rule 7004(d) is constitutional when applied in a non-core (state law) proceeding to nonresident defendants. Judge Cudahy was satisfied that the minimum contacts test of *International Shoe Co. v. Washington*⁵⁷ was satisfied by

52. *Id.* at 1248.

53. *Id.* at 1239.

54. *Id.* at 1241.

55. See 28 U.S.C. § 157(a) (1988) ("Each district court may provide that . . . any or all proceedings . . . arising in or related to a case under title 11 shall be referred to the bankruptcy judges for district.").

56. *Diamond Mortgage Corp. v. Sugar*, 913 F.2d 1233, 1242 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 968 (1991) (quoting *Stavriotis v. Litwin*, No. 86-C2328, 1986 WL 12005, at *3 (N.D. Ill. Oct. 19, 1986)).

57. 326 U.S. 310 (1945).

the defendants' contacts with the United States, not with Illinois.⁵⁸

We believe . . . that the [defendants'] contacts with the State of Illinois are, for our purposes, simply irrelevant. . . . Since section 1334 provides federal question jurisdiction, the sovereign exercising its authority over the [defendants] is the United States, not the State of Illinois. Hence, whether there exist sufficient minimum contacts between the [defendants] and the State of Illinois has no bearing upon whether the United States may exercise its power . . . pursuant to its federal question jurisdiction. Certainly, the [defendants] have sufficient contacts with the United States to be subject to the district court's *in personam* jurisdiction.⁵⁹

Some commentators have questioned the adequacy of this analysis.⁶⁰ At the same time, one should note that the result in *Diamond Mortgage* is consistent with the approach taken in both the Fourth⁶¹ and Eleventh Circuits.⁶²

The awkwardness of the post-*Marathon* approach to bankruptcy adjudication is also reflected in litigation concerning the right to a jury trial.⁶³ In *N.I.S. Corp. v. Hallahan (In re Hallahan)*,⁶⁴ the debtor temporarily frustrated his former employee's attempt to collect damages for breach of a covenant not to compete by commencing a voluntary bankruptcy and thus obtaining the benefit of the automatic stay. The employer responded by commencing an adversary proceeding before the bankruptcy judge claiming that the damages arising from the wrongful competition were excepted from discharge by section 523(a)(6).⁶⁵ The bankruptcy judge agreed and entered a judgment against the debtor for more than

58. *Diamond Mortgage*, 913 F.2d at 1244.

59. *Id.*

60. Jeffrey T. Ferriell, *The Perils of Nationwide Service of Process in a Bankruptcy Context*, 48 WASH. & LEE L. REV. 1199, 1210-54 (1991); Daniel N. Gregoire, Note, *Fifth Amendment Due Process Limitations on Nationwide Federal Jurisdiction*, 61 B.U. L. REV. 403 (1981); Note, *Bankruptcy and the Limits of Federal Jurisdiction*, 95 HARV. L. REV. 703, 713-20 (1982).

61. *Hogue v. Milodon Eng'g, Inc. (In re Hogue)*, 736 F.2d 989 (4th Cir. 1984).

62. *Nordberg v. Granfinanciera (In re Chase & Sanborn Corp.)*, 835 F.2d 1341 (11th Cir. 1988), *rev'd on other grounds*, 492 U.S. 33 (1989).

63. An extraordinary amount has been written on this subject. A good statement of the current situation can be found in S. Elizabeth Gibson, *Jury Trials and Core Proceedings: The Bankruptcy Judge's Uncertain Authority*, 65 AM. BANKR. L.J. 143, 145-50 (1991). See also SNYDER & PONOROFF, *supra* note 50, ¶ 3.05[1].

64. 936 F.2d 1496 (7th Cir. 1991).

65. 11 U.S.C. § 523(a)(b) (1988) (no discharge "for willful and malicious injury by the debtor to another entity or to the property of another entity").

\$250,000.⁶⁶ On appeal, the debtor unsuccessfully argued that the bankruptcy judge erred in denying his demand for a jury trial. The Seventh Circuit reasoned that there was no constitutional right to a trial by jury.⁶⁷ First, the dischargeability litigation was equitable in nature and, as such, involved no right to a jury trial.⁶⁸ The court then offered a novel alternative justification for the absence of a jury trial:

Even if we were to assume that the dischargeability action was legal in nature, however, Hallahan cannot claim a right to jury trial because, as a Chapter 7 debtor, he voluntarily submitted his case to bankruptcy court. . . . [I]f creditors [by filing claims] . . . thereby [lose] any jury trial right otherwise guaranteed by the Seventh Amendment, debtors who initially choose to invoke the bankruptcy court's jurisdiction to seek protection from their creditors cannot be endowed with any stronger right. A defendant or potential defendant to an action at law cannot initiate bankruptcy proceedings, thus forcing creditors to come to bankruptcy court to collect their claims, and simultaneously complain that the bankruptcy forum denies him or her a jury trial.⁶⁹

The Fifth Circuit recently approved of the result achieved in *Hallahan*, while criticizing the above broad language:

We agree with the result in *Hallahan*, but not its reasoning with regard to why the debtor had no right to a jury trial, even if the claims against him were legal in nature. As we see it, the debtor was not entitled to a jury trial in *Hallahan*, not because the debtor had filed a petition in bankruptcy, but because the plaintiff had submitted his claim against the debtor to the equitable jurisdiction of the bankruptcy court. Filing a proof of claim denied both the plaintiff and the defendant, debtor, any right to jury trial that they otherwise might have had on that

66. The bankruptcy court held that the wilful breach of a contract was excepted from discharge by § 523(a)(6). On appeal, debtor conceded that the breach was wilful, but he did not argue that § 523(a)(6) is inapplicable to contract liability. This was an apparently unwise strategy in light of current authority. See *Friendly Fin. Serv. Mid-City, Inc. v. Modicue* (*In re Modicue*), 926 F.2d 452, 453 (5th Cir. 1991) ("Section 523(a)(6) is based on tort principles rather than contract"); *Palazzolo v. Colclazier* (*In re Colclazier*), 134 B.R. 29 (Bankr. W.D. Okla. 1991); *Dorr & Assocs. v. Pasek* (*In re Pasek*), 129 B.R. 247, 252 (Bankr. D. Wyo. 1991) (intentional breach of contract alone is insufficient to establish a willful and malicious purpose within the meaning of § 523(a)(6); 3 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 523.16 (Lawrence P. King ed., 15th ed. 1991).

67. *Hallahan*, 936 F.2d at 1505.

68. *Id.*

69. *Id.* (citations and footnote omitted).

claim. Debtor's petition in bankruptcy could have no legal effect on plaintiff's claim other than to stay it.⁷⁰

In addition to the current attention paid to the jury trial issue, the effect of prior adjudication is becoming a popular topic. For example, one of the most interesting cases decided during the last survey period, *Barnett v. Stern*,⁷¹ involved the application of claim preclusion principles to bankruptcy litigation. The objective of claim preclusion (*res judicata*) is to achieve finality in litigation by preventing a party from asserting a claim that it could have presented, but did not, in a prior proceeding between the same parties. The related doctrine of issue preclusion (*collateral estoppel*) prevents relitigation of a fact established in a prior proceeding between the same parties. Claim preclusion reduces the cost of litigation by forcing the combination of closely related claims in a single lawsuit. Issue preclusion does not compel litigation of a factual issue, but seeks to prevent the same issue from being litigated twice.

The Seventh Circuit, in *La Preferida, Inc. v. Cerveceria Modelo, S.A. de C.V.*,⁷² discussed the application of both principles to litigation occurring during and after a bankruptcy proceeding. In 1976, the debtor-to-be (Corona) licensed plaintiff to distribute Corona beer. This agreement was allegedly terminated in 1982. The following year Corona entered into a similar arrangement with the defendant. Corona's bankruptcy followed in 1984. Plaintiff then filed a proof of claim asserting that Corona's attempt to terminate the contract in 1982 and its subsequent agreement with the defendant were wrongful. Thereafter, the bankruptcy court approved the sale of the Corona trademark to defendant "free and clear of all liens, claims, and encumbrances." Plaintiff did not appeal the order of sale, but claimed that it was reserving its right to sue the defendant. Eight months later, the plaintiff entered into a consent judgment, withdrawing its claim and acknowledging that Corona's 1982 termination of the 1976 agreement was proper. Following the conclusion of the bankruptcy, plaintiff brought an action against defendant seeking a declaration that its 1976 agreement with Corona was enforceable against the defendant.

The defendant first argued that the plaintiff's consent judgment with the debtor contained a finding that the 1976 agreement was terminated in 1982 and prevented any further litigation concerning the continuing

70. *In re Jensen*, 946 F.2d 369, 374 (5th Cir. 1991).

71. 909 F.2d 973 (7th Cir. 1990). This decision is discussed in Boshkoff, *supra* note 1, at 563-67. For a further discussion, see Douglass G. Boshkoff, *Res Judicata and Collateral Estoppel in the Post-Northern Pipeline Era*, NORTON BANKR. L. ADVISER, Feb. 1992, at 5.

72. 914 F.2d 900 (7th Cir. 1990).

validity of the 1976 arrangement. The Seventh Circuit rejected this analysis. Under the rule of *Klingman v. Levinson*,⁷³ a consent judgment can be given collateral estoppel effect.⁷⁴ It was not given such effect in this instance because the consent judgment was ambiguous and did not clearly indicate an intent to bar the subsequent litigation against the defendant.⁷⁵ However, the doctrine of res judicata was applicable.⁷⁶ The effect of the 1976 contract on the plaintiff's rights against the defendant could have been litigated when the bankruptcy court authorized the sale of the trademark. The *La Preferida* litigation was simply a collateral attack on the order of sale and as such, was barred by the principle of claim preclusion.

The effect of a prior adjudication is also discussed in *Bicknell v. Stanley (In re Bicknell)*,⁷⁷ a district court opinion authored by Judge McKinney, which contains an interesting analysis of the relation between state (Indiana) and federal rules of issue preclusion in dischargeability litigation. In *Bicknell*, the question was whether an agreed judgment in state court should be given collateral estoppel effect in subsequent federal dischargeability litigation. As we have seen, the rule in the Seventh Circuit, announced in *Klingman v. Levinson*, is that issue preclusion will occur only if it is clear that the parties to the consent judgment intended to preclude further litigation.⁷⁸ Indiana arguably follows a different rule, announced by the court of appeals in *Hanover Logansport, Inc. v. Robert C. Anderson, Inc.*,⁷⁹ which would preclude further litigation unless there was a clear intent to reserve the issue.⁸⁰ If this was a correct characterization of the law, then it made a difference whether the issue preclusion rule was derived from Indiana precedent or from federal sources.

Judge McKinney first stated that the *Klingman* (federal) rule applied only when the initial consent judgment settled federal litigation.⁸¹ The Full Faith and Credit Statute⁸² required application of Indiana law in a case such as this, when the prior adjudication occurred in state court.⁸³ Judge McKinney then concluded that the Indiana rule, yet to be ruled

73. 831 F.2d 1292 (7th Cir. 1987).

74. *La Preferida*, 914 F.2d at 906.

75. *Id.* at 907.

76. *Id.*

77. 118 B.R. 652 (S.D. Ind. 1990).

78. *Id.* at 654.

79. 512 N.E.2d 465 (Ind. Ct. App. 1987).

80. *Bicknell*, 118 B.R. at 654.

81. *Id.* at 658.

82. 28 U.S.C. § 1738 (1988).

83. *Bicknell v. Stanley (In re Bicknell)*, 118 B.R. 652, 658 (S.D. Ind. 1990).

on by the Indiana Supreme Court, would follow the federal rule, despite the *Hanover Logansport* decision.⁸⁴

This short summary does not do justice to Judge McKinney's meticulous, detailed, and comprehensive review of Indiana and federal law. Although almost twenty pages in length, his opinion is rewarding reading for anyone interested in the relationship between Indiana and federal claim and issue preclusion rules.

IV. AUTOMATIC STAY

The post-bankruptcy effect of a violation of section 362⁸⁵ was considered in two recent cases. In *Pettibone Corp. v. Easley*,⁸⁶ a revested Chapter 11 debtor sought to enjoin the continuation of a lawsuit that had been commenced during bankruptcy in violation of the automatic stay. Nothing in the confirmed reorganization plan prevented prosecution of this action. Judge Easterbrook properly concluded that there no longer was any federal interest to be advanced by enjoining the litigation.⁸⁷ The effect of the completed bankruptcy proceeding upon the claimant's right to go forward in state court was now solely a matter of state law.⁸⁸ Therefore, the bankruptcy court lacked jurisdiction to determine the effect of the violation of the automatic stay.⁸⁹ In another decision, *Price v. Rochford*,⁹⁰ the court decided that an action to recover damages

84. *Id.* at 664-70. By concluding that the Indiana Supreme Court would adopt the majority (*Klingman*) rule, Judge McKinney avoided the necessity of determining whether the exclusive jurisdiction of the bankruptcy court over dischargeability proceedings required a further holding that there was an implied exception to the full faith and credit statute. *Id.* at 658-60, 670.

85. 11 U.S.C. § 362 (1988 & Supp. II 1990).

86. 935 F.2d 120 (7th Cir. 1991).

87. *Id.* at 121.

88. Now the only obstacles to the continuation of the tort suits are the statutes of limitations—Michigan's for two cases and Louisiana's for the third. Whether Michigan or Louisiana would treat a case filed in violation of the automatic stay as a non-event for limitations purposes is a question of state law. No federal interest is in play; the bankruptcy court authorized the continued prosecution of these cases when it confirmed the plan of reorganization. Federal law assured the plaintiffs 30 days in which to pick up the baton; if states want to give plaintiffs additional time, that is their business.

Id. This quotation suggests an interesting line of inquiry. If states are free to determine the effect of a violation of the automatic stay on the running of the statute of limitations, may they also attach consequences to other violations of bankruptcy policy? For example, could a state decide that a violation of the rules against bankruptcy based discrimination also created a cause of action under state law? *Cf. Gonzales v. AM Community Credit Union*, 442 N.W.2d 536 (Wis. Ct. App. 1989) (state law cause of action for wrongful attempt to collect discharged debt).

89. *Pettibone*, 935 F.2d at 122.

90. 947 F.2d 829 (7th Cir. 1991).

for a wilful violation of the automatic stay could be maintained in federal court after dismissal of the bankruptcy case during which the violation occurred.⁹¹

Both decisions are correct and consistent with each other. Once a bankruptcy case is concluded, the affirmative protection provided by the automatic stay is no longer needed. Thus, the litigation may go forward if otherwise permissible under nonbankruptcy law. Nevertheless, the violation of the stay may have resulted in monetary losses to the debtor and these losses remain compensable even though the bankruptcy case has been closed or dismissed. A footnote in *Price* indicates that a cause of action arising during bankruptcy can be enforced by a post-bankruptcy action in United States District Court.⁹² This suggests that an action alleging a post-bankruptcy violation of either section 524(a)(2) or section 525 can also be maintained in a district court action. Thus, there is no need to reopen the bankruptcy case.⁹³

A third decision, *Roete v. Smith (In re Roete)*,⁹⁴ considers the application of the automatic stay to a criminal prosecution under the Indiana check deception statute.⁹⁵ The facts in this case are quite simple. The debtor filed for bankruptcy after giving Smith a bad check. Smith contacted the prosecutor and was advised to present the check for payment. Following the drawee's refusal to honor the check, Smith signed an affidavit required by the prosecutor, and the debtor was arrested. This action for a wilful violation of the automatic stay followed.

Bankruptcy Judge Otte awarded Smith damages of \$3,189, reasoning that a criminal prosecution instituted for debt collection purposes violates the automatic stay, a proposition for which there is respectable lower court authority.⁹⁶ On appeal, the judgment was reversed. The presentment of the check was excepted from application of the stay by section

91. *Id.* at 831-32.

92. *Id.* at 832 n.1.

93. *But cf.* *Cheripka v. Republic Ins. Co. (In re Cheripka)* 122 B.R. 33 (Bankr. W.D. Pa. 1990) (district court lacked jurisdiction to determine dischargeability prior to a filing of petition for bankruptcy), *vacated*, 1992 U.S. App. LEXIS 898 (3d Cir. Jan. 22, 1992).

94. 936 F.2d 963 (7th Cir. 1991).

95. IND. CODE § 35-43-5-5 (Supp. 1991).

96. Judge Otte relied on *St. Joseph Wholesale Liquor Co. v. Butler (In re Butler)*, 74 B.R. 106 (Bankr. W.D. Mo. 1985) and *Underwood v. DeLay (In re DeLay)*, 48 B.R. 282 (Bankr. W.D. Mo. 1984) (dictum). See Entry on Verified Petition for Contempt Citation filed by Debtor, *In re Roete*, No. IP 88-2100J (June 12, 1989) (on file with the *Indiana Law Review*). See also *Hucke v. Oregon (In re Hucke)*, 128 B.R. 675 (D. Ore. 1991) (violation of automatic stay); *Howard v. Allard*, 122 B.R. 696 (W.D. Ky. 1991) (§ 105 injunction against criminal prosecution for purpose of collecting debt); *Bicro Corp. v. Mackes (In re Bicro Corp.)*, 105 B.R. 255 (Bankr. M.D. Pa. 1988) (§ 105 injunction against creditor participation in bad check prosecution); *In re Caldwell*, 5 B.R. 740 (Bankr. W.D. Va. 1980) (§ 105 injunction against creditor participation in bad check prosecution).

362(b)(11).⁹⁷ Therefore, the court reasoned, there was no violation of the stay.⁹⁸ This conclusion ignores the fact that section 362(b)(11) protects only the act of presentment, but does not immunize the entire process of prosecution from scrutiny. The Seventh Circuit failed to explain why the activity which preceded and followed the presentment did not amount to an entirely independent violation of the stay.⁹⁹

Debtors should not be able to negate criminal sanctions by invoking bankruptcy. Nonetheless, courts are entitled to look past legislative labels and examine the substance of a proceeding or a statute.¹⁰⁰ Today, the identification of a true criminal proceeding may be difficult because the demarcation between criminal and civil laws is not as clear as it was fifty years ago. Restitution is now recognized as an element of criminal justice.¹⁰¹ Nevertheless, the compensatory aspect of a criminal remedy can support the inference that it is a private pecuniary interest, rather than the public interest, which is being protected through a prosecution. If the protection of private pecuniary interest predominates, then bankruptcy should abate the pseudocriminal prosecution.¹⁰² To date, this argument has not been persuasive. Debtors have been completely unsuccessful in convincing circuit courts that intervention to protect their interests is either necessary or appropriate.¹⁰³ In one sense then, the

97. 11 U.S.C. § 362(b)(11) (1988).

98. *Roete*, 936 F.2d at 966.

99. Roete argued that § 362(b)(11) did not apply because he had been harassed. The court refused to consider this argument because "[t]he transcript . . . contains no evidence of harassment." *Id.* at 966 n.5. There is no explanation of why the second contact with the prosecutor did not support a finding of harassment. Roete's pleading in the bankruptcy court clearly included the contact with the prosecutor in his charge of harassment. See Verified Petition for Contempt Citation, *In re Roete*, No. IP 88-2100J (March 22, 1989) (on file with the *Indiana Law Review*).

100. In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Supreme Court held that Congress's attempt to pass jurisdiction through the district court to the bankruptcy court in 28 U.S.C. § 1471 violated Article III of the Constitution because "it impermissibly removed most, if not all, of the essential attributes of the judicial power from the Article III district court, and has vested those attributes in a non-Article III adjunct." *Id.* at 87.

101. See *Huggett v. State*, 266 N.W.2d 403, 407 (Wis. 1978). See also Katherine A. Francis, Note, *Dischargeability of Criminal Restitution Obligations Under Chapter 13 of the Bankruptcy Code*, 59 U. CIN. L. REV. 1349, 1369-71 (1991).

102. The Eleventh Circuit recently indicated doubt that the Alabama bad check statute provides for criminal sanctions. *Reynolds v. Dixie Nissan (In re Car Renovators)*, 946 F.2d 780, 783 n.6 (11th Cir. 1991).

103. *Fussell v. Price (In re Fussell)*, 928 F.2d 712 (5th Cir. 1991) (refusal to enjoin prosecution for criminal conversion); *United States v. Caddell*, 830 F.2d 36 (5th Cir. 1987) (refusal to enjoin revocation of probation); *Davis v. Sheldon (In re Davis)*, 691 F.2d 176 (3d Cir. 1982) (refusal to enjoin bad check prosecution); *Barnette v. Evans*, 673 F.2d 1250 (11th Cir. 1982) (refusal to enjoin prosecution which might result in restitution

result in *Roete* is consistent with existing authority and is unsurprising. Yet, a strong argument can also be made that in *Roete*, the failure to intervene and find a violation of the automatic stay was a serious mistake. First of all, the potential interference with prosecutorial discretion, a major concern in this area, was negligible. The prosecutor was well aware of the check deception event prior to bankruptcy and had, apparently, decided not to prosecute. It took a second complaint, after bankruptcy had begun, to arouse his interest. More importantly, it is difficult to characterize the Indiana check deception statute as anything other than a glorified collection remedy.¹⁰⁴ Even though the penalty for violation is a misdemeanor,¹⁰⁵ payment of a dishonored check within ten days is a complete defense to prosecution.¹⁰⁶ The prosecutor is denied the discretion to proceed after payment even if he believes that a prosecution would be in the public interest.

Because direct challenges to pseudocriminal prosecutions have been mainly unsuccessful, it may be worthwhile for debtor counsel to consider alternative approaches which eliminate incentives to invoke the criminal process by depriving creditors of restitution gains. One possibility is to seek an injunction which prevents the creditor from accepting payment which is made to bar a criminal prosecution.¹⁰⁷ Another possibility is to persuade the bankruptcy trustee to avoid such a payment under section 547.¹⁰⁸ Recently, the Eleventh Circuit held that a payment made to avoid a possible bad check prosecution was an avoidable preference.¹⁰⁹ Suggesting avoidance is a risky strategy, however, because avoidance of the restitution payment may result in a renewal of the criminal prosecution.

V. DEBTOR BENEFITS: DISCHARGE

Section 523(a)(5) excepts from discharge certain familial obligations, but only if they are owed "to a spouse, former spouse, or child of the

order); *United States v. Carson*, 669 F.2d 216 (5th Cir. 1982) (restitution order is appropriate).

104. For a general criticism of bad check statutes, see Steven Kratsch & William E. Young, *Criminal Prosecutions and Manipulative Restitution: The Use of State Criminal Courts for Contravention of Debtor Relief*, 1984 ANNUAL SURVEY OF BANKR. L. 107; Josephine R. Potuto, *And Mussolini Had the Trains Running on Time: A Review of the Bad Check Offense and the Law Enforcement Debt Collector*, 65 NEB. L. REV. 242 (1986).

105. IND. CODE § 35-43-5-5(a) (Supp. 1991).

106. *Id.* § 35-43-5-5(e).

107. See *Holder v. Dotson (In re Holder)*, 26 B.R. 789 (Bankr. M.D. Tenn. 1982) (debtor was denied permanent injunction enjoining prosecution for bad checks, but the court noted that the creditor was prohibited from accepting restitution as a result of the prosecution).

108. 11 U.S.C. § 547 (1988).

109. *Reynolds v. Dixie Nissan (In re Car Renovators)*, 946 F.2d 780, 782-83 (11th Cir. 1991) (president of debtor-corporation, seeking to avoid criminal prosecution, causes debtor to make restitution).

debtor.”¹¹⁰ Two years ago, the Seventh Circuit held that attorney’s fees incurred by a mother in connection with paternity litigation did not fall within this exception because she was neither a spouse nor former spouse.¹¹¹ At that time the court stated:

The cases which deny discharge for attorneys’ fees incurred to obtain child support assimilate the debt owed the attorney to a debt owed “to a spouse, former spouse, or child of the debtor.” The theory is that the spouse’s or child’s expenses of collection are part of the underlying obligation. That theory cannot stretch to cover fees for an attorney hired by the debtor, unless there is some legal obligation to hire an attorney on behalf of the spouse or child. [Creditor] has admitted that [debtor] had no legal obligation to pursue a support order at all. [Debtor] was merely seeking financial relief in meeting her own support burden. [Debtor’s] contract with [creditor] did not generate a debt to [debtor’s] child. It follows that [debtor’s] obligation to [creditor] was not in the nature of child support.¹¹²

Now the court has taken an apparently inconsistent position in holding that a mother’s pregnancy and confinement expenses are not dischargeable because they are part of a support obligation owed to the child.¹¹³ This time the court reasoned:

[B]ut for the pregnancy, Deanne would not have incurred medical and confinement expenses associated with baby Derek’s birth. These medical services, although performed upon the mother, necessarily and directly benefit the child as well.

. . . .

. . . A father should not be allowed to avoid liability for the mother’s medical care arising from the birth of their child merely because the parents did not marry until after their child was born or did not marry at all.¹¹⁴

This latest reasoning would also support a finding of nondischargeability with reference to the attorney’s fees incurred in an attempt to establish paternity. The definitive opinion on this subject remains to be written.

110. 11 U.S.C. § 523(a)(5) (1988).

111. *In re Rios*, 901 F.2d 71, 72 (7th Cir. 1990).

112. *Id.* (citations omitted).

113. *In re Seibert*, 914 F.2d 102, 106 (7th Cir. 1990).

114. *Id.* at 106-07.

