

BANKRUPTCY IN THE SEVENTH CIRCUIT: 1993

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This Article surveys the work of the Seventh Circuit between December 27, 1992 and November 30, 1993. During this period, the Court addressed a number of issues. Only the most significant opinions are discussed here.

I. DEBTOR ELIGIBILITY

In re Estate of Medcare HMO,¹ is certain to attract substantial attention outside the Seventh Circuit because it is the first appellate opinion to consider whether a health maintenance organization (HMO) is eligible for bankruptcy. *Medcare* decided that an HMO does not qualify because, as an insurance company, it is excluded from the category of eligible debtors by 11 U.S.C. § 109(b)(2).²

Even though this exclusion dates from 1910,³ Congress has never provided statutory guidance as to what constitutes an ineligible "insurance company." Courts have, therefore, developed several tests to fill this definitional void. Most popular is the "state classification" test under which companies are excluded either if they are defined as insurance companies by state law or if they are the substantial equivalent of such entities.⁴ In *Medcare*, the Seventh Circuit decided that each branch of the state classification test had been satisfied. The debtor (1) was considered an insurance company by Illinois law and (2) provided insurance protection to its clients. At the same time, the court refused to apply two other tests—the "independent classification" test and the "alternative relief" test—to the facts of the case, reasoning that "the classification of an entity should

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1. 998 F.2d 436 (7th Cir. 1993).

2. *Id.* at 437. 11 U.S.C. § 109(b) states:

(b) A person may be a debtor under chapter 7 of this title only if such person is not—

(1) a railroad;

(2) a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); or

(3) a foreign insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, or credit union, engaged in such business in the United States.

3. 1 COLLIER ON BANKRUPTCY § 4.01[2.3] (14th ed. 1974).

4. *See, e.g.*, *Cash Currency Exchange v. Shine*, 762 F.2d 542 (7th Cir. 1985) (currency exchange eligible for bankruptcy because it was not classified as a bank by state law and was not authorized to accept deposits).

generally follow the law of the state of its incorporation, so long as that classification does not frustrate the purposes of the Code."⁵

This heavy reliance on state law seems appropriate in light of Congress' longstanding deference to state regulation of the insurance business. Whether continued deference to state law is wise in light of the increase in interstate insurance activity is more problematic.⁶ It is, nevertheless, clear that any significant change in the law governing rehabilitation and liquidation of insurance companies will have to come through congressional action. As the court observed near the close of its opinion, "Congress was certainly aware of the potential for inconsistent insolvency regimes, but obviously concluded that the interest in continuing state regulation into insolvency outweighed any interest in uniformity. We will not second guess that determination."⁷

II. POWERS OF AVOIDANCE

Bankruptcy Code § 547(b) permits avoidance of a broad range of preferential transfers, so broad that Congress has provided protection for seven different types of otherwise avoidable transactions in 11 U.S.C. § 547(c). Section 547(c)(2), for example, prevents avoidance of certain routine pre-bankruptcy payments to creditors. To obtain the protection of § 547(c)(2), the preferred creditor must show that (A) the debt was incurred in the ordinary course of business, and that the payment was "(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms. . . ."⁸ Element (B) is established by showing that the transaction was subjectively routine.⁹ Courts divide on the question of whether element (C) is also subjective or whether the statute imposes an objective, industry-wide standard for measuring the conduct of the parties.¹⁰ One leading bankruptcy treatise argues for a purely subjective interpretation:

In any event, we do not read into (c)(2) an objective component requiring that payment be made in accordance with general industry or trade customs or practices. To read it otherwise requires that creditors conform, at least when the debtor appears in financial trouble, to a vague community standard that cannot readily (if ever) be determined in advance. Yet, that is the worst time to change the comfortable and, perhaps, more flexible pattern the parties have established for them-

5. *Medcare HMO*, 998 F.2d at 442.

6. See Colette B. Resnik, *Maxicare As a Guide For Health Maintenance Organizations (HMOs) In Bankruptcy*, 8 BANKR. DEV. J. 271, 287-89 (1991).

7. *Medcare*, 998 F.2d at 447.

8. 11 U.S.C. § 547(c)(2) (1988).

9. *WJM, Inc. v. Massachusetts Dep't of Pub. Welfare*, 840 F.2d 996 (1st Cir. 1988).

10. *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494 (8th Cir. 1991) (subjective standard); *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989) (objective standard).

selves. Even if the community standard is not, in fact, more rigid, making any change requires the creditor accurately to define and properly to comply with an ambiguous and distant standard. The odds are against the creditor whose natural reaction may well be to abandon the debtor when the debtor most needs continuing credit.¹¹

Prior to *Matter of Tolona Pizza Products Corp.*¹² the proper interpretation of element (C) was an open question in the Seventh Circuit. *Tolona* decided that this term requires consideration of industry practice.¹³ However, it defines that practice so broadly that the parties probably have as much freedom under this objective standard as they would have under a completely subjective standard. The court stated:

We conclude that "ordinary business terms" refers to the *range* of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C. . . . There is no single set of terms on which the members of the industry have coalesced; instead there is a broad range and the district judge plausibly situated the dealings between Rose and Tolona within it.¹⁴

III. CLAIMS

Rule 15 of the Federal Rules of Civil Procedure is made applicable in bankruptcy proceedings by Bankruptcy Rule of Procedure 7015.¹⁵ The rule permits amendment of pleadings and other documents, including proofs of claim. Either leave of court or consent of the adverse party is required and the rule instructs that "leave shall be freely given when justice so requires."¹⁶ The Seventh Circuit has been struggling since 1991, without much success, to provide a coherent explanation of the circumstances in which amendment should be permitted.

In re Unroe,¹⁷ criticized in the *Indiana Law Review* in 1992,¹⁸ allowed a tardy amendment by the Internal Revenue Service, even though the Service provided no justification for its late claim. A few months later, *In re Stavriotis*¹⁹

11. 1 DAVID G. EPSTEIN ET AL., BANKRUPTCY 619 (1992).

12. 3 F.3d 1029 (7th Cir. 1993).

13. *Id.* at 1033.

14. *Id.*

15. Fed. R. Bankr. P. 7015.

16. Fed. R. Civ. P. 15.

17. 937 F.2d 346 (7th Cir. 1991).

18. Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1991*, 25 IND. L. REV. 981, 985-86 (1992).

19. 977 F.2d 1202 (7th Cir. 1992).

refused to allow amendment of an IRS claim. *Unroe* was cited in *Stavriotis* but not discussed at any length.²⁰ These opposite results can be reconciled on the ground that, in each instance, the Court of Appeals decided to defer to the decision of the bankruptcy judge.

However, this rationale cannot explain the result in two recent decisions. *Holstein v. Brill*²¹ rejected a post confirmation amendment of a proof of claim, notwithstanding the Seventh Circuit's recognition that the action of the trial court was a decision to which "appellate review is deferential."²² Both *Unroe* and *Stavriotis* are cited as examples of "the exercise of reasoned discretion."²³ Most recently, *In re Stoecker*²⁴ indicated disagreement with a bankruptcy judge's rejection of a proof of claim without leave to amend. *Unroe* was cited without discussion, *Holstein* was ignored, and *Stavriotis* was distinguished as being "not to the contrary."²⁵

Even with four decisions in less than three years, the Seventh Circuit still does not have a well defined position on the amendment of proofs of claim. More appeals can be expected until the court articulates a clear position on this issue.

IV. DISCHARGE

For much of the twentieth century, conduct alone determined whether a debtor would receive rehabilitative relief. Discharges were granted, denied, or revoked solely because of what the debtor did, or did not do, before and during bankruptcy. So also, the debtor's conduct determined whether a specific obligation could be discharged. The debtor's ability to pay was ignored.²⁶ All this began to change in 1976, when Congress provided that educational loans would be nondischargeable for a limited period of time unless repayment would constitute an "undue hardship."²⁷ For the first time, the debtor's prospective ability to satisfy obligations was to be considered in determining whether discharge of debt was appropriate. Since 1976, prospective ability to satisfy present obligations has been incorporated in two other code provisions; the substantial abuse dismissal rule of 11 U.S.C. § 707(b), and the disposable income confirmation requirement found in 11 U.S.C. § 1325(b). It is quite possible that our bankruptcy law in the twenty-first century will move away from conduct-

20. *Unroe* is cited without comment at 977 F.2d at 1204, and then briefly discussed at 977 F.2d at 1206 n.4.

21. 987 F.2d 1268 (7th Cir. 1993).

22. *Id.* at 1270.

23. *Id.*

24. 5 F.3d 1022 (7th Cir. 1993).

25. 5 F.3d at 1028.

26. See Douglass G. Boshkoff, *Limited Conditional And Suspended Discharges In Anglo-American Bankruptcy Proceedings*, 131 U. PA. L. REV. 69, 73 (1982).

27. 3 COLLIER ON BANKRUPTCY ¶ 523.18 (15th ed. 1993).

based discharge rules and place greater reliance on prospective ability to pay. Student loan dischargeability litigation, therefore, is particularly interesting for the insights it offers concerning the content of discharge rules which rely, at least in part, upon ability to pay concepts.

The message for future debtors is daunting. Courts have not favored student borrowers. “‘Undue hardship’ has proved to be a very small hole through which only the most pitiful of bankrupt students have been able to escape from the general rule of nondischargeability.”²⁸

*In re Roberson*²⁹ announced the Seventh Circuit view of what constitutes the “undue hardship” required by 11 U.S.C. § 523(a)(8) for the immediate discharge of an educational debt. In *Roberson*, the court decided to follow the Second Circuit and require a tripartite showing that: (1) there is a present inability to maintain a minimal standard of living, (2) this situation is likely to persist for a significant time and (3) the debtor has made a good faith effort to repay the loans.³⁰ While Mr. Roberson currently was unemployed and without a driver’s license, the bankruptcy court found, and the Seventh Circuit agreed, that this situation was not likely to continue indefinitely.³¹ Therefore, the educational loan was not presently dischargeable. Although discharge of the educational debt was denied, the bankruptcy court’s order did provide the debtor some relief. The temporary loss of earning power was handled through a two year moratorium on collection activity, coupled with the right to renewed consideration of the undue hardship issue if the debtor’s financial condition failed to improve.³²

Roberson suggests that it will be very difficult to establish “undue hardship” in the Seventh Circuit. Something akin to abject and permanent misery more probably approximates the applicable standard for relief through immediate discharge of educational obligations.

V. EXEMPTIONS

Bankruptcy Rule 4003(b) establishes a time limit for objections to exemptions by either the trustee or any creditor. In *Taylor v. Freeland & Kronz*,³³ the Supreme Court recently decided that this time limit must be observed even when there is absolutely no legal basis for the exemption claim. The holding in *Taylor* emphasizes a literal approach to the language of the rule and is consistent with the Court’s general approach to the interpretation of the bankruptcy statute.

28. 2 DAVID G. EPSTEIN ET AL., BANKRUPTCY 394 (1992).

29. 999 F.2d 1132 (7th Cir. 1993).

30. *Id.* at 1135.

31. *Id.* at 1137.

32. *Id.* at 1134.

33. 112 S. Ct. 1644 (1992).

*In re Kazi*³⁴ demonstrated that the Seventh Circuit is prepared to follow the Supreme Court's lead and strictly apply the requirements of Bankruptcy Rule 4003(b). In *Kazi*, the trustee failed to file a written objection within the prescribed time. However, the debtor had received timely actual notice of the trustee's objection. Adhering faithfully to the principle articulated in *Taylor*, the court held that the actual notice of the objection was irrelevant.³⁵

If the time limit of Rule 4003(b) is to be interpreted literally, it follows that the requirement of written objections should also be interpreted literally. It would be inconsistent with *Taylor's* emphasis on finality to allow objecting parties to raise the issue of the debtors' actual notice of opposition to claimed exemptions after the 30-day period has run.³⁶

*In re Bianucci*³⁷ reached a result less favorable to debtors. The court affirmed the bankruptcy judge's refusal to reopen a case for the purpose of lien avoidance pursuant to 11 U.S.C. § 522(f) and Bankruptcy Rule 4003(d).³⁸ It should be noted that subdivision (d) does not establish a time period for lien avoidance. Nonetheless, the lower court thought that the motion to reopen was untimely.

Two aspects of *Bianucci* are noteworthy. First, the court and counsel apparently assumed that reopening was a prerequisite to avoidance, although there is case authority³⁹ and scholarly opinion supporting avoidance without reopening.⁴⁰ The better practice is to permit the use of § 522(f) at any time, even if the case has been closed. Section 522(f) establishes a legal right which can be enforced by federal courts in the same fashion as any other federally created right. Since individual debtors often have difficulty paying legal fees, courts should attempt to develop legal rules which protect individual debtors at the least possible cost. Reopening an estate for the purpose of lien avoidance is an unnecessary formality.

The timeliness of lien avoidance was also an issue in *Bianucci*. The debtor waited five months before taking any action to avoid the lien. During this period, the lien creditor incurred some litigation expenses. Affirming the bankruptcy judge's refusal to allow lien avoidance, the court took a dim view of the debtor's inaction.⁴¹ Waiting, however, may be the wisest and least expensive course of action for a debtor. The Bianuccis had hoped that the lien

34. 985 F.2d 318 (7th Cir. 1993).

35. *Id.* at 320-22.

36. *Id.* at 322.

37. 4 F.3d 526 (7th Cir. 1993).

38. *Id.* at 529.

39. *E.g.*, *In re Keller*, 24 B.R. 720 (Bankr. N.D. Ohio 1982); *In re Schneider*, 18 B.R. 274 (Bankr. N.D. 1982).

40. *E.g.*, 8 COLLIER ON BANKRUPTCY ¶ 4003.06 (15th ed. 1993); HENRY J. SOMMER & GARY KLEIN, CONSUMER BANKRUPTCY LAW AND PRACTICE § 10.4.2.2 (4th ed. 1992).

41. *In re Bianucci*, 4 F.3d at 529.

would become unenforceable with the passage of time.⁴² It is not at all clear why inaction thus justified should be equated with bad faith.

VI. CHAPTER 13

Circuits differ in their views on the preclusive effect of a Chapter 13 plan.⁴³ *In re Pence*,⁴⁴ decided three years ago, suggested that the Seventh Circuit would be reluctant to allow collateral challenges to the treatment of secured claims in a confirmed plan. *In re Chappell*⁴⁵ reaffirms the court's commitment to principles of finality.

In *Chappell*, the debtor proposed a plan providing for 100% payment of a second mortgage. Both the plan and the mortgagee's proof of claim valued the claim at \$20,661.20. This amount represented principal alone. After the Chapter 13 case had been closed, the mortgagee attempted to collect interest through a foreclosure action in state court. The bankruptcy case was then reopened for a determination of the second mortgagee's rights. The bankruptcy court decided that the entitlement to interest was lost when the creditor, aware of the problem, neglected to press the issue during the Chapter 13 proceeding.⁴⁶ Quoting with approval from its decision in *Pence*, the Seventh Circuit affirmed the ruling below, and reiterated the view that, absent fraudulent circumstances, tardy challenges to a confirmed chapter 13 plan are not likely to succeed.⁴⁷

42. *Id.* at 529 n.3.

43. See KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 6.9 (1992).

44. 905 F.2d 1107 (7th Cir. 1990). See Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1989-1990*, 24 IND. L. REV. 551, 567 (1991) for a discussion of this case.

45. 984 F.2d 775 (7th Cir. 1993).

46. *Id.* at 778-79.

47. *Id.* at 783.

