

BANKRUPTCY IN THE SEVENTH CIRCUIT: 1996

DOUGLASS G. BSHKOFF*

INTRODUCTION

At least with regard to decisions involving bankruptcy issues, 1996¹ was a very uneventful year in the Seventh Circuit. Most opinions dealt with routine matters.² Therefore, this short survey discusses only five decisions.

I. THE AUTOMATIC STAY

The case, *In re Carousel International Corp.*,³ involved the unsuccessful attempt of a nondebtor to invoke the protection of the automatic stay. The asset involved was \$250,000 held by an escrow agent pending resolution of a controversy between Carousel (the debtor) and Carousel's shareholders. Creditors of the shareholders (not creditors of the debtor) obtained liens against the escrowed funds prior to the resolution of the controversy. Other creditors of the shareholders argued that these liens were void because they were obtained prior to the resolution of the debtor's claim to the escrowed funds, during a period when the automatic stay was in effect. The court rejected this argument. It reasoned that funds not belonging to the debtor were not part of the estate and thus not protected by the automatic stay.⁴

This is the correct result. However, there are other, and sounder, lines of reasoning which lead to the same result. The court could have decided that nondebtor co-owners of the escrowed funds had no standing to assert a violation of the automatic stay.⁵ Such a rationale would have eliminated the need to conclude that the stay does not protect nonownership claims to property, an arguably incorrect conclusion in certain circumstances.⁶ Because the dispute involved only nondebtors, the court could also have decided that the bankruptcy court had no jurisdiction to adjudicate this controversy. Such a holding would have been consistent with the Seventh Circuit's narrow view of the bankruptcy court's "related to" jurisdiction.⁷

* Robert H. McKinney Emeritus Professor of Law, Indiana University—Bloomington.

1. This survey covers cases decided between November 1, 1995, and October 31, 1996.

2. *In re Wabash Valley Power Ass'n, Inc.*, 72 F.3d 1305 (7th Cir. 1995), *cert. denied*, 117 S. Ct. 389 (1996), involves cram-down of a plan for a not-for-profit entity, hardly a routine matter. In fact, it is so unusual that it is of more academic than practical interest.

3. 89 F.3d 359 (7th Cir. 1996).

4. *Id.* at 362.

5. *See Winters v. George Mason Bank*, 94 F.3d 130, 135 (4th Cir. 1996).

6. 11 U.S.C. § 362(a)(3) (1994) prohibits "any act to obtain possession property of the estate or of property from the estate . . ." (emphasis added). This language covers situations in which the debtor has only a possessory interest in an asset. *See* 3 COLLIER ON BANKRUPTCY ¶ 362.03[5] at 362-19 (Lawrence P. King et al. eds., 15th ed. rev. 1997).

7. *See In re Fedpak Sys., Inc.*, 80 F.3d 207, 213-215 (7th Cir. 1996).

II. POWERS OF AVOIDANCE

Section 547(c)⁸ protects certain preferential transfers from avoidance. Section 547(c)(2) is one of the most important protection provisions. It prevents avoidance when the alleged preferential transfer both is subjectively and objectively "ordinary." The past practices of both the parties (the subjective element) and the industry (the objective element) must be considered when making this determination. In the case, *In re Tolona Pizza*,⁹ decided by the Seventh Circuit several years ago, the court accepted a moderately relaxed standard of proof for establishing the industry practice. The party defending the transaction does not need to establish the precise contours of industry norms. Rather, it must only show that a challenged payment was "within the outer limits of normal industry practices."¹⁰

*In re Midway Airlines, Inc.*¹¹ demonstrates that *Tolona Pizza* did not eliminate the need to present evidence of objective industry practice. In *Midway* the creditor-transferee offered evidence of its relationship with Midway and other members of the industry to establish the objective, industry-wide standard of practice. The court decided that this was not sufficient. Even though the exact parameters of the industry practice need not be established, the transferee must provide "proof beyond solely what is normal between the debtor and the creditor."¹²

III. DISCHARGE POLICY

When first adopted, the current bankruptcy code made it very difficult for debtors to enter into enforceable reaffirmation agreements. Court approval was always required, and the standards for approval were very demanding. The situation changed in 1984 when statutory control over the reaffirmation process was relaxed.¹³ There is some evidence that the loosening of control occurred, in part at least, because Congress believed that § 362(a)(6)¹⁴ prohibits any creditor initiated discussions of reaffirmation.

The committee believes that the automatic stay provided under section 362 of the Bankruptcy Reform Act of 1978 has drastically reduced, if not eliminated, the abusive practices encountered under the pre-1978 bankruptcy law. Creditors can no longer independently contact debtors to encourage them to reaffirm debts because such contact is

8. 11 U.S.C. § 547(c) (1994).

9. 3 F.3d 1029 (7th Cir. 1993). See Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1993*, 27 IND. L. REV. 761, 762-63 (1994).

10. *Tolona Pizza*, 3 F.3d at 1033.

11. 69 F.3d 792 (7th Cir. 1995).

12. *Id.* at 798

13. See ELIZABETH WARREN & JAY WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 323-24 (3d ed. 1996).

14. 11 U.S.C. § 362(a)(6) (1994).

prohibited by the code.

The proposals before the committee to remedy defects in the reaffirmation process would not alter the prohibitions on contact with the debtor. Therefore, the major protection provided under the code to prevent coercive reaffirmation remains intact. Reaffirmations obtained presently that are subsequently denied by a bankruptcy court are, in fact, truly voluntary reaffirmations.¹⁵

Nonetheless, the Seventh Circuit in the case, *In re Duke*¹⁶ recently endorsed the view that a creditor's noncoercive request for a reaffirmation does not violate § 362(a)(6).¹⁷ According to Judge Wood, "[t]here is no reason to believe that reaffirmation agreements inevitably disadvantage debtors, and thus that the automatic stay should be used to protect debtors against this type of creditor effort to collect a pre-petition debt."¹⁸

Not all would agree that reaffirmation requests are so benign.¹⁹ Nevertheless, we are in a period when creditor interests are more highly valued than debtor concerns. A retrenchment in many respects of debtor bankruptcy protection began shortly after the new code became effective and continues today. The *Duke* decision, although not admirable, is consistent with the spirit of the times.²⁰ To preserve a modicum of debtor protection, the validation of creditor-initiated reaffirmations should be limited to situations like the one in *Duke* where (1) the debtor is represented by counsel and (2) counsel is informed of the reaffirmation request. Communications directed only to the debtor²¹ or involving pressure tactics²² should still be found to violate § 362(a)(6).

IV. PROCEDURE

The legislation which introduced changes in reaffirmation practice also created a new structure and operating procedure for the post-*Marathon* court system.²³ Section 157(a)²⁴ permits the district court to refer bankruptcy litigation to bankruptcy judges. Section 157(d) then requires withdrawal of proceedings from

15. S. Rep. No. 98-65, at 10, 11 (1983).

16. 79 F.3d 43 (7th Cir. 1996).

17. *Brown v. Pennsylvania State Employees Credit Union*, 851 F.2d 81, 85 (3d Cir. 1988).

18. *Duke*, 79 F.3d at 45.

19. See Douglass G. Boshkoff, *Fresh Start, False Start, or Head Start?*, 70 IND. L.J. 549, 557-59 (1995); HENRY SOMMER & GARY KLEIN, CONSUMER BANKRUPTCY LAW AND PRACTICE § 8.8.1, at 149-50 (5th ed. 1996).

20. See Douglass G. Boshkoff, *Debtor Protection at the Close of the Twentieth Century*, 23 CAP. U. L. REV. 379, 393 (1994).

21. See *In re Flynn*, 143 B.R. 798, 802-03 (Bankr. D.R.I. 1992).

22. *In re Walker*, 194 B.R. 165, 169 (Bankr. E.D. Tenn. 1996).

23. *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, 458 U.S. 50 (1982) had decided that the then existing bankruptcy court system was unconstitutional.

24. 11 U.S.C. § 157(a) (1994).

the bankruptcy judge when resolution of the dispute “requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.”²⁵ The rationale for this rule “can only be the subject of conjecture.”²⁶

Sensing the possibility that withdrawal motions may be employed to stall litigation, courts have narrowly construed § 157(d). *In re Vicars Insurance Agency, Inc.*,²⁷ the first opinion on withdrawal standards in this circuit, holds that “mandatory withdrawal is required only [w]hen [the] . . . issues require interpretation, as opposed to mere application, of the non-title 11 statute, or when the court must undertake analysis of significant open and unresolved issues regarding the non-title 11 law.”²⁸

In *Vicars*, the non-title 11 law was RICO. Even though the court of appeals had not yet spoken on the issue presented, the court felt that there was enough guidance available in district court opinions. Therefore, withdrawal was not required.

V. CROSS-BORDER INSOLVENCY

Must cross-border insolvency disputes arise in the Southern District of New York. That fact alone should create interest in such litigation when it occurs in the Northern District of Indiana. Although *In re Rimsat, Ltd.*²⁹ will probably not receive much critical attention because it presents fairly mundane issues, readers of this survey will surely be interested in Judge Posner’s description of the debtor.

Rimsat had been formed in 1992 to provide satellite communications (using Russian equipment) to Tonga and other islands in the South Pacific. Most of its investors are Malaysian. It was incorporated in the Federation of St. Christopher and Nevis (also known as the Federation of Saint Kitts and Nevis), a Caribbean nation that belongs to the British Commonwealth. . . . Its principal place of business is in Fort Wayne, Indiana. Most of its financial assets are there, but its nonfinancial assets, principally leaseholds in satellites, have no terrestrial site.³⁰

Would a law professor dare to put such an implausible fact situation on a final exam?

25. 28 U.S.C. § 157(d) (1994).

26. 1 COLLIER, *supra* note 6, ¶ 3.01[e][iii], at 3-69.

27. 96 F.3d 949 (7th Cir. 1996).

28. *Id.* at 954.

29. 98 F.3d 956 (7th Cir. 1996).

30. *Id.* at 957.