STATE BAR OF TEXAS

# BANKRUPTCY LAW SECTION

NEWSLETTER

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## A MESSAGE FROM YOUR CHAIR:

## OUT AMONGST 'EM

***By: Byrnie Bass, Section Chair***

Serving as Chair of the Bankruptcy Section of the State Bar in one respect may be as hard as trying to clean up the Gulf. Last year's Chair, H. Christopher (Soon-to be Bankruptcy Judge in the Western District of Texas) Mott, left some pretty big shoes to fill. And he didn't have it so easy following the likes of Berry Spears, Debbie Langehennig, Deborah Williamson, Charlie Beckham, and the founding Chair, my friend and long time colleague out here in Lubbock, Robert Wilson. Riding a combination of strong leadership, good planning, great participation, and good luck, the Section has grown to over 1,150 members, has money in the bank, and is heavy into doing what I think it ought to be doing, that being promoting the quality practice of bankruptcy law, collegiality among its practitioners, giving back to the public through pro bono service, and generally improving the public's perception of the bankruptcy lawyer.

My grandfather on my mom's side farmed up in Swisher County near Tulia. For those of you who don't know, that would be about 15 miles north of Kress and 18 miles south of Happy (70 miles north of Lubbock on the way to Amarillo might help you peg it better). "Pappee", as we called him, had a 6th grade education. His oldest daughter moved to Lubbock when she graduated from high school. She met and married a lawyer who had hitchhiked there from Waco after he graduated from Baylor Law School. Practicing law was not Pappee's idea of putting in an honest day's work for an honest day's pay, and he, at first, didn't want his daughter to marry no lawyer. But he finally came around to the idea that this lawyer fella (my father) that his oldest daughter married might be alright. And he was.

Familiarity does not always breed contempt, and the more the public becomes familiar with the kind and quality of folk that practice bankruptcy law in this state, I'm bettin' that they too will come around to the notion that, well, those folks are alright. Watch this year, and stay tuned through this great newsletter that Tim Million out of Houston puts out for how you, individually, and we, as a Section, can and will make ourselves more "familiar" to the folks out there. Out amongst 'em. I look forward to seeing you at a conference or two.

P.S. I attended the Western District's Bench Bar Conference in San Antonio the last week of June. Now that, folks, was quite an event. I'll talk a lot more about that later (unless someone, or several someones, and you know who you are, buy my silence).

## SUPREME COURT PREVIEW: THE SUPREME COURT TO DETERMINE WHETHER "OWNERSHIP COST" DEDUCTION APPLIES WHEN DEBTOR IS NOT MAKING PAYMENTS ON HIS VEHICLE: *RANSOM V. MBNA*

By: Kimberly St. Clair, Judicial Intern to the Hon. Barbara M.G. Lynn and the Hon. Harlin D. Hale, third-year student at the University of Chicago Law School (kstclair@uchicago.edu)

The Supreme Court recently granted *certiorari* in *Ransom v. MBNA* and will decide whether, in calculating projected disposable income for a chapter 13 debtor, the debtor may deduct the "ownership cost" of a vehicle that the debtor owns free and clear. *Ransom v. MBNA*, 130 S. Ct. 2097 (2010).

### The Statute at Issue

Section 707(b)(2)(A)(ii)(I) of title 11 of the United States Code provides that "[t]he debtors monthly expenses shall be the debtor's applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides." For persons who use cars rather than public transportation, the National and Local Standards include two types of transportation expenses--operating costs and ownership costs. Local Standards: Transportation, http://www.irs.gov/businesses/small/article/0,,id=104623,00.html. The Standards are provided in a grid format that informs the reader of the allowable expenses for the number of cars the debtor owns and the area in which he resides. *Id.* For example, a debtor in Dallas with one car would be allowed a $496 owner-

*(Continued on page 14)*

# REPORT FROM THE ANNUAL MEETING OF THE BANKRUPTCY LAW SECTION OF THE STATE BAR OF TEXAS

The Annual Meeting of the Bankruptcy Law Section was held on Thursday, June 3rd during the Advanced Business/Consumer Bankruptcy Conferences in Dallas, Texas. Congratulations to the following attorneys who received awards and accolades at the annual meeting: Ret. Judge Larry D. Kelly – recipient of the Banco Rotto Award; Elizabeth Guffy – recipient of the Robert B. Wilson Distinguished Service Award; Timothy A. Million – recipient of the Outstanding Service Award; Mary Daffin – recipient of the John C. Akard Community Service Award; Omar Alaniz – recipient of the Romina L. Mulloy-Bossio Achievement Award (outstanding young attorney).

An In Memoriam award was presented to Tim Mountz of Baker Botts in tribute to the late Romina Mulloy-Bossio. The family of Romina Mulloy-Bossio attended the awards presentation, and Ms. Beatriz D. Bossio accepted a posthumous award for her daughter.

Mary Daffin, Johnnie Patterson and Berry Spears were given gifts as outgoing Executive Council members.

Bankruptcy Law Section members Gillett Sheppard, John C. Akard, Neal R. Allen, Hallie W. Gill, Robert Hohenberger, Jarrel D. McDaniel, and Myron "Mickey" Sheinfeld were given awards in honor of their 50+ years of service in the legal profession.

Byrnie Bass was presented with the Incoming Chair Award, and H. Christopher Mott was presented with the Outgoing Chair Award.

Congratulations to all!

Omar Alaniz and Tim Million

Byrnie Bass

Chris Mott and Judge Larry Kelly

Chris Mott, Byrnie Bass, and Mary Daffin

Chris Mott and Elizabeth Guffy

Beatriz D. Bossio, Omar Alaniz, and Tim Mountz

Omar Alaniz and Romina Mulloy-Bossio's Mother

Brian Rogers

# SUPREME COURT CASE LAW UPDATE

## SUPREME COURT CONSIDERS SCHEDULE C EXEMPTION VALUATIONS IN *SCHWAB V. REILLY*

By: Jonathan L. Howell, associate at Munsch Hardt Kopf & Harr P.C. (jhowell@munsch.com)

### When Must an Interested Party Object to a Claimed Exemption that is Within Statutory Limits of the Exemption Statute to Preserve the Estate's Ability to Recover Excess Value in the Exempted Asset if the Exempted Asset is Later Determined to Have a Greater Value?

In *Schwab v. Reilly*, 130 S.Ct. 2652 (2010), the United States Supreme Court reconciled a split of authority among several federal Circuit Courts about what constitutes a claim of exemption to which an interested party must object under section 522(l) of the Bankruptcy Code. Specifically, the Court held that in instances where a debtor claims an exemption that is within the statutory limits of section 522(d) of the Bankruptcy Code, "an interested party need not object to an exemption claimed in this manner in order to preserve the estate's ability to recover value in the asset beyond the dollar value the debtor expressly declared exempt."

Following the failure of her catering business, Nadeja Reilly (Reilly) filed for relief under chapter 7 of the Bankruptcy Code. In completing her bankruptcy schedules, Reilly claimed exempt on her Schedule C cooking equipment, which according to her Schedule B had an estimated value of $10,718. In doing so, Reilly claimed $1,850 of the equipment as falling under section 522(d)(6) and $8,868 of the equipment as exempt under section 522(d)(5).

William G. Schwab (Schwab), the chapter 7 trustee of Reilly's bankruptcy estate, did not object to Reilly's exemptions within thirty-day period window provided by Rule 4003(b) of the Federal Rules of Bankruptcy Procedure because the dollar value Reilly assigned to the cooking equipment fell within the limits of sections 522(d)(5) and (6). However, the cooking equipment was later appraised to have a total market value of $17,200, after which Schwab moved the bankruptcy court for permission to auction off the equipment so that the bankruptcy estate could benefit from any excess proceeds received above and beyond Reilly's $10,718 exemption in the equipment. Reilly opposed Schwab's motion, arguing that by listing the cooking equipment as exempt on her Schedule C she placed Schwab on notice, and that by his failure to object to the claimed exemption within the time period prescribed by Rule 4003(b), Schwab had forfeited his right to claim any excess value in the cooking equipment. Ultimately, the bankruptcy court denied Schwab's motion. Schwab sought relief from the district court, arguing that neither the Bankruptcy Code nor Rule 4003(b) requires a trustee to object to a claimed exemption where the amount of the exemption is an amount within the limits the Bankruptcy Code allows. The district court, however, rejected Schwab's argument, and the Third Circuit affirmed, relying in part on the Supreme Court's ruling in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992).

Granting Schwab's *writ* of *certiorari*, the Supreme Court reversed the Third Circuit's judgment, holding that "the Court of Appeals' approach fails to account for the text of the relevant Code provisions and misinterprets our decision in *Taylor*." Turning to first to the plain language of section 522(l) of the Bankruptcy Code, the Supreme Court dismissed Reilly's argument that the provision stating that the "property claimed as exempt on [Schedule C] is exempt" is the controlling language. Rather, the Supreme Court concluded that "it is the portion of § 522(l) that defines the target of the objection, namely, the portion that says Schwab has a duty to object to the 'list of property that the debtor claims as exempt *under subsection (b)*.'" Following the Supreme Court's reasoning, the Court provided that section 522(b) does not define "the property that the debtor claims as exempt," but simply refers to section 522 (d) which in turn lists categories of property that the debtor may claim as exempt and defines the property a debtor may claim as exempt as an "interest" up to a specified dollar amount in assets, and does not define the property as the assets themselves. Applying this statutory construction to the facts, the Supreme Court determined that Schwab had no duty to object to the property Reilly claimed as exempt "because the stated value of each interest, and thus of the 'property claimed as exempt,' was within the limits the Code allows."

Looking next to the Third Circuit's improper reliance on the Court's decision in *Taylor*, the Supreme Court distinguished *Taylor* from the present case. In particular, the court noted that the issue in *Taylor* was whether a trustee was obligated to object to a claimed exemption that was *not* within the statutory limits of the Bankruptcy Code. The Supreme Court in *Taylor* held that under such circumstances and where the trustee failed to object the improper exemptions within the 30-day window provided by Rule 4003(b), the trustee waived his or her right to object and, thus, the estate could not benefit from any excess value above the statutory limit. Unlike the trustee in *Taylor*, Schwab was not obligated to object to Reilly's exemptions because Reilly's stated exemptions were within statutory limits of section 522(d). Accordingly, Schwab had no duty to object pursuant to Rule 4003(b) and thus, the deadline enforced in *Taylor* is inapplicable.

# Review of the Fifth Circuit Bench Bar Conference

By: Frances A. Smith, Of Counsel at Shackelford Melton & McKinley, LLP
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Over 150 attorneys gathered at the Center for American and International Law on April 1 and 2, 2010 for the first 5th Circuit Bench-Bar Bankruptcy Conference. Attorneys from Texas, Louisiana, and Mississippi were invited to attend. Among the speakers at the conference were The Hon. Patrick Higginbotham of the Fifth Circuit Court of Appeals and Bankruptcy Judges Douglas D. Dodd, Harlin D. Hale, Barbara J. Houser, David W. Houston, Marvin Isgur, Robert L. Jones, Ronald B. King, Brenda Rhoades, Barry Russell, Richard Schmidt, and Robert Summerhays.

The Bench-Bar Conference offered a two-day, hands-on program featuring large group sessions and separate break-out sessions on two tracks. One track focused on chapter 11 business bankruptcy issues and the other on chapter 7 and 13 consumer bankruptcy issues.

After a networking continental breakfast and welcoming remarks by Mark Smith, Vice President of the International Law Center, the participants began attending their chosen break-out sessions.

The business module discussions were based on a fact scenario written by Eric Terry, a partner in the bankruptcy section at Haynes and Boone, LLP and Martin Sosland, a business finance and restructuring partner in the Dallas office of Weil Gotshal & Manges LPP. The scenario described a fictional family-owned company, Zydeco-Tejano Family Farms, Inc. and the issues it encountered as it sought to develop golf resorts through the entity Coastal Links, LLC. Using the scenario, the Business Modules covered key bankruptcy topics and offered local insight into each topic.

Module A discussed pre-bankruptcy planning and workout issues including conflicts of interest, how the tax ramifications of filing bankruptcy may vary depending on the business formation, the WARN Act, how to analyze the potential debtor's cash position and the necessity of considering the debtor's exit strategy at the beginning of the case. The panelists suggested conducting a "reality check" early in the case and to determine if the debtor company could be self-sustaining.

Module B covered first day motions, section 362 lift stay motions, section 363 sale motions and related issues. The group discussed uniform complex chapter 11 rules promulgated in response to the Enron bankruptcy and interim fee procedures that allow an 80% draw for attorneys' fees. Panelists noted that critical vendor motions are disfavored in both Louisiana and Mississippi since the enactment of BAPCPA. In addition, debtors in Louisiana may not stipulate to the validity of a secured creditor's liens.

Module C examined plan confirmation, exit financing, and structuring issues, including recent cases on preservation of causes of actions and releases. Module D analyzed bankruptcy-related litigation issues including lender liability, avoidance actions, and claims fights including recharacterization, subordination, Ponzi schemes, safe harbors, and receivers.

The Consumer Module examined both chapter 7 and chapter 13 bankruptcies. Module A analyzed recent developments in mortgages and predatory lending. Module B discussed discharge and dischargeability issues. Module C dealt with exempt property. Module D provided litigation tips and focused on offering and excluding evidence in adversary and confirmation hearings. Consumer lecturers, discussion leaders, and facilitators included Byrnie Bass of the Law Office of R. Byrn Bass, Jr., Areya Holder of the Law Office of Areya Holder, P.C., Debbie B. Langehennig, Chapter 13 Trustee, and Behrooz P. Vida of The Vida Law Firm.

In between the Business and Consumer Modular sessions, the whole group gathered in the large auditorium for entertaining and thought-provoking presentations full of practice tips. For example, a Judge's Roundtable featuring Judges Houston, Jones, Isgur, Summerhays, Rhoades, King, Dodd, Schmidt, and Hale focused on two questions. First, the panel addressed, "What have you learned since becoming a bankruptcy judge?" Judge Houston quipped that he has learned to live on a lot less money. He then, with tongue in cheek, explained that there is a Bankruptcy Code and it is a good place to start on most issues. Judge Isgur chimed in that there are also Bankruptcy Rules. He also reminded the crowd that the judges may have thousands of cases on their dockets and that it was impossible for the judges to read every pleading in every case. Therefore, attorneys need to tell the judges about their cases. Judge Jones echoed that sentiment requesting that attorneys "help us out" by explaining what is going on in the case.

Judge Summerhays noted that some lawyers think filing more is better, while he is of the opinion that filing less actually focuses the argument and makes for better briefing. Judge Rhoades continued the theme and advised that if, for example, the parties had no issue with the applicable standard, they need not spend a lot of time and pages discussing it. She also discussed local rules and noted that because there may be hundreds of ways to do something right, local rules may vary. A local rule may be particularly important to that local bench.

Second, the panel answered, "What has happened in your court that has bothered you the most?" Although some judges had no complaints, others were very specific. One of the most troubling issues to the judges was the failure of attorneys to communicate with the court and with each other. Attorneys were asked to let the judges know when a matter has settled so that the judge did not spend time preparing for a contested hearing only to be told at the last minute that there was a settlement. Conversely, the judges asked that attorneys let the courtroom deputy know if a matter is contested and therefore may take more time on the docket than previously requested or scheduled so that the court can be prepared.

Additional conduct that concerned the judges included:

Bullying -- especially of pro se parties;

Filing briefs at the last minute or late at night;

Lack of civility in the courtroom;

Addressing remarks to opposing counsel rather than the court;

Failing to give the judge enough information to make a decision;

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# ELLIOT CUP TEAMS DOMINATE AT NATIONAL DUBERSTEIN BANKRUPTCY MOOT COURT

BY: DEBBIE LANGEHENNIG, CHAPTER 13 TRUSTEE AUSTIN AND PAST SECTION CHAIR (trustee@ch13austin.com)

## ELLIOTT CUP TEAMS DOMINATE NATIONAL BANKRUPTCY MOOT COURT COMPETITION – AGAIN !!

The Bankruptcy Law Section sponsored again this year its Elliott Cup Competition, a warm-up competition developed to prepare Texas law students for the National Duberstein Bankruptcy Moot Court competition. The Elliott Cup is named in memory of Judge Joe Elliott, U.S. Bankruptcy Judge for the Western District of Texas. This competition rotates among cities within the Fifth Circuit and has been expanded to include law students from schools within the Fifth Circuit. This year's competition, held in New Orleans, Louisiana, was held on Friday, February 19 at the U.S. District Court in New Orleans and on Saturday, February 20 at the Fifth Circuit Court of Appeals. The Cup was shared by Kelli Benham and Rex Mann of the University of Texas Law School and Lee Hill and Sarah Beth Wilson of Mississippi College of Law. Kelli Benham, UT Law, received the Best Speaker award.

The law students who compete in the Elliott Cup consider it excellent preparation for the national competition, held each March in New York City, and the results of the national competition the past few years certainly support that belief. According to Mark Andrews of Dallas, who served as the chair for this year's Elliott Cup, "The caliber of the competition at the Elliott Cup is truly outstanding. Law students and their coaches work hard to prepare for this bankruptcy moot court competition and it shows in the quality of the presentations. The success of the competition in preparing law students for national competition is evident. What would surprise those of you who have not attended, is that the vast majority of the teams at the Elliott Cup are highly competitive with each other and the margins for decision are razor thin."

The 18th Conrad B. Duberstein National Competition was held in New York on March 13 - 15, with all of the Elliott Cup teams competing. The Duberstein competition is named for the late Judge Conrad B. Duberstein, a St. John's University alumnus and former American Bankruptcy Institute director, and has grown into one of the larger appellate moot court competitions in the nation, with nearly 50 teams competing. This year's case problem was derived from today's headlines involving Ponzi schemes, fraudulent transfers, and attorney-client privilege. The fact pattern raised two interesting issues: whether a sophisticated investor who becomes suspicious and withdraws funds from the investment is denied the protection provided to good-faith transferees, and whether a bankruptcy trustee can waive the attorney-client privilege of an individual debtor. The results of the competition are set out below. Eight Elliott Cup Teams advanced to octo-finals; five advanced to quarter-finals; three advanced to semi-finals and the two University of Texas teams faced off against each other in the final round of the national competition. David Shank and Patrick Schmidt won the Duberstein title this year. "The Duberstein is one of the most competitive moot court competitions with extremely challenging problems. This is the first time we've seen both teams from a school meet in the finals," commented Professor G. Ray Warner, Associate Dean for Bankruptcy Studies at St. John's University.

Several Elliott Cup participants received awards at Duberstein for writing and advocacy skills. The University of Texas team of Kelli Benham, Rex Mann and Mark Little won Best Brief. Nicole Hay of SMU Dedman School of Law won Best Advocate. The University of Houston Law Center picked up an Outstanding Brief award and Outstanding Advocates included Alexis Butler, Texas Tech University School of Law, Aubrey Colvard, Southern Methodist University School of Law and Jon P. Spiers, University of Houston Law Center.

More than two dozen bankruptcy judges from across the country served on the final rounds as judges. The Final round bench included Judges R. Guy Cole (6th Circuit), Steven Colloton (8th Circuit), Wallace Tashima (9th Circuit), Gerald Tjoflat (11th Circuit), Carla Craig (Chief Judge, EDNY) and Stuart Bernstein (SDNY).

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|---|---|
| First Place | The University of Texas School of Law – Patrick Schmidt and David Shank |
| Second Place | The University of Texas School of Law – Kelli Benham and Rex Mann |
| Third Place (semi-finalists): | Texas Tech University School of Law – Alexis Butler, Morgan Lewis, and Nathaniel Peevey |
| Third Place (semi-finalists): | University of Miami School of Law – Jake Greenberg, Joshua Marcus and Jessica Laleh |
| Quarter-Finalists: (Elliott Cup teams included in the top 8 teams) | Southern Methodist University Dedman School of Law<br>Texas Tech University School of Law<br>The University of Texas School of Law – Team 1<br>The University of Texas School of Law - Team 2<br>University of Houston Law Center |
| Octo-Finalists: (Elliott Cup teams included in the top 16) | Baylor Law School<br>Mississippi College School of Law – Team 2<br>Southern Methodist University Dedman School of Law<br>Texas Tech University School of Law<br>The University of Texas School of Law – Team 1<br>The University of Texas School of Law - Team 2<br>University of Houston Law Center – Team 1<br>University of Houston Law Center – Team 2 |
| Best Brief | The University of Texas School of Law – Kelli Benham, Rex Mann and Mark Little |
| Best Advocate | Nicole Hay, Southern Methodist University Dedman School of Law |
| Outstanding Briefs | University of Houston Law Center – Team 2 |
| Outstanding Advocates | Alexis Butler, Texas Tech University School of Law<br>Aubrey Colvard, Southern Methodist University<br>Jon P. Spiers, University of Houston Law Center |

(From left to right) Second Place Team: Kelli Benham and Rex Mann and First Place Team: Patrick Schmidt and David Shank

(From left to right) Coach Jay Ong, Kelli Benham , Rex Mann and Coach Debbie Langehennig

# FIFTH CIRCUIT CASE LAW UPDATE

## FIFTH CIRCUIT CONSIDERS TRUSTEE'S TAX LIABILTY: IN RE TEXAS PIG STANDS, INC.

By: Gordon Green, Judicial Extern to the Honorable Harlin D. Hale and second year-student at Pepperdine School of Law
(gordon.w.green@pepperdine.edu)

### BANKRUPTCY TRUSTEE'S PERSONAL LIABILITY FOR FAILURE TO REMIT SALES TAXES

In an important case for trustees, the Fifth Circuit Court of Appeals recently ruled in *In re Texas Pig Stands, Inc.* that a trustee may be held personally liable for deficiencies in sales taxes owed by the estate. *In re Texas Pig Stands, Inc.*, No. 09-50544, 2010 WL 2653282 (5th Cir. July 6, 2010).

#### The Adversary Proceeding

The Texas Comptroller of Public Accounts ("Comptroller") filed an adversary proceeding against Texas Pig Stands, Inc.'s trustee in bankruptcy court for a deficiency in sales taxes after he failed to remit post-confirmation sales taxes from Texas Pig Stands's estate. *In re Texas Pig Stands, Inc.*, 2010 WL 2653282 at *1. Texas Pig Stands, the debtor-in-possession, ran its San Antonio restaurants while the bankruptcy court ordered the trustee to remit sales taxes once they became due. *Id.* The trustee withheld due sales taxes to pay Texas Pig Stand's creditors at a faster rate, hoping to sell the restaurants as going concerns rather than through liquidation. *Id.* After a reorganization plan was completed (the "Plan"), a liquidation trust was created of which the trustee was made plan trustee. *Id.* at *2. The Plan included an Effective Date for all unpaid sales taxes up to that point. *Id.* The trustee managed to pay merely a small percentage of the total sales taxes due on the Effective Date. *Id.* As a result, the Comptroller issued notices of deficiency for greater than a hundred thousand dollars before filing the adversary proceeding. *Id.*

The United States Bankruptcy Court for the Western District of Texas held that the trustee was not liable for the deficiency. The bankruptcy court also held that the Plan's Trust Agreement limited the trustee's liability to gross negligence. *Id.* The District Court reversed the lower court's decision, finding not only that the trustee was liable under the Trust Agreement but that he displayed willful misconduct in his failure to remit the sales taxes. *Id.*

#### The Statutes at Issue

Texas Tax Code Section 111.016(b) holds that a controlling party who "willfully" fails to remit sales taxes held in trust will be held personally liable for any deficiency. This section of the state tax code was modeled after Section 6672 of the Internal Revenue Code, which is the source of the state code's interpretation for the term "willfully." 26 U.S.C. § 6672; *see State v. Crawford*, 262 S.W.3d 532 (Tex. App. --- Austin 2008, no pet.). Willful evasion of sales taxes is established merely "by evidence that the responsible person had knowledge that taxes were due . . . and yet paid other creditors." *Crawford*, 262 S.W.3d at 538 (citing *Barnett v. I.R.S.*, 988 F.2d 1449, 1457 (5th Cir. 1993)). All that need be shown is a volitional act on the part of the controlling party, irrespective of intent. *Barnett*, 988 F.2d at 1458.

Section 959(b) of title 28 of the United States Code mandates that a trustee "shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated . . . ." Moreover, section 959 (a) states that trustees can be sued for any "acts or transactions" conducted in regards to property in their possession. This provision confirms a trustee's personal responsibility to meet state tax requirements though not directly addressing the trustee's liability for failure to do so. Also, the U.S. Trustee's Chapter 11 Trustee Handbook, which refers to section 959, warns that a trustee may be held personally liable for taxes from the trust fund not remitted to the government. U.S. Dep't of Justice, Chapter 11 Trustee Handbook 52 (May 2004), http://www.justice.gov/ust/eo/private_trustee/library/chapter11/docs/Ch11Handbook-20040 5.pdf.

#### The Fifth Circuit's Ruling

On appeal, the trustee argued he did not violate state tax law despite his knowledge that the sales taxes were due. *In re Texas Pig Stands, Inc.*, WL 2653282 at *2. He alleged that bankruptcy law supersedes state tax law and permitted his 'deferral' of sales tax payments. *Id.* It was the trustee's alleged belief that the "duty" to 'maximize the estate's value' trumped the duty to timely remit sales taxes. *Id.* at *3. However, based on the predominant interpretation of the word "willful" in Texas Tax Code Section 111.016(b), the court held his knowledge of the duty to pay the taxes was sufficient to find him liable under section 111.016(b) and to find willful misconduct. *Id.* Despite the trustee's arguments, the Fifth Circuit Court of Appeals ruled that the trustee's 'good intentions' could not absolve him of the duty to pay taxes or mitigate his willful misconduct. *Id.* In the Court's words, "[g]ood intentions are irrelevant." *Id.*

More importantly, the Court also held that no special standard exists for trustees in regards to the timely payment of sales taxes. *Id.* The trustee inaccurately relied on case law which dealt with a trustee's duty to the estate to come to his determination that gross negligence must be present to establish a trustee's liability. *Id.* The language of 28 U.S.C. § 959 was relied upon by the Court to find that trustees are subject to the same standard as any other citizen under the law. *Id.* at *4. The Court also relied on the United States Trustee Manual and the U.S. Trustee's Chapter 11 Trustee Handbook to determine that trustees can be held liable if the estate lacks the funds to pay all taxes due. *Id.* Even the Trust Agreement could offer no protection to the trustee due to his violation of the Plan. *Id.* In fact, the trustee did not follow the Plan's requirement of timely payment of sales taxes along with the Trust Agreement's command that the trustee not "attempt to modify the plan." *Id.* at *6.

#### Conclusion

In a case which may prove worrisome to chapter 7 professionals, the Fifth Circuit Court of Appeals held that a trustee can be held personally liable to tax collectors for willful failure to pay trust fund taxes. The Court also clearly established that trustees will not be held to a more relaxed standard than any other citizen when it comes to timely paying state taxes or otherwise complying with the law. A takeaway point from this case is that a trustee's obligation to the estate will not supersede the obligation to timely pay taxes to the state.

# Chapter 11 Practice- Bankruptcy Nuts & Bolts: The Basics of Cash Collateral and DIP Financing

By Kevin M. Lippmann, shareholder Munsch Hardt Kopf & Harr, P.C., and Jonathan L. Howell, associate Munsch Hardt Kopf & Harr, P.C. (klippmann@munsch.com and jhowell@munsch.com)

## Generally

### A. Importance

In most chapter 11 bankruptcy cases, a debtor[1] will need to use cash that is subject to a lien of a secured creditor and/or obtain postpetition financing to continue operating postpetition. Section 363 of the Bankruptcy Code permits a debtor to use such encumbered cash (and its proceeds, collectively "cash collateral") to satisfy a debtor's postpetition expenses.[2] In most chapter 11 cases, however, a debtor cannot rely solely on its existing cash balance or postpetition accounts receivable to meet its postpetition obligations. As such, section 364 of the Bankruptcy Code permits the extension of postpetition credit to a debtor (DIP financing).[3] In order for a debtor to be permitted to use cash collateral or receive DIP financing, however, a debtor may be obligated to satisfy several conditions.

### B. Objectives of Different Parties

The Bankruptcy Code recognizes that, absent protection, some lenders may be reluctant to either consent to a debtor's use of cash collateral or provide a debtor DIP financing because the debtor only recently chose to pursue bankruptcy protection, very often without the lender's consent. Therefore, to encourage secured lenders to allow the use of cash collateral and the extension of DIP financing, the Bankruptcy Code provides lenders certain incentives and protections.[4] Thus, a lender that is willing to consent to the use of its cash collateral or extend DIP financing will naturally want to receive as many protections and incentives as it can to protect its collateral to ensure repayment.[5]

DIP financing may be provided by either a debtor's existing (or prepetition) lender or a new lender. The prepetition lender's reasons for wanting to extend DIP financing will not necessarily coincide with the reasons why a new lender is willing to extend DIP financing. The postpetition lender, for example, may only be willing to extend DIP financing if the new lender perceives value in the debtor's collateral and believes there is a high likelihood of full repayment.[6] Whereas, the prepetition lender may be willing to extend additional financing for mere tactical reasons, such as: (i) preventing a new, postpetition lender from being granted liens superior to the prepetition liens; (ii) addressing defects in the perfection of its prepetition security interests; (iii) increasing or preserving the value of its prepetition collateral; (iv) cross-collateralizing prepetition and postpetition indebtedness (discussed in more detail below); or (v) gaining substantial leverage over the direction of the bankruptcy case, as a result of receiving a high priority claim.[7] Regardless of its reasons for wanting to provide DIP financing, whichever lender provides the DIP financing will want to maximize the protections and incentives it receives in return.

On the other hand, a debtor will almost always want to use cash collateral and obtain DIP financing with the least amount of strings attached as possible. A debtor, however, may be reluctant to take a hard stance against a lender in negotiating terms of cash collateral use and DIP financing because the debtor has little bargaining power and needs the lender's cooperation. Thus, in bankruptcy cases in which an unsecured creditors' committee is appointed, the committee will often play a critical role in the negotiations with the lender. Like a debtor, an unsecured creditors' committee will typically encourage use of cash collateral and DIP financing. But, the committee will oppose terms and conditions being demanded by a lender if they are overreaching and will negatively impact the distributions to the committee's constituency.[8]

## Cash Collateral

### A. What is it?

The Bankruptcy Code defines cash collateral as including "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents . . . in which the estate and any entity other than the estate have an interest . . . ."[9] Put plainly, cash collateral is comprised of cash or rights to cash subject to a lender's liens.

### B. Statutory Requirements for Use of Cash Collateral

There are several ways in which a debtor may obtain use of cash collateral. The simplest way is by consent of the secured lender. Alternatively, a debtor may obtain use of cash collateral by court order if, after a hearing on the matter, the debtor demonstrates that the secured lender's interest in the cash collateral is adequately protected.[10]

### C. Miscellaneous Procedures and Requirements

#### Segregation and Accounting

A debtor must segregate and account for any cash collateral in its possession, custody, or control.[11] This duty begins on the petition date and continues throughout the pendency of the bankruptcy case.

#### Motion and Agreed Orders

The proper means of seeking use of cash collateral is by motion.[12] The motion should provide at a minimum: (i) the name of the secured lender; (ii) the purpose of the debtor's use of cash collateral; (iii) the material terms of such use, including duration; and (iv) a description of adequate protection to be provided to affected secured parties.[13] Very often the key parties will agree to the terms of cash collateral usage.

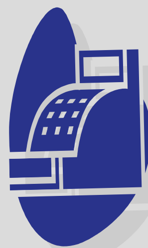
#### Preliminary and Final Hearing

In its motion, a debtor may request that a hearing on use of cash collateral be broken up into a preliminary hearing and a final hearing. The reason for such a request is that a court may not hold a final hearing on the debtor's use of cash collateral within fourteen days after service of the motion requesting the relief. However, if the court holds a preliminary hearing (which will occur before the fourteen-day period expires), it may authorize preliminary use of cash collateral, but only if such use is "necessary to avoid immediate and irreparable harm to the estate."[14]

#### Security Agreements and Financing Statements

Key parties to a bankruptcy case should never assume that a particular secured lender has a perfected, lien interest in cash

*(Continued on page 16)*



# Consumer Corner Supreme Court Case Update II: Supreme Court Construes "Projected Disposable Income"As Forward-Looking *Hamilton v. Lanning*

By: Elizabeth J. Polk, Judicial Extern to the Honorable Harlin D. Hale, third-year student at SMU's Dedman School of Law (ejpolk@gmail.com)

## Supreme Court Construes "Projected Disposable Income" As Forward-Looking: Hamilton v. Lanning

On June 7, 2010, the United States Supreme Court issued an opinion addressing the meaning of "projected disposable income" under section 1325(b)(1) of title 11 of the United States Code. In chapter 13 bankruptcy, a debtor may keep his property by agreeing to a court-approved plan devoting future income to the payment of creditors. The bankruptcy court may only approve the plan if it provides for full payment of unsecured claims or "provides that all of the debtor's projected disposable income to be received" over the duration of the plan "will be applied to make payments" in accordance with the terms of the plan. 11 U.S.C. § 1325(b)(1).

In *Hamilton v. Lanning*, 130 S.Ct. 2464 (2010), the Supreme Court granted *certiorari* to determine the proper calculation of a debtor's "projected disposable income." The language "projected disposable income" appeared in Bankruptcy Code prior to the 2005 BAPCPA amendments. The previous statute loosely defined "disposable income" as the debtor's "income which is received by the debtor" less amounts reasonably necessary for "the maintenance or support of the debtor." 11 U.S.C. § 1325(b)(2)(A), (B); *see also Hamilton*, 130 S.Ct. at 2469. With BAPCPA, the Bankruptcy Code adopted a revised definition of "disposable income," including formulas to determine the income and expense components of the previous definition. *See* 11 U.S.C. § 101 (10A)(A)(i). While the Bankruptcy Code defines "disposable income," the term "projected" is not defined. After BAPCPA, two methodologies developed in applying section 1325: the mechanical approach and the forward-looking approach.

A minority of courts implemented the "mechanical approach" in calculating projected disposable income. Under this approach, the debtor's disposable income, as defined by the Code, is projected over the "applicable commitment period." In other words, the debtor's disposable income is simply multiplied by the number of months of the plan, with no consideration of known changes in the debtor's actual income during the plan period. *Hamilton*, 130 S.Ct. at 2469. In contrast, the "forward-looking approach" starts with the defined term "disposable income," but permits adjustments based upon known or virtually certain changes in income and expenses. The majority of courts adopted this forward-looking approach, including the Fifth Circuit. *See In re Nowlin*, 576 F.3d 258 (5th Cir. 2009).

In an 8-1 decision, the Supreme Court held that "projected disposable income" is properly calculated through the "forward-looking approach."

### Bankruptcy Proceedings

In *Hamilton*, the debtor sought Chapter 13 relief in October 2006 for $36,793.36 in unsecured debt. *Id.* at 2470. During the six months prior to filing, the debtor received a one-time buyout from her former employer, greatly inflating her gross income for April and May of 2006. *Hamilton*, 130 S.Ct. at 2470. In reporting her current monthly income on Form 22C, the increased income from the buyout payments rendered debtor's monthly income in excess of the median income of a family of one in Kansas. *Id*. On the same form, debtor calculated monthly expenses pursuant to section 707(b)(2) resulting in "disposable income" of $1114.98. *Id.*

In reporting monthly income on Schedule I, debtor reported income from her new job of $1922 per month – an amount below the state median. *Id*. Her actual monthly expenses as reported on Schedule J totaled $1772.97. *Id*. Subtracting the Schedule J expenses from the Schedule I income produced a monthly disposable income of $149.03. *Id.*

When the debtor sought confirmation of her chapter 13 plan with monthly payments of $144, the chapter 13 trustee objected, claiming section 1325 was not satisfied because the payments would be less than the full amount of the unsecured claims and debtor was not committing all her projected disposable income to the payment of creditors. *Id*. According to the trustee, the debtor's projected disposable income was properly calculated on Form 22C and that amount should be multiplied by the number of months in the commitment period. *Id.*

The bankruptcy court rejected the trustee's approach to "projected disposable income" in favor of the debtor's calculation based on actual income and expenses. *Id.* at 2470-71. The court reasoned that "projected" in §1325(b)(1) requires consideration of the debtor's *actual* income over the plan period. *Id*. at 2471. Holding otherwise, the court reasoned, could result in absurd outcomes where individuals with deteriorating finances in the six months before filing could be denied bankruptcy protection. *Id*.

### At the Bankruptcy Appellate Panel for the Tenth Circuit and Tenth Circuit Court of Appeals

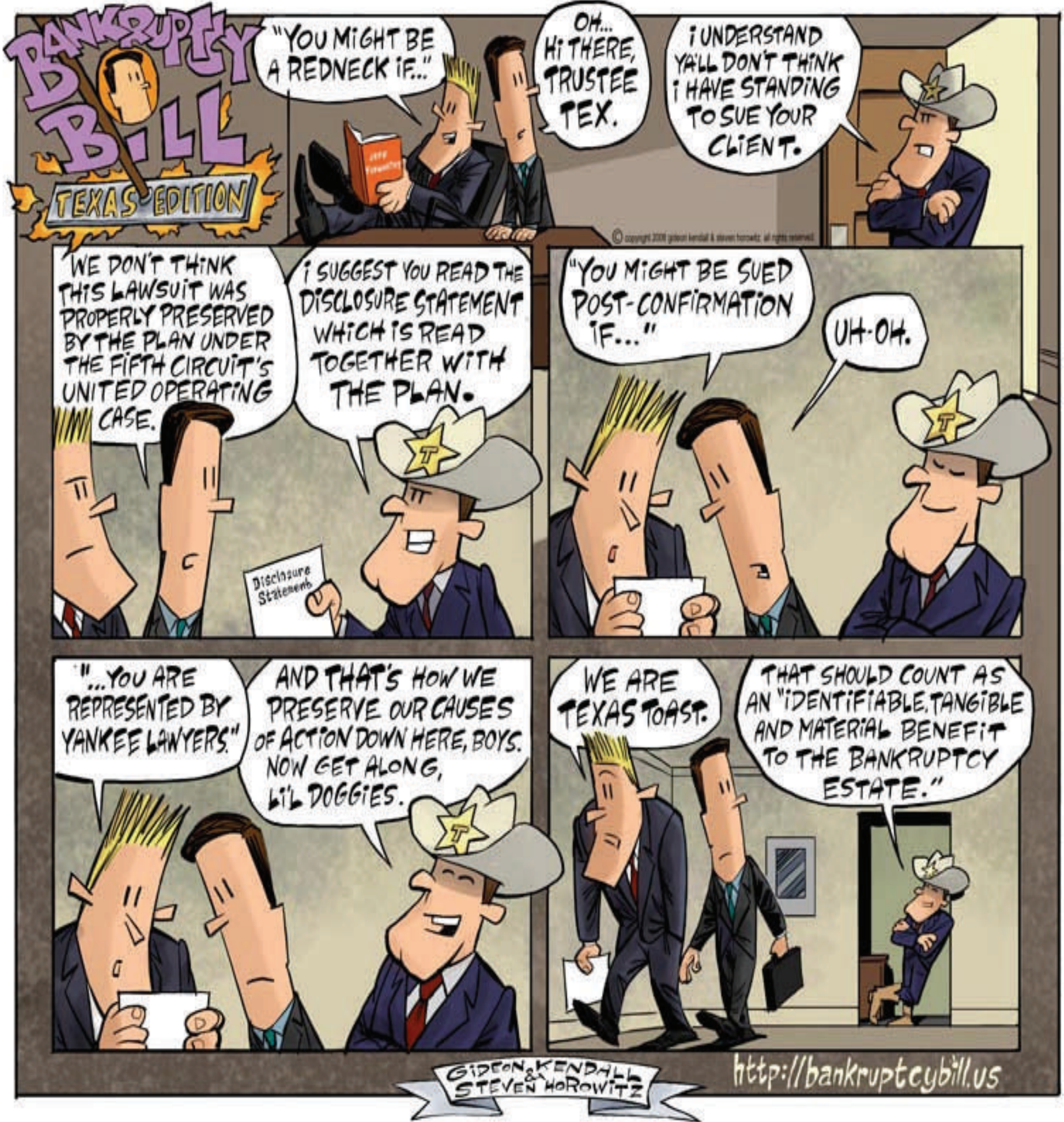
The trustee appealed to the Tenth Circuit Bankruptcy Appellate Panel which affirmed, noting that although the term "disposable income" was redefined in the 2005 amendments, the pre-existing term "projected disposable income" was not changed. *Id.* The Tenth Circuit affirmed, holding that calculating projected disposable income should begin with the mechanical approach and a presumption that the resulting figure is correct; however, the figure may be rebutted if evidence of substantial change in the debtor's circumstances warrants adjustments. *Id.*

### The Supreme Court Affirms

The Supreme Court affirmed, holding that the forward-looking approach is the proper method for calculating projected disposable income. *Id.* at 2474. In rejecting the mechanical approach, the Court pointed out three ways in which the mechanical approach clashes

*(Continued on page 15)*

# Special Feature: Bankruptcy Bill - Texas Edition




**Editor's Note**: Newsletter Special Feature: Bankruptcy Bill – Texas Edition The Bankruptcy Section is pleased to announce that the Texas edition of the now famous Bankruptcy Bill cartoon will be published in the newsletter on a semi-annual basis.

## *Review of the Fifth Circuit Bench Bar Conference*

(Continued from page 4)

Unprepared or uncaring attorneys;

Discovery disputes;

Fee disputes; and

Getting reversed on appeal by an issue not before them.

The judges praised attorneys who communicated with the court and each other and came to hearings well prepared.

Along with the substantive sessions, the Bench Bar Conference offered participants several opportunities to network and socialize. On both days, the conference began with a networking continental breakfast in the Center lobby. In addition, on April 1, participants were invited to a luncheon in the lobby that included a presentation by Fifth Circuit Judge Patrick Higginbotham. A networking reception and Italian buffet dinner concluded Day One.

Overall, the Bench-Bar Conference provided attorneys throughout the Fifth Circuit an opportunity to meet the judges and their fellow attorneys, to reconnect with friends and colleagues, to ask questions, and to gain valuable continuing legal education on bankruptcy topics both broad and consumer or business-specific.

The Bench-Bar Conference was sponsored by Bankruptcy Law Section of the State Bar of Texas and numerous law firms whose lawyers practice within the Fifth Circuit.

Heather Forrest and Zachary Annabel

Hope Hughes, Stephen Manz, Deborah Langehenning, and Jeffrey Bizon

The Hon. Harlin D. Hale

Martin Sosland and Douglas Draper

The Hon. Patrick E., Higginbotham

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# YOUNG LAWYERS COMMITTEE

**The Young Lawyers Committee for the Bankruptcy Section is a group of motivated young attorneys from across the State who have volunteered their time and talent. The purpose of the Committee is to increase the involvement of and integrate young lawyers on a State-wide basis into the Section at all levels, promote participation of young lawyers in seminars and events at all stages, and raise the visibility of our young lawyers by assisting them in professional networking and promoting professional development on a State wide basis. The Committee holds monthly conference calls on the second Wednesday of each month, and has a variety of exciting opportunities for young bankruptcy professionals to be involved. If you are interested in joining, please contact one of the Committee's new officers below.**

**The Committee's leadership has recently changed, and will be led by Joshua Searcy of Longview as Chair (joshsearcy@jsearcylaw.com); Jermaine Watson of Dallas as Vice-Chair (jwatson@coxsmith.com); and Layla Milligan of Austin as Secretary (layla@ch13austin.com).**

**The Committee's new Liaisons to the respective Section's Vice-Presidents are:**

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**Liaison - Business Division - Russell Perry (Dallas)**

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# CALL FOR ARTICLES AND ANNOUNCEMENTS

The **State Bar of Texas Bankruptcy Law Section** is dedicated to providing Texas practitioners, judges, and academics with comprehensive, reliable, and practical coverage of the evolving field of bankruptcy law. We are constantly reviewing articles for upcoming publications. We welcome your submissions for potential publication. In addition, please send us any information regarding upcoming bankruptcy-related meetings and/or CLE events for inclusion in the newsletter calendar, as well as any items for our "Troop Movements" section (changes in practices).

If you are interested in submitting an article to be considered for publication or to calendar an event, please either e-mail your submission to a member of the Editorial Staff at tmillion@munsch.com, evanhorn@romclawyers.com or eborrego@whc.net or send your submission by regular mail (addresses on page 12).

Please format your submission in Microsoft Word. Citations should conform to the most recent version of the Bluebook, the Texas Rules of Form, and the Manual on Usage, Style & Editing.

Should you have any questions, please visit our website at http://txbankruptcylawsection.com.

# Upcoming events

| | |
|---|---|
| August 5 | DAYBL Summer Happy Hour - Lemmon Bar, 3699 McKinney Avenue, Dallas (5:30 p.m.) |
| August 12-13 | University of Texas Consumer Bankruptcy Conference, Galveston |
| August 18-21 | Southern District of Texas Bench Bar Conference, Corpus Christi: Information available at http://www.txs.uscourts.gov/news /SDTXBenchBar2010SavetheDate.pdf |
| September 23-25 | ABI Southwest Bankruptcy Conference, Las Vegas: Information available at http://www.abiworld.org/SW10/ |
| October 13-16 | National Conference of Bankruptcy Judges, 84th Annual Conference - New Orleans: Information available at http://www.ncbj.org/ |
| October 28-29 | West Texas Bankruptcy Institute f/k/a Farm, Ranch and Agribusiness Bankruptcy Institute—Lubbock/Call Robert Wilson—(806) 763-9555 |
| November 18-19 | 29th Annual Jay L. Westbrook Bankruptcy Conference, Austin, Texas at the Four Seasons: Information available at http://www.utcle.org/conference_ overview.php?conferenceid=934 |

# LOCAL EVENTS

Dallas:
The Dallas Bar Association Bankruptcy and Commercial Law Section normally meets the first Wednesday of each month at the Belo Mansion. Social begins at 5 p.m. with program beginning at 5:30 p.m.

Fort Worth - Tarrant County:
Bankruptcy Section - monthly CLE luncheon meetings on the third Monday of each month to its members. Contact - Marilyn Garner at (817) 462-4075 or marilyndgarner@flashwave.com. Meetings are normally held at the Ft. Worth Petroleum Club.

San Antonio:
The San Antonio Bankruptcy Bar Association meets on the 4th Tuesday of every month at the San Antonio Country Club. Social begins at 5 p.m. with program beginning at 5:30 p.m. Participants receive 1 hour CLE .

A Brown Bag lunch with Judge Clark, Judge King, the Bankruptcy Clerk, and members of the Bankruptcy Bar is held quarterly at the Adrian Spears Judicial Training Center.

Houston:
The last Friday of each month from 7:30 to 9:00 Judge Bohm and the Moller/Folts Inn of Court present the Issues in Chapter 11 Program in Judge Bohm's Courtroom. The program is available to all lawyers (Inn membership is not required). CLE credit and donuts provided. For more information or to RSVP, please contact Liz Freeman (efreeman@porterhedges.com).

Members of HAYBL are invited for monthly "Chamber Chats" with Judge Bohm and a special guest. Eight monthly spaces available and HAYBL membership required. For more information, contact Allison Byman (Allison.Byman@tklaw.com).

Members of HACBA are invited for monthly "Chamber Chats" with Judge Bohm and a special guest. Eight monthly spaces available and HACBA membership required. For more information, contact Pam Stewart (plsatty@swbell.net).

# Troop Movement

**Vickie Driver** (formerly of Pronske Patel, P.C.) cofounded Coffin & Driver PLLC.

**Francis Smith** (formerly of Haynes & Boone, LLP) joined Shackelford, Melton & McKinley as Of Counsel.

**Vanessa Gonzalez** (formely of Munsch Hardt Kopf & Harr, P.C.) joined Mullin Hoard Brown LLP as associate.

# SUPREME COURT PREVIEW: *RANSOM V. MBNA*

(Continued from page 1)

ship cost and a $270 operating cost per month. *Id.* The IRS uses these standards in its calculation of payments required of delinquent taxpayers. *Id.* The IRS's Internal Revenue Manual (IRM) instructs that the ownership cost should only be applied when a delinquent taxpayer is actually making loan or lease payments on a vehicle, and not when the taxpayer owns the car free and clear. Internal Revenue Service Manual, Financial Analysis Handbook, Pt. 5, ch. 8, § 5.8.5.6.3(3), http://www.irs.gov/irm/part5/irm_05-008 005.html. The IRM also treats the Standards as caps and deducts either the taxpayer's actual cost or the Standard, whichever is less. *Id.*

## The Ninth Circuit Ruling

In *In re Ransom*, the Ninth Circuit held that the ownership cost deduction should not apply in bankruptcy when the debtor owned the car free and clear at the time of the filing. *In re Ransom*, 577 F.3d 1026 (9th Cir. 2009). The court reasoned that the ownership cost could not be an "*applicable* monthly expense" under section 707(b)(2)(A)(ii)(I) because it does not exist. *Id.* at 1030. The court also argued that this reading of the statute is preferable because it furthers "one of the main objectives of BAPCPA: to ensure that debtors repay as much of their debt as reasonably possible." *Id.* at 1031.

However, as noted by the Ninth Circuit in *Ransom*, many courts have taken the opposite view and have interpreted section 707(b)(2)(A)(ii)(I) to allow the ownership cost deduction whenever the debtor owns a car, regardless of whether the debtor is making loan or lease payments on the car. *Id.* at 1029. Such courts include the Fifth Circuit, the Seventh Circuit, the Eighth Circuit, the Sixth Circuit Bankruptcy Appellate Panel, and the Tenth Circuit Bankruptcy Appellate Panel. *See In re Tate*, 571 F.3d 423 (5th Cir. 2009); *In re Ross-Tousey*, 549 F.3d 1148 (7th Cir. 2008); *In re Washburn*, 579 F.3d 934 (8th Cir. 2009); *In re Kimbro*, 389 B.R. 518 (B.A.P. 6th Cir. 2008); *In re Pearson*, 390 B.R. 706 (B.A.P. 10th Cir. 2008), *vacating as moot* 309 F.App'x 216 (10th Cir. 2009).

These courts claim to follow the "plain language approach" and refer to the Ninth Circuit's reasoning as the "IRM approach." *See In re Ross-Tousey*, 549 F.3d at 1157. The courts following the plain language approach interpret "applicable" to mean "the selection of an expense amount corresponding to the appropriate geographic region and number of vehicles of the debtor." *Id.* These courts note that section 707(b)(2)(A)(ii)(I) refers only to the National and Local Standards and argue that Congress did not intend to incorporate other parts of the IRM, including the part that limits ownership costs to cases in which a person is making loan or lease payments. *Id.* at 1159. This contention is supported by the fact that an earlier version of section 707(b)(2)(A)(ii)(I) which would have provided for monthly expenses to be calculated "under the Internal Revenue Service financial analysis" was not passed by Congress. *Id.* They also argue that the ownership cost should not be limited to cases in which there are actual loan or lease payments because Congress used "applicable," not "actual," to refer to expenses under the National and Local Standards, and provided for "actual" expenses under Other Necessary Expenses. *Id.* at 1158. Additionally, the plain language courts claim that the IRM approach that limits ownership cost deductions to cases where there are actual loan or lease payments conflicts with another provision of section 707(b)(2)(A)(ii)(I) which states: "Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments for debts." *Id.*

The plain language courts also see their approach as conforming to BAPCPA's purpose of encouraging uniformity and discouraging discretion. *Id.* at 1160. These courts also point out that there are other costs associated with owning a car besides loan or lease payments, including "depreciation, insurance, licensing fees and taxes" and that allowing this deduction for paid-off cars might reflect the possibility of the need for a replacement vehicle in the future, which would require loan or lease payments. *Id.* at 1160-61.

Additionally, the IRM approach can produce unfair results because it allows the full deduction for a debtor with very small monthly car payments, far below the Standard, and permits the full deduction for a debtor with only a couple of payments remaining, while depriving a debtor of the deduction if he just finished paying off his car right before filing for bankruptcy. *Id.* at 1161. Moreover, the plain language courts believe that the IRM approach unfairly punishes responsible debtors who continue to drive older, paid-off vehicles, rather than incurring more debt to buy new, expensive cars. *Id*.

## The Debtor's Argument

In his petition for *certiorar*i, Ransom explained that there were many courts on each side of the divide and called on the Supreme Court to resolve the split. *Petition for Writ of Certiorar*i, 2010 WL 342159, at *7. However, MBNA argued that the Supreme Court did not need to decide the case because the issue would be decided by the outcome in *Hamilton v. Lanning*, which had not yet been argued at the time. *Hamilton v. Lanning*, No. 08-998, 560 U.S. __, 2010 WL 2243704 (June 7, 2010); *Brief of Respondent MBNA America Bank, N.A. In Opposition to Petition for Writ of Certiorari*, 2010 WL 333672, at *3. In *Lanning*, the Supreme Court affirmed the Tenth Circuit's holding that, when calculating a chapter 13 debtor's "projected disposable income" for purposes of plan payments, the bankruptcy court may consider evidence that the debtor's income or expenses are likely to be different from the debtor's average income in the six months prior to filing. *Hamilton v. Lanning*, 2010 WL 2243704, at *4.

MBNA contended that "if the Court in *Hamilton v. Lanning* decides that the calculation of projected disposable income may or shall be adjusted for differences between a debtor's pre-filing expenses and those paid during the plan period, then, of necessity, any expense, such as a vehicle loan or lease payment, that a debtor will not pay during the plan period is excluded from the calculation of projected disposable income." Brief of Respondent, 2010 WL 333672, at *4. In his Reply Brief, Ransom argued that the outcome in *Lanning* would not determine *Ransom* because "[t]he *Lanning* issue will be resolved on ***when*** the debtor's income will be calculated, not ***what deductions*** will be allowed in determining disposable income." Reply Brief, 2010 WL 990573, at *5. Moreover, Ransom noted that the Fifth, Seventh, and Eighth Circuits follow *Lanning*'s forward-looking approach to calculation of projected disposable income, but also allow the ownership cost deduction for debtors who own their vehicles free and clear. *Id.* at *9; *In re Nowlin*, 576 F.3d 258, 267 (5th Cir. 2009) ("hold[ing] that a bankruptcy court may consider reasonably certain future events when evaluating a Chapter 13 plan for confirmation under § 1325").

The Seventh Circuit was the first circuit court to examine the vehicle ownership cost issue, and all but one of the subsequent circuits to consider the matter, including the Fifth Circuit, have agreed with the Seventh Circuit analysis in *Ross-Tousey* and relied heavily on the reasoning in that case. *See In re Ross-Tousey*, 549 F.3d at 1157; *In*

(Continued on page 15)

## SUPREME COURT PREVIEW: *RANSOM V. MBNA*

(Continued from page 14)

re Tate, 571 F.3d at 426; *In re Washburn*, 579 F.3d at 937. The Ninth Circuit is the only circuit court to follow the IRM approach, but there are also numerous district courts in the circuits where the circuit court has not yet decided the issue that agree with the Ninth Circuit. *See* Reply Brief, 2010 WL 990573, at *2-3 (noting that splits even exist among different districts within the same state: the Eastern District of New York follows the IRM approach, while the Northern District of New York follows the plain language approach).

It will be interesting to see whether the Supreme Court, after rejecting a "mechanical," formulaic calculation of projected disposable income in *Lanning* in favor of an approach that took into account the actual present and future circumstances of the debtor, will determine that the rather mechanical plain language approach to the vehicle ownership cost deduction should prevail. Because the Fifth Circuit has ruled squarely on the issue now before the Supreme Court, Texas practitioners will want to watch what happens in *Ransom*.

## CONSUMER CORNER: SUPREME COURT CASE UPDATE II *HAMILTON V. LANNING*

(Continued from page 8)

with the terms of section 1325. First, section 1325(b)(1)(B)'s language "to be received in the applicable commitment period" indicates a forward-looking approach. *Hamilton*, 130 S.Ct. at 2474. Second, section 1325(b)(1)'s instruction to measure projected disposable income "as of the effective date of the plan" is consistent with the forward-looking approach. *Id*. And third, the requirement that projected disposable income "will be applied to make payments" indicates the amount of which the debtor will actually be able to pay creditors. *Id.* Accordingly, the Court settled on the forward-looking approach because it is supported by the ordinary meaning of the word "projected," conforms with Congress's past use of the term projected, and pre-BAPCPA case law indicates that the forward-looking approach is correct. *Id*. at 2478.

<u>Dissent</u>

In a purely textual approach, Justice Scalia dissented, describing the majority's process for calculating projected disposable income as "utterly abandoning the text the Court purports to construe." *Hamilton*, 130 S.Ct. at 2478-2485 (Scalia, J., dissenting). Justice Scalia asserted there is "no basis in the text for the restrictions the Court reads in" and the majority, by adopting the forward-looking approach, "fiddles" with the text of the Code. *Id.* Even conceding that the mechanical approach may, in some circumstances, result in "undesirable outcomes," Justice Scalia still reasoned that it is proper because Congress chose it. *Id*. Justice Scalia argued that the calculation results "make no difference" in the approach to be implemented by the Court. *Id*. Deferring to the legislative powers of Congress, Justice Scalia stated "[w]hatever the wisdom of the window it chose, we should not assume it did not know what it was doing and accordingly refuse to give effect to its words." *Id.* Justice Scalia's biting language makes clear that the mechanical approach may not produce the "right" results, but he was unwilling to abandon the text of the Code, as he asserts the majority does.

<u>Effect</u>

In construing the term "projected disposable income" as forward-looking, the Supreme Court affords debtors a degree of flexibility in confirming a chapter 13 plan, yet maintains limits. Adjustments to projected disposable income to be committed to the plan are limited to changes in income and expenses that are "known or virtually certain." *Hamilton*, 130 S.Ct. at 2478. Such language restricts unnecessary adjustments to projected disposable income, yet allows debtors with unique situations to assert protection under chapter 13 bankruptcy. Almost certainly, the Supreme Court will be called on again to construe BAPCPA amendments, and *Hamilton* indicates the Supreme Court's willingness of to recognize the practical realities of bankruptcy.

# *Chapter 11 practice- Bankruptcy Nuts & Bolts: The Basics of Cash Collateral and DIP Financing*

*(Continued from page 7)*

collateral. A careful review of the applicable loan documents, including the security agreements and financing statements, is always the best practice.

## DIP Financing

### What is it?

DIP financing is new financing that a debtor may obtain following the commencement of its bankruptcy case. Much like use of cash collateral, DIP financing is critical to most debtors that choose to reorganize, particularly if a debtor cannot satisfy its postpetition expenses solely using cash collateral.[15] DIP financing may be in the form of unsecured or secured credit.

### Types of DIP Financing

### Unsecured Financing

A debtor may obtain unsecured financing without court approval so long as it is in the ordinary course of the debtor's business or industry.[16] Nevertheless, it is the best practice to always obtain prior court authorization before entering into a postpetition credit facility. By doing so, the lender avoids a situation where the bankruptcy court later finds the extension of credit was outside the ordinary course and, as a result, denies the lender an administrative claim for the unpaid amounts.[17] An unsecured loan to a debtor that is considered outside of the ordinary course requires notice and a hearing.[18] If the court determines that the loan is being made for a legitimate business purpose, the lender will be awarded an administrative claim for the amount advanced and unpaid.[19]

### Superpriority or Secured Financing

In the event a debtor cannot obtain unsecured financing following the commencement of its bankruptcy case, which is likely, the bankruptcy court may allow it to receive financing in exchange for providing the lender a superpriority administrative claim, a lien on the debtor's unencumbered property, or a junior lien on the debtor's encumbered property.[20]

In the context of DIP financing, a lender who is given a superpriority claim in exchange for extending credit to a debtor will have an administrative claim to the extent that any other type of adequate protection extended to it proves insufficient.[21] The superpriority claim is senior to all other administrative claims, including that administrative claim of the debtor's professionals.

### Senior or Equal Liens

If a debtor is unable to obtain an unsecured loan or a secured loan in exchange for a superpriority claim, replacement lien, or junior lien, the bankruptcy court may authorize the debtor to obtain secured credit by granting the lender a lien that is senior or equal to existing liens on the property.[22] While a debtor must make reasonable efforts in attempting to secure other means of financing, the debtor need not exhaust every lender before deciding that such credit is unavailable.[23] The court, however, may not approve such financing if sufficient adequate protection cannot be provided to the existing lien holders.

### C. Valuation of Collateral

### Process

To ensure that a secured lender receives sufficient adequate protection in exchange for DIP financing, it is important to determine the value of the lender's secured claim early on in the bankruptcy case. Essentially, a lender's secured claim is equal to the sum of the value of its collateral as of the petition date (plus any property the secured lender holds that is subject to setoff).[24]

In determining the value of a secured lender's collateral, courts have employed varying methods of valuation depending on the facts of the case. Therefore, the key parties in a bankruptcy case may be required to measure a secured lender's collateral using fair market value, liquidation value, and going concern value.[25]

In the event there is some later dispute as to whether a secured lender is adequately protected, the key parties in the case may measure the value of the collateral again, at which point the previous calculations will be helpful in determining the extent, if any, in which the adequate protection proved insufficient.

### Position of Different Parties

In the event adequate protection proves to be insufficient, the secured lender should receive a superpriority claim for the deficiency.[26] A superpriority claim is an administrative claim that is given a higher priority than all other administrative expense claims, even professional fees.

Therefore, if there is subsequently a dispute as to whether adequate protection provided to the lender was sufficient, the debtor may argue that the collateral securing the secured lender's claim at the commencement of the bankruptcy case had a relatively low value as compared to the value of the collateral adequately protecting the secured lender at the end of the case. By making this argument, the debtor hopes that the bankruptcy court will find the adequate protection proved sufficient, thus granting a superpriority claim to the lender is unnecessary.

In stark contrast, the secured lender will likely argue that the value of the collateral securing its claim at the commencement of the case had a relatively high value as compared to the value of the collateral adequately protecting the secured lender at the end of the bankruptcy case. By making this argument, the secured lender hopes that the bankruptcy court will find the adequate protection proved insufficient, thus entitling the lender to a superpriority claim for the deficiency.

## Lender's Terms

Since lenders hold most of the bargaining power when negotiating cash collateral and DIP financing with a debtor, lenders are often coming up with creative terms that will assist in making sure they are adequately protected and fairly compensated. Sometimes, however, such terms can be construed as far more overreaching than necessary. The following is a list of terms that are very often found in proposed orders for cash collateral and DIP financing that are considered controversial by many bankruptcy courts.

### A. Cross-Collateralization

There are two types of cross-collateralization. Forward cross-

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collateralization occurs when a prepetition debt is secured by postpetition collateral. This type of cross-collateralization is controversial and is not allowed in some courts and heavily scrutinized in others. Backwards cross-collateralization occurs when a postpetition debt is secured, in part, by prepetition collateral. Unlike forward cross-collateralization, backwards cross-collateralization is far less controversial.[27]

B. Roll-Ups

Prepetition secured lenders sometime agree to provide postpetition financing, a portion of which includes the "rolling up" of the prepetition debt into the postpetition credit. In considering whether to permit a postpetition facility that is contingent upon a roll-up, bankruptcy courts should consider whether: (i) the proposed order requesting a roll-up is an interim or final order; (ii) there is a substantial negative impact on unsecured creditors;[28] and (iii) any exceptional circumstances justifies the roll-up.[29]

C. Chapter 5 Causes of Action

The granting of a lien on avoidance actions (or proceeds from those actions) to a secured lender is a very controversial practice. Many courts prohibit the conveyance of interests in avoidance actions, reasoning that such actions are particular to bankruptcy in order to ensure equal distributions to similarly situated creditors, and the granting of liens in such actions or the proceeds of those actions to the secured lender undermines their purpose.[30] Regardless of a particular court's temperament on conveying an interest in chapter 5 causes of action to a secured lender, a court is less likely to grant such provision on an interim basis.[31]

D. Waivers

Proposed orders for cash collateral or DIP financing will often include various waivers. Examples of common waivers include: (i) if applicable, the secured lender's prepetition liens are valid, fully perfected and senior to all other liens; and (ii) limits on the debtor's ability to file a chapter 11 plan without the lender's prior consent. Increasingly, such waivers are being scrutinized by bankruptcy courts, particularly on an interim basis, because they prevent the debtor and the unsecured creditors' committee from fulfilling their fiduciary obligations of investigating claims against the bankruptcy estate.[32]

As for waivers of section 506(c), which allow a trustee to surcharge a secured creditor's collateral for expenses incurred by the trustee in connection with preserving the lender's collateral, most bankruptcy courts will not allow such waivers because the Supreme Court has construed 506(c) as giving a trustee exclusive standing, and a waiver of 506(c) is generally viewed as waiving an important right belonging to the bankruptcy estate.[33]

IV. Conclusion

Very often a debtor who seeks chapter 11 relief will enter in the reorganization process with limited cash flow. Accordingly, sections 363 and 364 of the Bankruptcy Code provide incentives to secured lenders for allowing the debtor to use cash collateral and obtain DIP financing. For if the debtor is unable to use cash collateral or obtain DIP financing, it will likely cease operating and be forced to liquidate all of its assets.

While sections 363 and 364 of the Bankruptcy Code provide incentives to secured lenders such that a debtor with a going-concern value should be able to obtain use of cash collateral or DIP financing, it is important for a debtor and other creditors to make sure that the terms of such use do not give a lender too much control or value in return. Indeed, agreements to allow cash collateral usage and DIP financing usually occur early in the bankruptcy case and can significantly impact its outcome. If a party has a firm understanding of the dynamics of cash collateral usage and DIP financing, allowing it to negotiate a favorable agreement, such positioning may prove advantageous throughout the remainder of the case.

Endnotes:

This article was written with the typical factual circumstances in mind. Every legal representation is different, and a simple change in the factual circumstances of a particular client or case can be significant and lead to a different result.

[1] While 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code") and specifically sections 363 and 364 of the Bankruptcy Code refer to the "trustee," section 1107 of the Bankruptcy Code gives a debtor-in-possession all of the rights of a trustee appointed to a bankruptcy case administered under chapter 11 of the Bankruptcy Code. Any reference in this article to a "debtor" shall mean either a debtor-in-possession or a chapter 11 trustee.

[2] 11 U.S.C. § 363(c)(2) (2010); *see also* Johnathan C. Bolton, et al., *Cash Collateral Use and Debtor-in-Possession Financing* (State Bar of Tex./Nuts & Bolts of Bus. Bankr. Course, Austin, Tex.), April 30, 2008, Chp. 2.1, at 1, *available at http://www.texasbarcle.com/CLE/OLSearchResults.asp?sPage=2&sSearchAreas=39&searchtext=debtor%2Din%2Dpossession+financing&searchtype=S&iSortType=0&sCalledFrom=OLSEARCH2.ASP*.

[3] 11 U.S.C. § 364; *see* Bolton, *supra* note 2, at 1.

[4] *See* Hon. Barbara J. Houser, et al., *Current Issues in Debtor in Possession Financing; The Art of Bankruptcy Financing: When does a Pig Become a Hog?* (Nat'l Conf. of Bankr. Judges, Chicago, Ill.), Oct. 2, 2002, at 2-7 (on file with author).

[5] *See* Bolton, *supra* note 2, at 1.

[6] *See* Michael L. Cook and Edward H. Mills, Jr., *Financing a Reorganization Case: Obtaining Post-Petition Financing and Using Cash Collateral*, 68 PRAC. L. INST. COM. L. & PRAC. HANDBOOK SERIES 189, 196 (1994).

[7] *See id.*

[8] *See* Bolton, *supra* note 2, at 1.

[9] 11 U.S.C. § 361.

[10] Adequate protection is defined in 11 U.S.C. § 361 and *includes*: (i) periodic cash payments equal to the reduction of a secured creditor's interest; (ii) a replacement lien equal to the reduction of a secured creditor's interest; and (iii) the indubitable equivalent to the reduction of a secured creditor's interest.

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[11] 11 U.S.C. § 363(c)(4).

[12] FED. R. BANKR. P. 4001(b)(1).

[13] *Id*
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[14] *See id.* at 4001(b)(2).

[15] Bolton, *supra* note 2, at 1.

[16] 11 U.S.C. § 364(a). Several courts apply a two-prong test in determining whether a particular act is within the "ordinary course" of the debtor's business--(i) the horizontal dimension test and (ii) the vertical dimension test. Applying the horizontal dimension test, the court will determine whether it is common in the debtor's industry. And, in applying the vertical dimension test, the court will determine if the debtor's creditors would consider it to be consistent with the debtor's prepetition acts. If both of these prongs are satisfied, then the act should be construed as ordinary course. *See* Bolton, *supra* note 2, at 2-3 (citing 2 COLLIER ON BANKRUPTCY, ¶ 364.02[2] (15th ed. rev'd).).

[17] *See* Houser, *supra* note 4, at 2-8.

[18] *See* 11 U.S.C. § 364(b).

[19] *See* Houser, *supra* note 4, at 2-8.

[20] 11 U.S.C. § 364(c).

[21] *See* 11 U.S.C. §§ 364(c)(1), 507(b). Accordingly, a "carve out" for reasonable professional fees is appropriate. *See* Houser, *supra* note 4, at 2-8.

[22] 11 U.S.C. § 364(d).

[23] Bolton, *supra* note 2, at 3.

[24] *See* 11 U.S.C. § 506(a).

[25] Berry D. Spears, *Is it Ready Yet? Grilling the Lawyers on Cash Collateral and DIP Financing Orders* (State Bar of Tex./Advanced Bus. Bankr. Course, Houston, Tex.) May 18-19, at § II-D, *available at http://www.texasbarcle.com/CLE/OLSearchResults.asp?sPage=6&sSearchAreas=39&searchtext=debtor%2Din%2Dpossession+financing&searchtype=S&iSortType=0&sCalledFrom=OLSEARCH2.ASP*.

[26] *See* 11 U.S.C. §§ 503(b), 507(b).

[27] Houser, *supra* note 4, at 2-15.

[28] The DIP lender will receive an administrative claim on account of the loan balance of the postpetition credit facility, which includes the prepetition debt "rolled up" into the postpetition credit facility. So if, for example, the administrative claim is excessive, it will lessen the distributions received by unsecured creditors and could effectively give the prepetition/postpetition secured lender a "veto" over any proposed plan of reorganization because the plan must pay all administrative claims in full absent an agreement to the contrary with the holder of the administrative claim. *See id.*

[29] *See id.* at 2-16-17.

[30] *See id.* at 2-10-11. Note that this reasoning is less persuasive if the debtor is proposing a chapter 11 plan that satisfies creditors in full.

[31] *See id.* at 2-11.

[32] *See id.* at 2-12.

[33] *See id.* at 2-17.