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Insolvency Law Committee

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Dear constituency list members of the Insolvency Law Committee, the following is a case update analyzing a recent United States Supreme Court case of interest:

SUMMARY:

In a unanimous opinion authored by Justice Ruth Bader Ginsburg, on May 18, 2015, the United States Supreme Court overruled a Fifth Circuit Court of Appeal's decision, holding that a bankruptcy debtor who, in good faith, converts a post-plan confirmation Chapter 13 case to Chapter 7 is entitled to a return of his undistributed postpetition wages held by the former Chapter 13 trustee. Harris v. Viegelahm, 575 U.S. _____ (2015) .

To read the full decision, click here:

http://www.supremecourt.gov/opinions/14pdf/14-400_f2ah.pdf

FACTS:

In February 2010, Charles Harris III ("Debtor") filed for bankruptcy protection under Chapter 13. The court subsequently confirmed a Chapter 13 plan (the "Plan"), requiring Debtor to continue to make monthly home mortgage payments. Additionally, \$530 per month was withheld from Debtor's postpetition wages, of which \$352 per month went to pay down prepetition outstanding mortgage debt and \$75.34 per month went to pay the Debtor's only other secured creditor. Once the two secured creditors and Debtor's counsel were paid in full, the Plan called on the Chapter 13 trustee ("Trustee") to distribute the funds to the unsecured creditors.

Debtor fell behind on his postpetition monthly mortgage payments, and in November 2010, Chase Manhattan, the mortgage lender, with the court's permission, foreclosed on Debtor's home. Following the foreclosure, Trustee continued to receive \$530 per month from Debtor's postpetition wages, but did not distribute the \$352 received each month to either Chase or the unsecured creditors. As a result, by November 2011, when Debtor converted his case to Chapter 7, Trustee held \$5,519.22 in undistributed postpetition wages.

On December 1, 2011, ten days after the conversion, Trustee distributed the funds on hand to Debtor's counsel (\$1,200), herself (\$267.79), to the remaining secured creditor and to certain unsecured creditors (\$4,051.43). Debtor moved for a refund of the accumulated wages the Trustee paid to creditors post conversion, arguing that Trustee had no authority to disburse the funds once the case was converted to Chapter 7. The bankruptcy court granted the motion, and the district court affirmed.

The Fifth Circuit reversed. It initially explained that before Congress codified 11 U.S.C. section 348(f), in 1994, courts disagreed about whether, in a converted case, the Chapter 7 estate included the debtor's Chapter 13 postpetition assets or just the property the debtor had when the Chapter 13 case was filed. *Viegelahn v. Harris (In re Harris)*, 757 F.3d 468, 472.

However, in 1994, Congress codified Section 348(f), which states in relevant part:

when a case under chapter 13 ... is converted to a case under another chapter ... property of the estate in the converted case shall consist of property of the estate, **as of the date of filing of the petition**, that remains in the possession of or is under the control of the debtor on the date of conversion.

11 U.S.C. § 348(f)(1) (emphasis added).

On the other hand, if the conversion was in bad faith, "the property of the estate in the converted case shall consist of the property of the estate **as of the date of conversion.**" *Id.*, at § 348(f)(2) (emphasis added). Unfortunately, while Congress was clear that postpetition

Chapter 13 funds did not transfer to the Chapter 7 estate after conversion, the Fifth Circuit concluded that it was unclear what should happen to these funds. *In re Harris*, 757 F. 3d at 473.

The Fifth Circuit pointed out that despite a conversion, a Chapter 13 trustee is still required to perform certain “clean up” administrative duties. A trustee’s post-conversion duties include, “a responsibility to distribute the remaining funds in her possession to the parties with the best claim to them.” *Id.*, at 474. Noting that the Bankruptcy Code provides little guidance on who has the best claim to these funds, the court turned “to considerations of equity and policy.” *Id.*, at 478.

The court found that allowing the Chapter 13 trustee to distribute the postpetition funds pursuant to a confirmed plan would not create a disincentive for debtors considering Chapter 13, which was the impetus for codification of Section 348(f). Moreover, “distribution of the funds to creditors is supported by strong considerations of fairness,” as the debtor already received the benefits associated with filing a Chapter 13 case, and his payment of postpetition wages to the Chapter 13 trustee was a *quid pro quo* for such earned benefits. *Id.*, at 480.

The Fifth Circuit’s ruling was contrary to a prior ruling in *In re Michael*, 699 F. 3d 305 (3d Cir. 2012), in which the Third Circuit held that the funds in question must be returned to the debtor upon conversion, creating a circuit split.

The United States Supreme Court granted Certiorari, and reversed the Fifth Circuit’s decision.

REASONING:

Focusing largely on Section 348(f), Justice Ginsburg concluded that, by removing postpetition wages from a converted Chapter 7 estate, with the exception of bad faith conversions, Congress excluded the earnings from the pool of assets available for distribution to creditors. Allowing the Chapter 13 trustee to distribute the funds to the same creditors after the conversion would therefore be “incompatible” with Section 348(f)(1)(A). Thus, while agreeing with the Fifth Circuit that the Code is unclear about who should receive accumulated postpetition wages upon conversion, the Supreme Court concluded that the “most sensible” reading of Congressional intent was to return the funds to the debtor. Justice Ginsburg dismissed the Fifth Circuit’s argument that a Chapter 13 trustee’s post-conversion duties include the responsibility to

distribute remaining postpetition funds, concluding that under Section 348(e) a trustee's "service" is terminated upon conversion. The term "service" includes "payments to creditors under the plan." See 11 U.S.C. § 1326(c). A conversion therefore strips trustees from the power to provide such a "service". On the other hand, returning the funds to the debtor is not a terminated "service" under Section 348(e).

The Court found that Sections 1327(a) (stating that creditors and debtors are bound by a confirmed Chapter 13 plan) and 1326(a)(2) (which requires the trustee to distribute funds according to a plan) were not relevant in this case, because these provisions no longer applied once the case was converted to Chapter 7. Similarly, the Court held that the Chapter 13 plan did not vest in Debtor's creditors the right to undistributed postpetition wages held by the Chapter 13 trustee.

Finally, the Court disagreed with Trustee's argument that, because the confirmed plan stated that postpetition funds remained property of the Debtor's estate, rather than vest in the Debtor, the funds were available to the Trustee for distribution to creditors. The Court stated that, while the funds may have been property of the estate during the Chapter 13 case, the "property does not become property of creditors until it is distributed to them." (citing to *Michael*, 699 F. 3d at 313.) Moreover, it appears that the Plan stated that, upon conversion, property that did not become part of the Chapter 7 estate reverted in the Debtor.

AUTHOR'S COMMENTARY:

Though the Supreme Court's decision may appear obvious on its face, the crux of the controversy between the Trustee and Debtor appears to be the question, when do the rights to postpetition funds paid by a debtor to a Chapter 13 trustee, pursuant to a confirmed plan, become fixed? The Trustee, as well as the National Association of Chapter 13 Trustees as Amicus Curiae, argued that once a trustee receives the funds the debtor's rights to the funds terminate in favor of creditors entitled to payment under the plan. Thus, they posited, while a debtor is entitled to terminate a plan by converting the case, the termination only applies prospectively. Returning the funds to the debtor, Amicus argued, would deny "the binding effect the plan had at the time the payments were made [by the debtor]." According to Amicus brief, the trustee's right to distribute the funds was established by the plan prior to the conversion, and should not be subsequently undone.

The Supreme Court rejected the above approach, concluding that the rights to the postpetition wages became “fixed” only upon distribution to the creditors, and therefore in the vacuum created by the Code as to who is entitled to the undistributed postpetition funds after conversion, the Court sided with debtors, largely based on the Court’s interpretation of Congressional intent underlying Section 348(f).

While another Amicus Curiae, G. Eric Brunstad, Jr., commented that the issue raised in this case is “an important and recurring issue,” one wonders whether the lesson for Chapter 13 trustees will be to distribute promptly all or most postpetition funds under the confirmed plan on a monthly or semi-monthly basis, leaving little funds on account in the event of conversion.

These materials were prepared by Uzzi O. Raanan of Danning, Gill, Diamond & Kollitz, LLP, in Los Angeles, California (uraanan@dgd.com). Mr. Raanan is a member of the Executive Committee of the California State Bar’s Business Law Section and the immediate past Co-Chair of the ILC. Editorial contributions were provided by Peter J. Gurfein, Landau Gottfried & Berger, LLP (pgurfein@lgbfirm.com). Mr. Gurfein is a member of the Insolvency Law Committee and is co-editor-in-chief of the ILC e-Bulletin.

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