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How are Lower Courts Approaching Formal v. Practical Interpretation?

It is against the background of both long term and shorter term history that we come to *City of Chicago v Fulton* 140 S.Ct.680 (2019). The respondent in that case filed a bankruptcy petition and required the City of Chicago (City) to turnover a vehicle that the City had impounded prepetition for failure to pay fines and fees assessed for motor vehicle infractions. The debtors and the lower courts relied on 362(a)(3) [and presumably the reasoning in *In Re Whiting Pools* 10 B.R. 755 (Bankr. W.D. N. Y. 1981)] to conclude that an act of continued possession was an exercise of control over property of the estate. The Supreme Court, without a dissent, concluded that the most natural and least problematic reading of the statute is that 362(a)(3) prohibits affirmative acts that would alter possession of estate property at of the petition date, but does not prohibit passive acts of possession. Although the court discussed the cumulative effect of the words "stay," "any act" and "exercise control" created the "natural reading", it acknowledged that it could not definitively rule out the alternate reading proposed by the debtor. The alternative reading, one that would prohibit continued possession, was not only "unnatural" according to the court, it would run afoul of 542's direction that property should be turned over to the trustee. The Court noted that the phrase "exercise control" was added to section 362(a)(3) by the 1984 amendments and was unaccompanied by specific discussion reflected in the legislative history. The court speculated that it was unlikely that Congress would have made such a transformative change without comment.

The decision was 8-0, newly installed Justice Barrett having taken no part in the decision. That unanimity would seem to augur an even more formalistic, strict constructionist reading of the Bankruptcy Code. Where it gets interesting, however, is in the concurrence filed by Justice Sotomayor. She begins by agreeing that the phrase "any act…to exercise control over property of the [bankruptcy estate] " in 362(a)(3) does not cover passive retention. She then veers off to raise some very practical concerns, and actually frets about the impact of the decision on the ability of many debtors to obtain a real fresh start. Justice Sotomayor leaves open the possibility that other provisions of 362 might require turnover of certain assets. She makes it clear that the court did not address enforcement of the 542 turnover provisions that it prioritized, even though 362 has an enforcement provision baked into the statute in way absent from 542. Even more interestingly, she notes that "Regardless of whether the City's policy of refusing to return impounded vehicles satisfies the letter of the Code, it hardly comports with its spirit." She all but encourages bankruptcy courts to utilize 542 turnover, but notes the practical impact arising from the amount of time (and money) such relief might take.

Given the clear trend towards formalism adopted by both conservative members of the court and also by some more liberal members, and given the recent

shift in the court towards justices with a more conservative approach, what is a lower court to do when faced with practical problems? When current bankruptcy caselaw is viewed through the prism of strict construction v. flexible fairness (or to put it another way, formalism v. practical interpretation) one fairly consistent theme emerges: Appellate courts are far less likely to affirm a practical, common-sense decision from a bankruptcy court unless the decision fits neatly within the clear language of the Code. This is particularly true when there is a statutory provision in the Bankruptcy Code that seems to speak to the issue. Appellate courts seem most likely to give practical interpretation of the Bankruptcy Code a stamp of approval only when lacunas in the Code are at play.

One recent example of this can be found *In re Shaikh*, 2020 WL 6867920 (B.A.P. 10th Cir. Nov. 23, 2020). In that case, the Bankruptcy Appellate Panel affirmed the bankruptcy court's use of the economic unit test for determining a debtor's "household" size for purposes of calculating how much a debtor had to pay through a Chapter 13 plan. Despite the centrality of the term "household" to the analysis under § 1325(b), the term is not defined in the Code. As a result, the BAP endorsed the flexible approach applied by the bankruptcy court. The bankruptcy court, using the economic unit test, found that the debtor was a household of one despite living in a home with his mother and sister and splitting some expenses. In affirming this practical approach, the BAP noted that the method chosen allowed "for an examination of the economic realities of the situation, and can prevent the over- or under-inclusion of individuals that other methods permit." *Shaikh* at *4. The BAP also considered the reality that if the more expansive methods for defining a household were adopted "[a]lmost every college student splitting an apartment with friends would be subject to having his or her contributions considered income in a roommate's bankruptcy case, a consequence neither intended nor desired under Section 1325(b)." So, when a gap in the Code was at issue, the BAP endorsed a flexible fairness approach.

By contrast, the bankruptcy court in *In re Anderson*, 545 B.R. 174 (Bankr. N.D. Miss. 2015), decided to take what it termed "a practical approach to debtor-creditor relations in a chapter 13 plan." The *Anderson* court found that even though § 1329, which governs modification of a plan after confirmation, does not provide for modifying a plan to allow for a vehicle to be surrendered it was sensible to allow such a modification. The court reasoned that if it denied the right to surrender and reclassify a secured claim, the debtor could simply convert to a chapter 7 and then proceed to surrender the collateral. Alternatively, the debtor could dismiss and refile the case, surrendering the collateral under the new plan. Each method would allow the debtor to reach the same result, so the *Anderson* court found that it defied common sense not to permit it through a modified plan. When the issue of a right to surrender a vehicle in a modified plan was considered by the Sixth Circuit in *In re Nolan*, 232 F.3d 528 (6th Cir. 2000); however, the appellate court rejected that interpretation of § 1329. The Sixth Circuit noted that section 1329(a) does not

expressly allow the debtor to alter, reduce or reclassify a previously allowed secured claim; instead, section 1329(a)(1) only affords the debtor a right to request alteration of the amount or timing of specific payments. The *Nolan* court strictly construed § 1329, giving no weight to the fact that a debtor could achieve that same result by simply converting or dismissing his case.

An example -- familiar to most Chapter 11 practitioners in this district -- of a practical approach that was rejected at the appellate level is the Third Circuit's decision regarding break-up fees in *In re O'Brien Envtl. Energy, Inc.,* 181 F.3d 527 (3d Cir. 1999). Courts recognize that outside of bankruptcy break-up fees, which reimburse an unsuccessful purchaser for its out-of-pocket expenses, are common in corporate transactions. *In re Integrated Resources, Inc.*, 147 B.R. 650 (S.D.N.Y. 1992). A break-up fee is an incentive payment made to a prospective bidder to act as a stalking horse and hopefully drive up the purchase price. The *O'Brien* court found that there was no statutory justification for approval of a break-up fee found in § 363, so if such a fee were to be approved as part of a bankruptcy sale it would have to be under the standards for an administrative expense set forth in § 503 as "actual, necessary costs and expenses of preserving the estate." That heightened standard makes it far more difficult to approve break-up fees, and virtually impossible to do so until after a sale has been conducted. *See also*, *In re Tama Beef Packing, Inc.*, 312 B.R. 192, 295 n.1 (Bankr. N.D. Iowa 2004), *rev'd* 321 B.R. 496 (B.A.P. 8th Cir. 2005).

The Third Circuit recently had occasion to revisit *O'Brien* in *In re Energy Future Holdings Corp* 2021 WL 957301 (March 15 3c Cir 2021). While *Energy Future Holdings* reaffirmed the concept that a break up fee is not in an of itself permissible under the strict language of the Code, it seemed to soften its approach for practical reasons. It noted that the word "benefit" does not appear in the text of 503(b)(1)A). While it still required an "actual benefit" as an element of "necessary", the benefit need not be substantial or reducible to a dollar value to qualify as a necessary expense within the meaning of the administrative expense provision of 503(b)(1)(A). Again, loosening a bit, the court held that the concept of "necessary expense" is broader than what is absolutely required. A 503(b)(1)(A) claimant need only "plausibly alleged that it provided some benefit to the debtor's Chapter 11 estate" which may include that it served as a catalyst to inspire other bidders or conducting due diligence that might allow other bidders to assess the thrue value of the property. Thus, in a kind of inversion, the Third Circuit used the strict construction approach to affix a more practical picture of the relative risks and benefits undertaken by the parties.

Courts outside this circuit have also tried to deal with the strict construction *O'Brien* and the real world consequences that such a strict construction may impose. The Bankruptcy Appellate Panel in the 8th Circuit held in *In Re Tama Beef Packing, Inc.* 321 BR 496 (BAP 8th Cir 2005) side-stepped the whole issue, despite a

lengthy discussion of O'Brien in an earlier iteration of an appeal in the same case, and simply concludes that the fees requested were not a break up fee, per se, but a claim for administrative fees in the context "in which break up fees often surface." It made a critical, but practical distinction, between a break up fee as designed to compensate an unsuccessful bidder for risk and costs incurred in advancing the competition bidding process and a request for reimbursement of its actual expenses. Tomato, tomahto, as long as the expenses were actual, necessary and conferred a benefit on the estate.

Not surprisingly, Bankruptcy Courts have also had occasion to address the tension between strict construction and practicality. Most recently, the court in *In re Guthery*, 2020 WL 6930785 (Bankr. S.D. Ill. Sept. 9, 2020) found that it was appropriate for a single mother of two young children to include a healthcare expense of $350 per month and childcare expense of $1,144 per month in her projected disposable income calculation notwithstanding that debtor was not currently paying those expenses. The *Guthery* court found those expenses to be reasonable, known and virtually certain expenses for purposes of *Hamilton v. Lanning*, 560 U.S. 505 (2010) because the debtor intended to increase her insurance coverage during her employer's open season, and that the daycare expense will resume when the pandemic permits her daycare to reopen. The judge found it to be an unreasonable burden on the Debtor to have to confirm a plan at a higher monthly payment amount and then pay attorney's fees to later seek to modify the plan perhaps not just once but twice.

A Bankruptcy Court in *Orchards Vill. Invs., LLC* 2010 WL 143706 (Bankr. D Or. 2010) made short shrift of the argument that the potential impact on employees should not be a factor in consideration of competing plans because that factor does not appear in the Code. The judge merely noted that neither of the competing plans suggested any intent to displace the current residents of Orchards Village and neither expressed any wish or intent not to reemploy employees who currently provided service. The court did not find the differences between the plans to be significant on these issues but clearly rejected the idea that such consideration was irrelevant under the statute. Where the statute was silent, the bankruptcy judge did not hesitate to be practical.

Similarly, in *In re AWTR Liquidation, Inc* 547 BR 831 (Bankr C.D. Cal. 2016) , the court noted the overall shift to textural reading, but for practical reasons, decided not to interpret *Stern v Marshall* too broadly. It acknowledged the desire not to impose undue costs on the parties and burden on the District Court, but tried to parse whether de novo litigation of public rights would be required. In that case, the Bankruptcy Judge's outcome was consistent with a more technical reading of the statute, but the judge made it very clear that the tension between formality and practicality was at the front of his analysis.

In the final analysis, the likelihood of success of an argument based on practicality vs formality seems to mirror the success of arguments that the bankruptcy court is "a court of equity." (a subject for a whole other day) The "practical" argument may succeed at the trial court level when the party urging practicality can convince the court that there is no section of the statute that directly addresses the problem. The practicality argument may or may not convince a reviewing court as the case moves up the appeals ladder. If there is a code section that applies, however, practicality is unlikely to carry the day.

If that conclusion is even close to correct, what is a bankruptcy litigant to do? Justice Sotomayor suggests that practical problems stemming from strictly correct readings are best addressed by changes to the Rules of Bankruptcy Procedure or to the statute itself. (And she thinks turnover complaints take a long time!!!) Litigants could be more active participants in the rulemaking process or write to their representatives in Congress. More to the point of practicality, they could convince the other parties to the litigation being affected by strict construction that it is in their interest to reach a practical solution. Perhaps most importantly, if practicality is the goal (she said cheekily) don't take an appeal.