No. 12-2127

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

In re GARON REEVES AND DIANE LINDSEY REEVES,
Debtors.

GARON REEVES AND DIANE LINDSEY REEVES,
Debtors-Appellants
— v. —
JOSEPH CALLAWAY
Trustee-Appellee
And
INTERNAL REVENUE SERVICE
Defendant-Appellee

ON DIRECT APPEAL FROM THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF NORTH CAROLINA No. 11-CV-280-F

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS IN SUPPORT OF DEBTORS AND SEEKING REVERSAL OF THE DISTRICT COURT'S DECISION

/s/ Tara Twomey
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January 21, 2013

RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Reeves v. Callaway (In re Reeves) No. 12-2127

Pursuant to FRAP 26.1 and Fourth Circuit Local Rule 26.1, *Amicus Curiae,* the National Association of Consumer Bankruptcy Attorneys, makes the following disclosure:

1) Is party/amicus a publicly held corporation or other publicly held entity? **NO**

2) Does party/amicus have any parent corporations? **NO**

3) Is 10% or more of the stock of party/amicus owned by a publicly held corporation or other publicly held entity? **NO**

4) Is there any other publicly held corporation or other publicly held enityt that has a direct financial interest in the outcome of the litigation (Local Rule 26.1(b))? **NO**

5) Is the party a trade association? **NOT APPLICABLE**

6) Does this case arise out of a bankruptcy proceeding? **YES**
If yes, identify any trustee and the members of any creditors' committee.

CHAPTER 7 TRUSTEE, JOSEPH CALLAWAY
THERE IS NO CREDITORS' COMMITTEE

_s/Tara Twomey_____ Dated: January 21, 2013
Tara Twomey, Esq.

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

Incorporated in 1992, the National Association of Consumer Bankruptcy Attorneys ("NACBA") is a non-profit organization of more than 4,000 consumer bankruptcy attorneys nationwide. NACBA's corporate purposes include education of the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. Additionally, NACBA advocates nationally on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors. NACBA has filed *amicus curiae* briefs in various courts seeking to protect the rights of consumer bankruptcy debtors. *See*, *e.g.*, *Kawaauhau v. Geiger*, 523 U.S. 57 (1998); *Gentry v. Siegel*, 668 F.3d 83 (4th Cir. 2012); *SunTrust Bank v. Millard*, 404 Fed. Appx. 2010 (4th Cir. 2010).

NACBA and its membership have a vital interest in the outcome of this case. NACBA members primarily represent individuals, many of whom file under Chapter 7 and claim an allowed exemption in property that is fully encumbered by liens but which is normally considered a necessity of daily life, like a personal residence or a personal vehicle. Thus, any issue concerning the nature and extent of a trustee's power to sell such property is of great significance to all such

debtors, who claim such exemptions with the expectation that the property will be available for their use during and after the bankruptcy process.

CONSENT

Each of the parties has consented to the filing of this amicus brief by the National Association of Consumer Bankruptcy Attorneys.

STATEMENT UNDER FED. R. APP. P. 29(c)(5)

No party's counsel authored this Amicus Curiae Brief in whole or in part; no party or party's counsel contributed money that was intended to fund preparing or submitting this brief; and no person, other than the amicus curiae, it members, or its counsel, contributed money that was intended to fund preparing or submitting the brief.

SUMMARY OF ARGUMENT[1]

The property at issue in this individual debtor Chapter 7 case—a a principal residence—is fully encumbered property in which the debtors have naturally taken their allowed exemption. The trustee nevertheless seeks to sell the property. He attempts to rely upon section 724(b) as somehow granting a power to sell the property regardless of its fully encumbered, exempted status, and he attempts to brush off the concern over whether the sale would provide an adequate

[1] Statutory references are to Title 11 of the United States Code.

benefit to the estate by relying upon a "carve-out" agreement with a secured creditor that purports to create such a benefit for the estate. The District Court essentially agreed with the trustee's position and thus ruled that the sale could proceed.

This is clearly the wrong result. First, section 724(b) does not confer upon the trustee a power to sell or otherwise dispose of estate property; it merely establishes a scheme of priorities for the distribution of proceeds from the sale of estate property. Moreover, even if section 724(b) contains a power of sale, it would not authorize the sale of fully encumbered property resulting in no meaningful return to the estate because a trustee may only properly exercise a power of sale if liquidation of the property would actually benefit the estate. Second, nothing in the text or intent of the Code supports the use of a carve-out agreement to artificially create a benefit for the purpose of circumventing the settled rules governing the proper treatment of fully encumbered property. And, to the extent such a practice may be legitimate in some cases, it clearly cannot be extended to cases where the debtor has taken an exemption in the property. Indeed, the theories proffered in support of selling the property at issue here fail to acknowledge the significance of the exemption in advancing the Code's fundamental, overriding objective of providing the debtor with a "fresh start."

ARGUMENT

I. SECTION 724(B) IS MERELY A SCHEME OF PRIORITIES FOR THE DISTRIBUTION OF PROCEEDS FROM A SALE; IT DOES NOT CREATE AN INDEPENDENT POWER OF SALE

A. The Plain Meaning of Section 724(b) Shows It Contains No Power of Sale and Instead Merely Establishes a Distribution Scheme

"Statutory construction of the Bankruptcy Code is a 'holistic endeavor' requiring consideration of the entire statutory scheme." *In re Certified Air Technologies, Inc.*, 300 B.R. 355, 365 (Bankr. C.D. Cal. 2003) (quoting *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.,* 484 U.S. 365, 371 (1988)). "The various sections of a legislative enactment must be construed together and harmonized in order to divine a congressional intent that effectuates its purpose." *Certified Air Technologies* at 365 (citing *Louisiana Pub. Serv. Comm'n v. F.C.C.,* 476 U.S. 355, 370 (1986)). "The starting point in discerning congressional intent is the existing statutory text. [Citations]. It is well established that 'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'" *In re J.R. Hale Contracting Co., Inc.*, 465 B.R. 218, 221 (Bankr. D.N.M. 2011) (quoting *Lamie v. U.S. Trustee*, 540 U.S. 526, 534).

Just as its title "Treatment of Certain Liens" implies, the plain language of section 724 shows that its purpose is to delineate the particular manner in which certain types of liens are treated in bankruptcy: subsection (a) specifies the nature

of liens that the trustee may avoid; subsection (b) establishes a schedule of priorities for certain lienholders in the distribution of estate property or the proceeds of such property; and the remaining subsections set forth procedures for handling specific competing priorities in the distribution scheme. 11 U.S.C. § 724(a)-(f). Nothing in the language of section 724 establishes -- or even mentions -- the nature or extent of a trustee's power to sell, lease, use, or otherwise assert authority over property of the estate that is subject to the type of liens specified under the section.

Indeed, with respect to subsection (b) of section 724, the key Code section in dispute here, it is settled that the function of this subsection is to prioritize payment of certain claims over payment of tax liens that would otherwise be paid first. "Section 724(b) subordinates tax liens to certain prior claims, and sets forth in detail the consequences of this subordination on the order of distribution to all claimants against property in an estate (or its proceeds) that is subject to a tax lien." *Pearlstein v. U.S. Small Bus. Admin.*, 719 F.2d 1169, 1175 (D.C. Cir. 1983). "The section in effect dictates that, where there are tax lien claims, those claimants, rather than other secured creditors, will pay for the cost of estate administration." *In re Sherrill*, 78 B.R. 804, 807 (Bankr. W.D. Tex. 1987). As a result, their treatment "is altered so that instead of being paid ahead of secured creditors and all administrative claimants, they are paid after secured creditors with senior liens and

after § 507(a)(1)–(6) administrative claimants, but only to the extent of the amount of the tax liens." *In re A.G. Van Metre*, 155 B.R. 118, 121-22 (E.D. Va. 1993).

So the effect of section 724(b) under the Code is quite clear from its face: it serves the limited function establishing a schedule of priorities among claimants with competing interests in property that is to be distributed; nothing in its terms creates a power to liquidate or otherwise dispose of property in the first instance. That is the function of section 363, which by its express terms empowers a trustee to "use, sell, or lease" property of the estate and specifically delineates the circumstances under which the trustee may properly exercise that power. *See* § 363(a)-(p). "Section 363 defines the rights and powers of the trustee regarding the use, sale or lease of estate property and the rights of third parties with interests in the subject property." *Matter of Vill. Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984); *see also Matter of Cudaback*, 22 B.R. 914, 917-18 (Bankr. D. Neb. 1982) ("[T]he test of what is property of the estate lies solely in § 541 and the test of whether a trustee or a debtor in an appropriate debtor-relief proceeding may use, sell or lease the property lies in § 363."). "This section [section 363] is the *only* basis for the Trustee to sell property of the estate . . ." *In re Feinstein Family P'ship*, 247 B.R. 502, 508 (Bankr. M.D. Fla. 2000) (italics added).

Section 363 is very specific in its delineation of the circumstances under which the trustee may properly liquidate or otherwise dispose of property.

Naturally, because the terms of section 724(b) do not create a similar power in the trustee, this section contains no limitations on the exercise of any such power. Thus, construing section 724(b) to create an independent power of this sort would allow the trustee to circumvent the essential function of section 363 by permitting the disposal of property without observing its carefully crafted limitations. This would violate fundamental canons of Code construction, which call for an interpretation that avoids conflict between provisions and ensures one provision does not suspend or supersede another. *In re Certified Air Technologies, Inc.*, 300 B.R. 355, 365-66 (Bankr. C.D. Cal. 2003) (citing *Louisiana Pub. Serv. Comm'n v. F.C.C.,* 476 U.S. 355, 370 (1986) & *Rake v. Wade,* 508 U.S. 464, 471 (1993)).

Simply put, sections 363 and 724(b) do not serve as independent bases of power to liquidate property. As their plain text and their placement within the structure of the Code show, section 363 grants the liquidation power and section 724(b) simply determines the manner in which the sale proceeds are distributed. *See In re Grand Slam U.S.A., Inc.*, 178 B.R. 460 (Bankr. E.D. Mich. 1995) ("Once the property is sold in accordance to Section 363(f), § 724(b) comes into play to determine the 'distribution' of the proceeds from such sale."); *In re Roberts*, 249 B.R. 152, 156 (Bankr. W.D. Mich. 2000) ("Section 363(c)(2), like the remaining portion of Section 363(c) and Section 363(b), concerns the circumstances under which the trustee has authority to use estate property."); *In re Oglesby*, 196 B.R.

938, 943 (Bankr. E.D. Va. 1996) (explaining that section 724(b) trumps section 363 only in the limited sense that "where a trustee's sale qualifies under § 363(f), tax liens are nevertheless subordinated to the extent allowed by § 724(b)").

B. The Legislative History of Section 724(b) and Its Predecessor Erase Any Doubt As to the Limited Purpose of the Statute

"[W]hen a statute is ambiguous, the court may also seek guidance in congressional purposes expressed in the pertinent act." *In re Knudsen*, 389 B.R. 643, 662-63 (N.D. Iowa 2008) (citing *Florida Power & Light Co.,* 470 U.S. 729, 737 (1985)). To the extent there is any ambiguity as to the purpose of section 724(b), the legislative history leaves no question that it was only intended to establish a schedule of priorities in property subject to the power of disposal.

Section 724(b) was derived from section 67(c) of the Bankruptcy Act "'without substantial modification in result.'" *In re Bino's Inc.*, 182 B.R. 784, 788 (Bankr. N.D. Ill. 1995) (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 382 (1977)). Thus, the essential underlying policy was the same: "to postpone or subordinate the payment of taxes secured by tax liens for the protection of certain administrative costs and other priority claims." *In re Bino's* at 788. This policy was first codified under Section 67(c) with the passage of the Chandler Act in 1938. *Goggin v. Div. of Labor Law Enforcement of Cal.*, 336 U.S. 118, 129 n.8 (1949) (quoting Committee Report Analysis of H.R.12889, 74th Cong., 2d Sess.

(1936)). Section 67(c) was specifically designed to address the increasingly prolific problem of "spurious" or "transparent" liens – those obtained "'with little formality and frequently without any of the normal attributes of a lien interest,'" particularly accumulated state and federal tax liens -- the value of which often consumed most or all of the estate assets, leaving little or nothing for payment of what Congress deemed to be "the most important" priorities in the administration of the bankruptcy estate. *Pearlstein*, 719 F.2d at 1173 (quoting S.Rep. No. 1159, 89th Cong., 2d Sess., *as reprinted in* U.S.Code Cong. & Ad.News 2456 (1966)).

The priority claims that Congress primarily intended to protect against such liens were claims for wages and administrative costs and expenses. *Goggin*, 335 U.S. at 127, 129 n. 8 (citing Committee Report Analysis of H.R.12889, 74th Cong., 2d Sess. (1936)); *In re Darnell*, 834 F.2d 1263, 1266 (6th Cir. 1987). *In re Darnell*, 834 F.2d 1263, 1266 (6th Cir. 1987). "It would be grossly unfair for the bankruptcy court and the attorneys who have labored to wind up the bankrupt's affairs and to accumulate an estate for distribution to receive nothing for their labor. It is also socially desirable that the claims of the wage earner who is normally entirely dependent upon his wages for the necessity of life should be paid to the extent of the restriction in Section 64a(2) before the estate is subject to the heavy burden of all tax liens." *In re Granite Lumber Co.*, 63 B.R. 466, 470-71 (Bankr. D. Mont. 1986). Thus, in enacting section 67(c), Congress sought "to

provide a measure of much-needed protection, (1) for administrative costs and expenses in the interest of bankruptcy administration, and (2) for wage claims in the interest of protecting a weak but deserving economic class, against the ravages of certain accumulated liens on the bankrupt's property." *In re Quaker City Unif. Co.*, 238 F.2d 155, 158 (3d Cir. 1956) (internal quotations omitted).

"From the legislative history it appears that the *sole* concern of Congress in enacting Sec. 67, sub. c was to insure payment of administrative expenses and small wage claims." *California State Dept. of Employment v. United States*, 210 F.2d 242, 244 (9th Cir. 1954) (italics added); accord *Pearlstein*, 719 F.2d at 1173. Section 67(c) was subsequently amended, but only to close certain loopholes that potentially left room for states to circumvent the subordination effect of the statute. See *Pearlstein* at 1174-75 (explaining the changes made to address this problem). So Congress's original "policy decision to favor the claims of wage earners, the costs of administration of the estate, and other priority claims over tax liens" continued in full force. *In re Bino's* at 788 (quoting H.R. Rep. No. 686, 89th Cong., 1st Sess. (1965), U.S. Code & Admin. News at 2442, 2462).

This same policy was expressly carried forward into the enactment of section 724(b) under the 1978 Bankruptcy Code: "the legislative history of the 1978 Bankruptcy Act indicates that Congress did not intend substantially to alter the rule of section 67(c)(3)," and indeed that section "retains the rule" of 67(c)(3).

Pearlstein, 719 F.2d at 1176. Congress actually expanded the scope of this rule so as to include a broader range of tax liens. *Granite Lumber*, 63 B.R. at 471 ("the policy of postponement or subordination was continued and expanded, since 724(b) applies to real property liens as well as tax liens on personal property, and it contains no requirement that the property be unaccompanied by possession"); *accord In re Kamstra*, 51 B.R. 826, 830 (Bankr. W.D. Mich. 1985). And section 724(b) continues to retain this essential meaning and effect under the present version of the Code. *Bino's*, 182 B.R. at 488; *Granite Lumber*, 63 B.R. at 470-71.

Nothing in the history of section 724(b) or its predecessor statute suggests Congress ever intended these rules regarding the subordination of liens to create any sort of power in the trustee to dispose of property – particularly when that section contains none of the specifically crafted limitations set forth in section 363. Rather, this history simply further supports the conclusion that section 724(b) serves the limited function of establishing a scheme of distribution for property or its proceeds to be disposed under the trustee's power of disposal.

C. The Sale Cannot Be Justified Under Any Power of Sale, Whatever the Specific Source, Because the Estate Lacks Any Equity in the Property

Even if section 724(b) may be construed to grant a trustee some sort of general power to dispose of estate property, it still would not authorize a trustee to sell property where the estate lacks any equity in the property because it is fully encumbered. Regardless of the particular Code section from which a power of sale

may be derived, it is clear that any such power is only properly exercised when it would result in a benefit to the estate apart from merely compensating the trustee.

"Where property is of inconsequential value to the estate, abandonment under § 554, rather than sale under § 363, is the proper course." *In re Rambo*, 297 B.R. 418, 433 (Bankr. E.D. Pa. 2003). In enacting section 554, Congress was confronting the "decried" practice of trustees who were "selling burdensome or valueless property simply to obtain a fund for their own administrative expenses." *In re Paollela*, 79 B.R. 607, 609 (Bankr. E.D. Pa 1988). So Congress sought '"to prevent a trustee from unnecessarily selling property without value to the estate merely in order to earn a commission."' *In re DiDario*, 232 B.R. 311, 313 (Bankr. D.N.J. 1999) (quoting *In re Paolella,* 85 B.R. 974, 979 (Bankr. E.D. Pa. 1988); *see also* 4 *Collier on Bankruptcy* ¶ 554.01 (L. King, 15th ed. 1985) (*Collier*) (section 554 codified the judge-made rule that "permitting the trustee to abandon property that was worthless or not expected to sell for a price sufficiently in excess of encumbrances to offset the costs of administration"); 5 *Collier* ¶ 554.02[7][a] (A. Resnick and H. Sommer, eds., 16th ed. 2012) ("Congress has encouraged the abandonment of nominal assets"); 6 *Collier* (16th ed. 2012) ¶ 704.02[1] (trustees are strongly discouraged from liquidating assets in nominal asset cases).

Thus, section 554 empowers the court "'to order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential

value and benefit to the estate.'" *DiDario*, 232 B.R. at 313 (quoting *Paolella,* 85 B.R. at 979). "[P]roof that an estate lacks equity in property sets forth at least a prima facie case that the property is of inconsequential value and benefit to the estate." *Paolella* at 610. Abandonment "will virtually always be appropriate" as to such property, "because no unsecured creditor could benefit from its administration." *Id.* at 609-10; *see also In re Feinstein Family P'ship*, 247 B.R. 502, 507 (Bankr. M.D. Fla. 2000) (this is "almost universally recognized where the estate has no equity in a property"). Clearly, a sale that "results in payment of administrative expenses associated only with its sale is not of any benefit to the estate." *Matter of Kerton Indus.*, 151 B.R. 101, 101-02 (Bankr. E.D. Mich. 1991).

In fact, based upon this strong policy concern, courts have held that administrative expenses incurred in conducting a sale of such property lose the priority status they would have otherwise enjoyed under section 724(b). For instance, in *Kerton*, 151 B.R. 101, the bankruptcy court held that "by negative implication, benefit to the estate is a *sine qua non* of proper subordination under § 724(b)." *Id.* at 103. Thus, when the sale of property produces no benefit to the estate, tax liens will not be subordinated to the expenses of the sale. *Id.*; *see also Feinstein*, 247 B.R. at 507 ("It is now clear and it is well established that Section 326 of the Code precludes compensation where fully encumbered property is abandoned, sold or turned over to a secured creditor."); *In re B & L Enterprises,*

Inc., 26 B.R. 220, 223 (Bankr. W.D. Ky. 1982) ("Thus where a trustee undertakes to sell fully encumbered property, or property with only a slight equity in it, or when the trustee abandons the property to a secured claimant, there is no actual or constructive disbursement and the trustee cannot collect any compensation.")

Notably, the *Kerton* court seems to have assumed that section 724(b) contains an implied power of sale, and yet this made no difference in its ultimate holding. *See Kerton*, 151 B.R. at 103 (italics added) ("[t]he parties have presented no case, and the court has found none, which explicitly authorizes the sale of property *pursuant to § 724(b)* under circumstances which provide no benefit to the estate."). This highlights the key point that, regardless of the Code section on which the trustee relies to assert a power of sale, that power is circumscribed by the general rule that the sale must produce a benefit for the estate. Indeed, section 363(f) enumerates the conditions under which property may be sold free and clear of all liens. The only potentially applicable condition in this case would be (f)(3), but that condition requires that "the price at which such property is to be sold is greater than the aggregate value of all liens on such property." 11 U.S.C. § 363(f)(3); *see also Matter of Riverside Inv. P'ship*, 674 F.2d 634, 640 (7th Cir. 1982) ("As a general rule, the bankruptcy court should not order property sold 'free and clear of' liens unless the court is satisfied that the sale proceeds will fully compensate secured lienholders and produce some equity for the benefit of the

bankrupt's estate."). And there is no dispute that the liens here would exceed the sale price.

This rule is even firmly embedded as a fundamental guiding principle in the official Handbook for Chapter 7 Trustees. In describing the trustee's duties, the Handbook states: "The trustee *must* consider whether sufficient funds will be generated to make a meaningful distribution to unsecured creditors, including unsecured priority creditors, before administering a case as an asset case." *Handbook for Ch. 7 Trustees*, U.S. D.O.J., Exec. Off. for U.S. Trustees, at 4-1 (2010) (italics added). It further dictates: "A trustee *shall not* administer an estate or an asset in an estate where the proceeds of liquidation will primarily benefit the trustee or the professionals, or unduly delay the resolution of the case." *Id.* (italics added). The Handbook admonishes the reader that: "The trustee *must* be guided by this *fundamental principle* when acting as trustee." *Id.* (italics added).

Ultimately then, section 724(b) does not authorize the trustee to sell the property at issue in this case, because it contains no power of sale and, even so, the sale would not be proper because the estate has no equity in the property.

II. NOTHING SUPPORTS THE USE OF PRIVATE CONTRACTS TO CIRCUMVENT THE SETTLED RULES GOVERNING THE TREATMENT OF FULLY ENCUMBERED PROPERTY, AND PERMITTING THIS PRACTICE WOULD CLEARLY BE INIMICAL TO THE CODE'S CORE PURPOSES WHEN THE DEBTOR HAS TAKEN AN EXEMPTION IN THE PROPERTY

The trustee in this case ultimately concedes that the proposed sale contravenes the traditional rule prohibiting the sale of fully encumbered assets. *In re Reeves*, Appellee's Brief at 6. But he seeks to justify the sale anyway, based primarily upon the theory that the estate would ultimately benefit through a "carve-out" agreement between the trustee and a secured creditor. *Reeves*, Appellee's Brief at 8-10. Nothing in the text or intent of the Code supports the notion that carve-out agreements may be used to create an artificial benefit to the estate for purposes of a justifying a sale that otherwise would have been barred under the traditional rules governing the proper treatment of fully encumbered assets. Even more fundamentally, this theory in support of the sale, which the District Court essentially accepted, fails to account for the effect of the exemption taken in the property, which is inextricably tied to the Code's overriding purpose of providing debtors a meaningful opportunity to seek and obtain a much-needed "fresh start."

A. There is No Support for the Use of Carve-Out Agreements

"Although the term is widely used but rarely defined, a 'carve-out agreement' is generally understood to be 'an agreement by a party secured by all or

some of the assets of the estate to allow some portion of its lien proceeds to be paid to others, i.e., to carve out of its lien position.'" *In re Robotic Vision Sys., Inc.*, 367 B.R. 232, 240 n. 23 (B.A.P. 1st Cir. 2007) (quoting *In re U.S. Flow Corp.* 332 B.R. 792, 796 (Bankr. W.D. Mich. 2005). "Bankruptcy courts have occasionally grappled with the problems carve-out arrangements present, but there is no broad body of consistent opinion." *Robotic Vision Sys.* at 232. There are, however, compelling reasons to condemn such agreements when they are used to justify the sale of property that is of inconsequential value or benefit to the estate.

The essential function and purpose of such agreements is to avoid the effect of the limitations normally placed on the sale of fully encumbered property:

> It is not rare that trustees of Chapter 7 estates are approached by secured creditors who seek the trustee's help to liquidate fully encumbered collateral. They realize that before the trustee is willing to go along with the proposition the secured creditor must put a little sweetener in the deal by agreeing to pay sufficient sums to compensate the trustee and to pay other costs of administration. The more sophisticated trustee may demand that the secured creditor throw in a pittance to pay a meaningless dividend to unsecured creditors, making the arrangement more palatable to the Court.

Feinstein, 247 B.R. at 507. And it is clear that the parties to such agreements stand to obtain a personal benefit they otherwise could not have obtained:

> The proposition is very attractive from the secured creditor's point of view and economically sound because it may stave off a possible attempt by the Trustee to seek to surcharge the collateral and, most importantly, save the potentially expensive cost of a foreclosure suit. The offered deal is also attractive to the trustee because it assures that he or she will earn a commission in an otherwise no asset case and

> may seek a commission based on the gross sales price and not on the net distributed to parties of interest.

Feinstein at 507; *see also In re Fialkowski*, 2012 Bankr. Lexis 5608 at *7 n. 4 (Bankr. W.D.N.Y., Case No. 12-12231K, Dec. 3, 2012) ("It is often beneficial for a lienholder to let a bankruptcy trustee sell its collateral, instead of incurring the expense of state-law foreclosure and sale.").

"While some courts may find this calculation of the trustee's commission acceptable, there is well reasoned authority to the contrary." *Feinstein*, 247 B.R. at 507. As the *Feinstein* court explained, that authority includes the text of section 554, the "almost universal[] recogni[tion]" among courts that property in which the estate lacks any equity should be abandoned rather than sold, and section 326's preclusion of compensation for the trustee "where fully encumbered property is abandoned, sold or turned over to a secured creditor." *Id.* at 507; *see In re Tobin*, 202 B.R. 339, 340 (Bankr. D.R.I. 1996) ("The approval of such token "carve outs" for the sole purpose of creating a Trustee's commission (for administering secured assets that should have been abandoned pursuant to 11 U.S.C. § 554), is a practice neither contemplated by nor provided for in the Bankruptcy Code.").

"Clearly, the Code never contemplated that a Chapter 7 trustee should act as a liquidating agent for secured creditors who should liquidate their own collateral." *Feinstein*, 247 B.R. at 507. Indeed, as a general matter, the interest of the secured creditor is "diametrically opposed to the interest and is totally antagonistic to the

interests of the general unsecured creditors." *Id.* Thus, the very notion of the trustee's performing this function on behalf of the secured creditor is inimical to the process, since "[t]he mission of the Chapter 7 trustee is also to 'enhance the debtor's estate *for the benefit of unsecured creditors . . .*'" *Tobin*, 202 B.R. at 349 (quoting *In re Bequette*, 184 B.R. 327, 333 (Bankr. 1995 S.D. Ill.) (italics original). The District Court in *Posin* even recognized this problem, "caution[ing] the trustee that the bankruptcy court may question whether the sale of the [car] was an attempt by the trustee to churn property worthless to the estate just to increase fees." *In re Posin*, Dist. Crt. Opn. at 5 n. 1 (internal quotes and citation omitted).

"Carve-out" agreements not only contravene these important policies of the Code, their ultimate effect is to fundamentally alter the application and operation of the Code's distribution scheme, by allowing the parties to dictate how the proceeds of the sale will be distributed among the creditors, even if section 724(b) would call for a different method of distribution. "Nowhere does the legislative history of § 724(b) discuss the potential for parties to waive § 724 or the ability of interested parties to contract its provisions out of the Code." *Bino's* 182 B.R. at 788. Nor does any other provision in the Code render the application of section 724 "discretionary for the judiciary or for the parties involved." *Id.* at 789. And it would simply be impracticable to obtain the necessary waiver of rights from all other priority claimants whose interests are affected under a carve-out. *Id.*

(discussing the practical difficulties of attempting to obtain a waiver of rights from all necessary parties, the court stated it "can find no circumstances under which all potential priority claimants under § 724(b) may effectively waive their rights.").

Much like the other interested claimants whose rights can be materially prejudiced regardless of whether they consent to the terms of a carve-out agreement, debtors stand to lose certain important rights and remedies without any recourse either. Because it is in the nature of a contract, the trustee is essentially binding the bankruptcy estate to liquidate the property on behalf of the secured creditor, thereby effectively eliminating the rights a debtor could have asserted had the creditor been required to pursue liquidation itself outside bankruptcy, such as raising available defenses against a home mortgage foreclosure or pursuing loss mitigation remedies that could have prevented any need for a foreclosure.

Thus, nothing in the text or intent of the Code supports the notion that the trustee and a secured creditor may enter into a private contractual agreement that circumvents the settled rules and policies for determining the proper treatment and distribution of property in which the estate has no equity. *Feinstein*, 247 B.R. at 507-09 (denying the trustee's motion to sell over-encumbered real property based on a carve-out agreement under which the lienholder would pay trustee's fees and costs along with a dividend to the unsecured creditors, given the lack of any authority in the Code allowing the trustee to sell fully encumbered property and the

strong policies militating against permitting the use of private agreements); *Bino's*, 182 B.R. at 787-790 (invalidating a cash collateral agreement that would have supplanted the schedule of distribution priorities in the event the case was converted to a chapter 7 liquidation subject to distribution under section 724(b)).

B. To the Extent Carve-Out Agreements May Generally Be Permissible, They Cannot Be Used to Justify the Sale of Exempted Property

Even if carve-out agreements are generally permissible as a device to artificially create a benefit to the estate from the sale of fully encumbered property, it is clearly inappropriate to permit the use of this device to justify the sale of fully encumbered property in which an individual debtor has claimed an exemption.

Exempted property in an individual debtor Chapter 7 case raises a host of independent considerations that militate against permitting sale of the property. At the outset, the Debtors in this case make a compelling argument that the mere fact of the exemption takes the property out of the bankruptcy estate and thus beyond the trustee's power of sale because, whether asserted under section 363 or 724(b), that power necessarily only applies to "property of the estate." Debtors' Opening Brief at 6-9. The logical persuasiveness of this contention is undeniable, and a litany of cases supports it. *See e.g.*, *In re Farr*, 278 B.R. 171, 175 (B.A.P. 9th Cir. 2002) (exemptions "set[] aside certain property" from the estate); *In re Gamble*, 168 F.3d 442, 445 (11th Cir. 1999) ("once the debtor lists property as exempt from the estate, and neither the trustee nor the creditors object during the 30-day time

period, the property no longer belongs to the estate and the debtor 'may use it as his own'"); *In re Heintz*, 198 B.R. 581, 585 (B.A.P. 9th Cir. 1996) ("By claiming property as exempt, a debtor removes the property from the estate and places it beyond the reach of creditors."); *In re Alsberg,* 161 B.R. 680, 683 (9th Cir. BAP 1993), *aff'd,* 68 F.3d 312 (9th Cir.1995) ("After property enters the estate, one way it may exit the estate is through exemption.")).[2]

But regardless of whether property in which an individual debtor claims an exemption remains "property of the estate" within the meaning of section 541, permitting liquidation of such property would seriously undermine the Code's

[2] While the Supreme Court recently suggested that an exemption merely removes the debtor's "interest" from the estate while leaving "the property itself" as part of the estate, *Schwab v. Reilly*, 130 S.Ct. 2652, 2661-62 (2010), the specific issue the court considered was the evidence upon which a party could rely in determining whether to object to a claimed exemption – not whether and the extent to which an exemption places property beyond a trustee's power of sale. It is axiomatic that opinions are not controlling on issues they did not consider. *See Indiana v. Edwards*, 554 U.S. 164, 169 (2008). Also, unlike in *Schwab*, there was no issue here about the debtor's interest possibly exceeding the allowable exemption limits. And courts evidently have not taken *Schwab* as having pronounced a hard and fast rule on the issue here. *See Fialowski*, 2012 Bankr. 5608, *10 (with no mention of *Schwab*, the court noted: "What is the Court to make of the numerous cases that say that 'exempt property' is no longer 'property of the estate' after the exemption has been claimed and has gone unopposed? This is important because § 724(b) applies only to 'property in which the estate has an interest and that is subject to a [tax lien] . . .' That, of course, is the crux of the Debtor's broader argument."); *In re Haken*, 443 B.R. 445, 446 (Bankr. D. Idaho 2010) (Construing *Schwab*, the court stated: "Debtors may elect to exempt certain property from the estate, preserving that property, or at least their interest in that property, for their personal use if applicable exemption requirements are met.").

purpose of providing the debtor a meaningful opportunity to reorganize his or her financial affairs without the same pressures that spurred the bankruptcy filing.

"Exemptions let the debtor maintain an appropriate standard of living as he or she goes forward after the bankruptcy case," and aid a debtor's 'fresh start' by enabling the debtor to emerge from bankruptcy with adequate and necessary possessions." *Farr*, 278 B.R. at 175 (quoting H.R.Rep. No. 95–595, at 126 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6087). Providing "fresh start" for debtors is in fact an "overriding federal interest" under the Code. *In re Demeter*, 478 B.R. 281, 292 (Bankr. E.D. Mich. 2012). "By providing debtors with the right to exempt certain property from the claims of creditors so that debtors have basic necessities to begin again, the exemption scheme under § 522(d) is crucial to, and an integral part of a debtor's "fresh start." *Id.* In *Schwab*, the Supreme Court "agree[d] that exemptions in bankruptcy cases are part and parcel of the fundamental bankruptcy concept of a "fresh start." *Schwab*, 132 S.Ct. at 2667. In fact, consistent with the spirit of fostering exemption rights, the Code preserves a debtor's right to take an exemption even in property secured by a lien that the trustee has the affirmative power to avoid under section 724(a), such that an exemption effectively trumps the interests of unsecured creditors. § 522(g) & (h).

Thus, even if creditors may obtain some sort of "benefit" from the sale, permitting liquidation of a debtor's exempted property would be inimical to the

Code's "overriding" purpose, because it jeopardizes the much-needed fresh start. That is precisely the problem with permitting the sale of the property at issue here: a home that serves as the debtor's principal residence. This is the sort of property in which individual debtors universally claim an exemption, much like a car that serves as the debtor's primary mode of transportation to and from work, because the debtor's ability to retain and use the property is essential "to emerge from bankruptcy with adequate and necessary possessions" and to "begin again." *Demeter*, 478 B.R. at 292. The "overriding," "fundamental bankruptcy concept of a fresh start" for debtors cannot be displaced by the narrow, completely unsupported concept that a trustee may use the device of a private contract to act as a liquidating agent for a select secured creditor and sell a debtor's exempted property for the primary benefit of the trustee and the creditor.[3]

Therefore, carve-out agreements simply cannot be used to justify the sale of property that is the subject of a debtor's exemption. No private contract between the trustee and a creditor should be permitted to override these fundamental debtor-protective provisions of the Code. Much more is at stake in such cases than

[3] As the Debtors aptly note, Debtors' Opening Brief at 19-21, the cases on which the trustees rely to justify the sales—In re *K.C. Machine & Tool Co.,* 816 F.2d 238, 247 (6th Cir.1987) and In re *SPM Mfg.,* 984 F.2d 1305, 1313 (1st Cir.1993)—are of no moment, because they involved *commercial* debtors who have no right, and often no need, to claim an exemption in the "basic necessities" individual debtors require to ensure a fresh start. *See also* In re *Sherrill*, 78 B.R. 804, 807-90 (Bankr. W.D. Tex. 1987) (a commercial debtor case in which the court followed the reasoning of *In re K.C. Machine* in approving a sale).

ensuring that creditors will receive a sufficient monetary return from a sale: the essence of the debtors' petition for bankruptcy relief depends upon their ability to use the exempted property as a means to facilitate a new beginning.

CONCLUSION

For these reasons, the lower court erred in holding that the trustee could proceed with the sale of the property, and thus its decisions must be reversed.

Date: January 21, 2013

Respectfully submitted,

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CERTIFICATION OF COMPLIANCE WITH TYPE-VOLUME LIMITATION

I hereby certify that the foregoing Brief contains approximately 6,428 words, excluding the parts of the Brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). In preparing this certification, I relied on the word-processing system used to prepare the foregoing Brief.

The foregoing Brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it was prepared in a proportionally spaced typeface using Microsoft Word 9.0 in 14-point Times New Roman font.

Dated: January 21, 2013.

_s/Tara Twomey_____
Tara Twomey

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on January 21, 2013.

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