State Attorneys General Powers and Responsibilities

Edited by
Emily Myers
National Association of Attorneys General

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This book is dedicated to Attorneys General and the men and women who work for them in the 56 jurisdictions. They continue to make an important contribution to state govenment and the American legal system. Without them, there would be no book to write.

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This book is a collaborative effort, in which different authors with expertise in each substantive area contribute their time and talent. The principal authors are noted on each chapter, but we would like to thank them again here for their hard work and dedication. Many thanks to the following authors:

Caitlin Calder
Bob Carlson
Chris Coppin
Karen Cordry
Adam Eisenstein
Amie Ely
Micheline N. Fairbank
Denise Fjordbeck
Ed Hamrick
Michael Hering
David Jacobs
Zachary T. Knepper
Hedda Litwin
Stephen R. McAllister
Judith McKee
A. Valerie Mirko
Ann Mines-Bailey
Salini Nandipati
Joe Panesko
Chalia Stallings-Ala'ilima
Dan Schweitzer
Abigail Stempson
Clive Strong
Marjorie Tharp
Sean Towles
Chris Toth
Barbara Zelner

Chapter 20

Collection, Enforcement and Bankruptcy

By Karen Cordry, Bankruptcy Chief Counsel, NAAG

Enforcement and collection of judgments are matters of critical importance for state attorneys general. Pursuing cases to judgment without ensuring that those judgments are actually enforced is a waste of time and money for the state, makes the process an empty exercise for the victims, and destroys the deterrent effect on the perpetrators and other similarly-minded parties. Law enforcement actions discussed elsewhere in this book become meaningless if the judgments and settlements that are obtained are merely pieces of paper without substance or effect.

Creating and implementing an effective and aggressive enforcement and collections program has two primary benefits for states and their citizens. First, in areas directly involving revenue collection – such as taxes, student loans, overpayments of benefits to individual and health care providers, and government contracts – careful attention to advance structuring of transactions and a thorough, proactive plan for enforcing the terms of those transactions are extremely cost-effective measures. Such efforts must also typically include a plan for dealing with the effects of potential bankruptcy filings by those who owe money to the state. While such filings are often disruptive of normal collection efforts, the Bankruptcy Code (the "Code")[1] recognizes the revenue concerns of governmental entities and may even, at times, prove helpful to them in collecting those revenues.

As an example, cases filed under Chapter 13 of the Code are subject to a court-supervised repayment program that requires payment in full within five years of most taxes, with the government needing only to file a simple proof of claim form for the amount owed. The costs of operating in Chapter 13, including

1 The Bankruptcy Code is contained in Title 11 of the United States Code and section references herein will be to that title, unless otherwise specified.

the payments to the trustees that collect and distribute funds, come from payments by the debtors themselves, relieving the government of the need to expend resources pursuing more traditional collection methods such as foreclosures or garnishment. Similarly, the Code gives special protection for other governmental claims, such as the right to create and enforce property tax liens during the case, and to have many governmental debts excepted from discharge.

Most collection work is relatively routine and lends itself to administration by law clerks and paralegals and the use of standard forms and procedures. A well thought out, assertive collection strategy prior to bankruptcy, combined with an active role for the state when bankruptcy cases are filed, can generally result in recoveries that significantly exceed the cost of the extra staff needed for such a program. This is particularly true when an active enforcement posture is combined with outreach programs to the legal community in general, and bankruptcy practitioners in particular, to educate them on governmental positions on recurring issues. Once fully implemented, such a program can result in significantly enhanced recoveries using fewer resources. Conversely, an inadequate collection program will likely lead to lower levels of general compliance by the public and will lower the success rate of revenue enforcement efforts in non-bankruptcy contexts. Moreover, the swift and stringent procedural requirements of the Code make it critical for the state agency to have a proactive approach in place before a debtor files bankruptcy. In short, a vigilant governmental program for bankruptcy issues is crucial to the integrity of the overall revenue system of the state.

The second critical interaction of attorneys general and the bankruptcy system is the many enforcement actions that are *not* specifically revenue driven, that is, all of the matters generally put under the heading of "police and regulatory" actions. A conscientious litigator recognizes that it is as much the government's job to enforce its orders and collect benefits for the victim as to obtain the judgment in the first place. In many cases, to make a judgment meaningful by collecting the amounts that have been ordered, the government will have to take on the role of creditor both in and outside of bankruptcy proceedings. While the government in these cases is usually not receiving the money directly, the orders may, for instance, require a defendant to pay large sums for restitution or to bring a facility into compliance with environmental laws. In such cases, a defendant will almost inevitably consider whether a bankruptcy filing can eliminate those burdens and settlement negotiations and litigation proceeds under the threat (explicit or implicit) that the defendant will file for bankruptcy if the terms are too harsh.

However, as with tax and revenue collection, while bankruptcy presents serious challenges to government entities with respect to their police and regulatory powers, the Code also recognizes and provides many protections for the special needs of law enforcement during and after bankruptcy filings. Again, a forward-looking, assertive enforcement program that is prepared to deal with bankruptcy issues ensures that such a filing will not result in the loss of the victim's rights or create a perception that bankruptcy is a "haven for wrongdoers."[2] In this regard, it is critical for governmental lawyers to be aware of the effects of a later bankruptcy when preparing and trying their cases in the normal course and when negotiating settlements. Properly structured complaints and settlement agreements can result in greatly enhanced protection for the government's interests if and when a defendant does file bankruptcy and/or create disincentives to a filing. In short, attorneys general cannot effectively enforce the law without taking into account the potential for future bankruptcy filings. The ability of attorneys general to function in the context of the federal bankruptcy system is an integral part of their powers and duties.

Legal Authority

Federal Law

Bankruptcy law is purely federal. Its substantive terms are contained in title 11 of the United States Code.[3]

Jurisdiction

The Code is often described as providing for the centralization of all litigation against the debtor before a single bankruptcy judge. The reality is far more complicated. After the Supreme Court's decision in *Northern Pipeline Co. v. Marathon Pipeline Co.*,[4] Congress amended Title 28 to provide that all bankruptcy

2 *Berg v. Good Samaritan Hosp. (In re Berg)*, 230 F.3d 1165, 1167 (9th Cir. 2000).

3 In addition, a number of provisions, dealing with the structure of the bankruptcy courts, jurisdiction and other related topics are contained in Title 28, the chapter on Judicial Code provisions. Other provisions relevant to bankruptcy are contained in a variety of sources such as language in Title 42 (which deals with payment and collection of domestic support obligations) that bars the discharge of those obligations; in Title 18, which bars discharge of certain federal criminal sentences; and in regulations of the Department of Education that deal with how states must treat student loans when the borrower files bankruptcy.

4 458 U.S. 50 (1982).

cases would be initially filed in the district court. That court could "refer" the case to a bankruptcy judge, but the latter would be limited as to matters in which she could enter a final judgment, as opposed to those in which she could only enter recommended findings of fact and conclusions of law.[5]

This holding was recently reiterated in the case of *Stern v. Marshall*.[6] The Court there held that bankruptcy courts did not automatically have power to issue final adjudications of all counterclaims filed by the debtor in response to a creditor's proof of claim, even if those counterclaims would qualify as mandatory counterclaims under Rule 13 of the Federal Rules of Civil Procedure and even if Congress had tried to give bankruptcy courts that power. The aim of the 1978 Bankruptcy Code was to centralize cases involving debtors in the bankruptcy courts to the greatest extent possible under the Constitution. *Stern* held, though, that Congress' decision in 1978 *not* to make bankruptcy judges Article III judges placed meaningful limitations on how far those judges may go in issuing final decisions.

Following the amendments to the Code that resulted from the *Marathon* case, all district courts now have provisions automatically referring bankruptcy cases to the bankruptcy courts. A party may request the district court to "withdraw" that reference and reassert control over some or all of a bankruptcy case.[7] In addition, any party may remove any pending non-bankruptcy case to the district court (and thence by reference to the bankruptcy court), but government police and regulatory claims are exempted from this provision.[8] Any removed action can be remanded[9] and there are mandatory or discretionary abstention provisions applicable to the bankruptcy court that may require or allow it to defer to proceedings before the state courts.[10] Such provisions complement the numerous exceptions to the automatic stay set out in Section 362 and described below.

Types of Filings

The Code provides for six types of filings or "petitions": Chapter 7 liquidations; Chapter 11 reorganizations; Chapter 12 and 13 payment plans for family farmers and individuals, respectively; Chapter 9 municipal bankruptcies; and, since 2005, Chapter 15, "cross-border cases" (i.e., cases involving international

5 28 U.S.C.§§ 157, 1334.
6 131 S. Ct. 2594, 564 U.S. 462 (2011).
7 28 U.S.C. § 157(d).
8 28 U.S.C. § 1452(a) .
9 28 U.S.C. §§ 1452(b).
10 28 U.S.C. §§ 1334(c).

bankruptcy issues.) This chapter will focus on chapters 7, 11 and 13, since filings under the other chapters are rare. Chapter 9 can apply to cities or counties, but more often is utilized by smaller entities such as health care or water districts. States may not file for bankruptcy, but the Code does allow States to determine whether a political subdivision that is otherwise eligible to file under Chapter 9 may be authorized to do so. To the extent that there are disputes over whether such authorization is required or has been obtained, the attorney general may well be called into the litigation. After a debtor files its petition, a bankruptcy case is automatically commenced.[11] There is no need for the debtor to demonstrate its *bona fides* or prove insolvency (other than in Chapter 9). Creditors may also be able to file an involuntary bankruptcy case against a debtor that is not generally paying its undisputed debts as they come due. Such petitions are not intended to provide an easy means for creditors to coerce debtors into payment of disputed debts; instead, these involuntary petitions may be contested and the filing creditors may be sanctioned if their petition is dismissed.[12]

After filing the petition, the debtor is required to file schedules of its assets and debts. Individual debtors may exempt certain property from their total assets, which would otherwise be made available for distribution to creditors. About two thirds of all filings are in Chapter 7; the remaining one third are mostly filed in Chapter 13. Although less than 1 percent of all filings are made in Chapter 11, those are primarily business cases that are often far larger than the filings in the other two chapters, and frequently involve issues that are significant for the states.

After creditors have filed their claims, the debtor's nonexempt assets are divided up and distributed to those creditors using priorities set by the Code.[13] In Chapter 7 cases, after secured claimants receive the value of their collateral, the first priority is accorded to claims for "domestic support obligations" ("DSOs").[14] DSOs are obligations for child support, maintenance, and alimony – whether such obligations are owed directly to the spouse or children, or owed to the state for expenses it incurs in providing support to such persons. DSOs in general, and those owed to the States in particular, were given a higher priority under the amendments to the Code that passed in 2005. The next priority is accorded to claims incurred in the administration of the bankruptcy case, including ordinary course operating expenses, taxes, and the expenses of the debtor's bankruptcy professionals. After that, priority is accorded in descending order to several other

11 11 U.S.C. § 301.
12 11 U.S.C. § 303.
13 11 U.S.C. §§ 503, 507.
14 11 U.S.C. § 507.

types of claims, including wages and benefits owed to employees in the period just prior to the bankruptcy filing, certain consumer claims, and most pre-petition taxes. All other unsecured compensatory claims are paid next; after that, claims for penalties are paid, then interest claims, and, finally, any remaining balance goes to the debtor.[15]

In Chapters 11 and 13, the confirmed plan dictates how claims will be treated but, in general, claims must be paid in roughly the same priority scheme as in Chapter 7 in order for the plan to be confirmed. The one major difference relevant to governmental entities is that penalty claims cannot be automatically subordinated in Chapter 11 in the same way that they are in Chapter 7.[16] Thus, debtors cannot automatically avoid payment of penalties imposed for wrongdoing merely by filing for bankruptcy.

Discharge

The most important aspect of a bankruptcy for the debtor is the "discharge." A discharge under the Code bars the pursuit of the debtor *personally* for payment of a debt. Secured creditors, on the other hand, may continue to exercise their *in rem* lien rights against the collateral pledged by the debtor to secure payment on their claims, but may not seek to recover from the debtor personally if the amount received from disposition of the collateral is insufficient. The discharge injunction may be enforced by the court through its contempt powers.

Many types of debts owed by individuals are excepted from the Chapter 7 and 11 discharge.[17] Of particular interest to the state are exceptions for debts for most taxes; fraudulent conduct; defalcation by a fiduciary; domestic support obligations; embezzlement and larceny; willful and malicious conduct; fines, penalties, and forfeitures; student loans; and debts incurred for driving while drunk or under the influence of drugs. When a debt is excepted from discharge, the creditor may continue to pursue the debtor personally for those amounts after the general discharge is entered. As can be seen from the list of exceptions, many (but not all) of the debts the government seeks to collect, such as those for consumer fraud, securities violations, penalties for environmental pollution, and the like, are all excepted from discharge. However, debts for the actual clean-up expenses for contaminated sites are *not* excepted from the discharge.

15 11 U.S.C. § 726.

16 *United States v. Noland*, 517 U.S.535 (1996); *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996).

17 11 U.S.C. §§ 523, 727, and 1141.

Completion of plan payments in Chapter 13 provides a debtor with a so-called "superdischarge." The scope of that superdischarge was substantially limited by the 2005 amendments, so that it now more closely resembles the Chapter 7 discharge, but there are still a number of areas that are excepted in Chapter 7 but covered by the Chapter 13 discharge.[18] Debtors remain liable for debts owed for DSOs, student loans, drunk and drugged driving, criminal fines and restitution, for trust fund taxes and taxes where a return was not filed or was filed late or the debtor sought to evade the taxes. In addition, debtors remain liable for debts for fraud, defalcation by a fiduciary, larceny, embezzlement; debts where a creditor had not been given notice of the case in time to file a claim; and debts arising from the debtor's willful or malicious injury that caused personal injury or death.[19] Among the items that *can* be discharged in a Chapter 13 case but not in a Chapter 7 case are penalties and debts for willful and malicious actions that do not cause bodily harm.

For corporations, the analysis is simpler—if the corporation liquidates, whether in Chapter 7 or 11, there is no discharge. If the corporation is successful in obtaining confirmation of a plan of reorganization in Chapter 11, then virtually *all* debts are discharged by the terms of the plan, which dictates what payment provisions shall be accorded to each creditor.[20] After confirmation of the plan, the creditor is bound to those payment terms and may not seek different or better treatment.

Automatic and Discretionary Stay; 28 U.S.C. § 959(b) Obligations

The filing of a bankruptcy petition invokes an "automatic stay" of all litigation against the debtor to collect on prepetition claims or to exercise control over property of the debtor's estate.[21] That automatic stay though, is subject to a number of exceptions, including a total exception to the stay for criminal

18 11 U.S.C. § 1328.

19 The last item is both narrower and broader than the related discharge exception in Chapter 7. It requires, for instance, personal injury or death, so it would exclude conversion, for instance, which would be covered in Chapter 7. On the other hand, it deals with injury from willful *or* malicious injury, while Chapter 7 required that the debt must arise from willful *and* malicious conduct.

20 The 2005 amendments made a very slight change to this simple dichotomy by excepting from the discharge of a company confirming a plan of reorganization debts for fraud owed to the government or to a person filing suit under the federal False Claims Act or similar state law, and debts for taxes where a fraudulent return was filed or the debtor willfully attempted to evade the tax. 11 U.S.C. § 1141(d)(6). There have only been a very limited number of cases decided to date under these provisions.

21 11 U.S.C. § 362(a).

matters[22] and limited exceptions for police and regulatory actions[23] and for the assessment of taxes.[24] In the latter two situations, the government is allowed to litigate the merits of its claim and liquidate the amount owed. It may not, however, actually collect on that claim or impose a new lien on the debtor. Instead, the liquidated claim must be brought to the bankruptcy court for allowance and payment. In addition to the automatic stay, the bankruptcy court has the power to impose discretionary injunctive relief it views as necessary to implement provisions of the Code.[25] While some bankruptcy courts have concluded that this gives them the authority to enjoin police and regulatory actions that seem to endanger the reorganization process, virtually all such decisions have been reversed on appeal.[26]

The automatic stay does not apply at all to efforts to litigate issues that only arose postpetition (although rights to collect on any such judgments from funds that would be assets of the bankruptcy estate are still limited). As a result, the government is entitled to continue its normal enforcement actions against the debtor for any violations of the law that occur during the case. Further, a debtor or a trustee is required to operate the property of the estate "according to the

22 11 U.S.C. § 362(b)(1).

23 11 U.S.C. § 362(b)(4).

24 11 U.S.C. § 362(b)(9).

25 11 U.S.C. § 105.

26 *See, e.g.*, *Matter of Commonwealth Oil Refining Co., Inc.*, 805 F.2d 1175, 1189-90 (5th Cir. 1986) (decision to issue injunction must turn on whether debtor is likely to succeed on merits of underlying enforcement action, not an equitable balancing of "equities" in the bankruptcy case; "While we do not decide today that there will never be a case where a court should issue a § 105 stay to stop proceedings that are exempted . . . under §§ 362(b)(4) or 362(b)(5), we do believe that this clearly is not such a case."); *EEOC v. Rath Packing Co.,* 787 F.2d 318, 325 (8th Cir. 1986) (where proceeding excepted from automatic stay, "litigation expenses alone do not justify a stay of a proceeding"); *In re First Alliance Mortgage Co.*, 264 B.R. 634, 652-55 and fn. 18 (C.D.Cal. 2001) (discussing issue of whether stay is ever justified and noting limited circumstances it could be appropriate); *In the Matter of Brennan*, 198 B.R. 445, 449-2 (D.N.J. 1996); *In re 1820-1838 Amsterdam Equities, Inc.*, 191 B.R.18 (S.D.N.Y. 1996) (rejecting bankruptcy court's use of discretionary stay to enjoin civil and criminal police and regulatory action); *In re Compton Corp.*, 90 B.R. 798, 805-08 (N.D. Tex. 1988) (Section 105 can only be used where exception to automatic stay would allow violation of some other provision of Code; police and regulatory actions, essentially by definition do not violate the Code); *In the Matter of Nicholas, Inc.*, 55 B.R. 212, 218 (Bankr. D. N.J. 1985) (improper to issue discretionary stay where Congress excepted action from automatic stay and proceeding did not threaten assets of the estate); *In re D.M. Barber, Inc.*, 13 B.R. 962, 965 (Bankr. N.D. Tex. 1981) (discretionary stay of action to determine back pay that was excepted from automatic stay not appropriate since court retained jurisdiction to determine allowance and priority of claim).

requirements of the valid laws of the State in which such property is situated."[27] The result is that the government has powerful tools to ensure that the debtor operates lawfully while the case is pending.

State Law

While the Constitution requires Congress to enact "uniform" laws of bankruptcy, the Code rests on a broad foundation of nonbankruptcy law, including foreign, federal, state, and local law. In a great many areas, the Code imposes only a thin veneer of federal law over a vast reservoir of substantive state law, so attorneys general practicing in this federal regime must be equally familiar with the state laws applicable to nonbankruptcy matters.

Establishment of Claims

Those non-Code provisions determine, with only very limited exceptions, the validity of a claim, the method for determining its amount, and whether it is subject to defenses such as the statute of limitations.[28] For instance, in *Raleigh v. Illinois Dept. of Revenue*,[29] the Court held that the Bankruptcy Code did not change the allocation of the burden of proof on a claim, or place any greater burdens on the state in establishing its tax claim in a bankruptcy case than it would in a normal state court proceeding. Moreover, the Code recognizes that similar facts may create different legal consequences in different states and that such differences remain valid even if all parties are brought before the same federal tribunal.[30] By the same token, state law determines such matters as who has standing to file a claim, including whether the attorney general may assert matters on behalf of defrauded consumers, under a *parens patriae* or similar theory.

Exemptions

State law in general also determines the types and amount of exemptions that an individual debtor may assert to preserve certain assets from distribution

27 28 U.S.C. 959(b).

28 There are a few areas where the Code imposes its own limits on the degree to which a claim that would be valid under state law will be "allowed" for payment against the estate. These limits are set out in Section 502(b) and set caps, for instance, on claims for debts arising from long-term employment or rental contracts. In addition, Section 505 allows the court to conduct its own review of certain tax claims. Apart from those provisions, it is non-bankruptcy law that determines the validity of claims to be asserted against the estate, and bankruptcy courts may not independently re-examine prior state court judgments.

29 530 U.S. 15.

30 *In re Tucson Estates, Inc.*, 912 F.2d 1162 (9th Cir. 1990).

to his creditors. The Code has a set of federal exemptions, but the states have the right to determine whether their citizens may only use the federal exemptions, may only use the state exemptions applicable outside of bankruptcy, or may choose between the two statutory schemes.[31] As a result of this deference to state law, exemption levels vary widely among states. Homestead exemptions, for instance, range from only a few thousand dollars in a number of states, up to the unlimited amount allowed in Florida, and the right in Texas to own up to 10 acres of urban land or 200 acres of rural land without regard to the value of the land. The Code does provide that certain debts, primarily for taxes and DSOs, may still be collected from exempt assets, regardless of the provisions of state law. The new amendments place some new limited restrictions on homestead exemptions where there have been attempts to hinder, delay, or defraud creditors, or where the debtor has moved to a new state within the 40-month period prior to filing bankruptcy.[32] There is still great room for variation with respect to exemptions.

Liens and Super-lien Laws

The Code also relies on state law to determine the existence, perfection, and priority of lien interests in the debtor's assets. Such laws can be used to provide protection for the state in numerous situations, whether imposed by consent, by statute, or as a result of litigation. While the Code does place somewhat greater limits on the protections for statutory or judicial liens than on liens imposed voluntarily, governmental liens will often be recognized and protected under the Code.[33] Such liens could be for unpaid taxes, or for judgments for many types of debts, where properly registered. In addition, a number of states, such as New Jersey and Massachusetts, have passed so-called "superlien" laws in the environmental area that protect the government's costs incurred to clean up contaminated property. In some circumstances, such liens can even be imposed after the bankruptcy case is filed. If so, the government's claim is greatly elevated and

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31 One change was made in this regard in the recent amendments which include a provision at Section 522(b)(3)(C) which imposes an across-the-board exemption for certain retirement funds, whether or not such exemption is included in the state exemptions.

32 *See* 11 U.S.C. § 522 generally.

33 That recognition, though, is limited in Chapter 7 cases by Section 724 which partially subordinates the government's liens to priority claims in the case. The extent of that subordination has been greatly reduced by the 2005 amendments and now is largely limited to subordinating the tax claims only to claims for wages and benefits and for Chapter 7 administrative expenses—but not the expenses incurred in a failed Chapter 11 reorganization that converts to Chapter 7. In addition, the trustee is required to use other unencumbered asset to pay those other claims, if possible, before resorting to the tax liens.

these superlien laws provide an extremely important and effective tool for governments when they have done work that the debtor cannot or will not perform.[34]

Property of the Estate

Because of their ongoing role in regulating and licensing business operations, States have proactively affected the course of future bankruptcy proceedings by requiring that businesses buy insurance or surety bonds,[35] or set up reserve accounts to ensure that a business can cover its cash flow needs if, for instance, its Medicaid reimbursement requests are denied.[36] Where insurance is available, either for tort claims or to cover matters such as workers compensation or unemployment benefits, there is greater certainty that such claims will be paid, regardless of the Bankruptcy Code's priority scheme for unrestricted funds.[37] Similarly, when an escrow account is properly established and structured so as to remove debtor control over its use, the funds therein are not property of the debtor's estate and, as such, are not subject to distribution in the bankruptcy case. Where any of these funding mechanisms are set up proactively, as ongoing, preexisting regulatory requirements for obtaining and maintaining a license to do business, the likelihood that particular claims will be paid can be greatly enhanced. States do need to be vigilant, though, to defend those escrow accounts against efforts by debtors to terminate them prematurely before the full extent of future liability provided for under state law has been exhausted. Attorneys general may be called on to protect these escrow funds from the claims of other creditors who seek to use the debtor's contingent reversionary rights as a basis for claiming the amounts being held in escrow.[38] The issues are similar to those the federal Pension Benefit Guaranty Corporation ("PBGC") faces when it asserts the amount needed to fund annuities for employees' vested benefits when a debtor seeks to terminate a pension plan. Although the earlier cases were split, more

34 *See, e.g.*, *In re 229 Main Street Ltd. Partnership*, 262 F.3d 1(1st Cir. 2001) discussing the effect of Section 362(b)(3) and the protections for the State's lien.

35 *See, e.g.*, *Safety-Kleen, Inc. (Pinewood) v. Wyche*, 274 F.3d 846 (4th Cir. 2001) (surety bonds for clean-up of landfill).

36 *See, e.g.*, *In re Doctors Health, Inc.*, 238 B.R. 594 (Bankr. D. Md. 1999) (reserve fund that state required HMO to set up for payment to service providers could be used during bankruptcy case to make those payments).

37 *See, e.g.*, *In re Allied Products Corp.*, 42 Bankr. Ct. Dec. 248 (N.D. Ill. 2004) (debtor did not have freedom to use insurance that covered environmental clean-up costs to pay general claims in the case).

38 *See, e.g., In re Irving Tanning Company (Irving Tanning Company v. Me Supt. of Insurance)*, 496 B.R. 644 (1st Cir. BAP 2013).

recent cases agree with the PBGC that bankruptcy does not authorize a debtor to use a different, more favorable calculation to determine the amount of the PBGC's claim.[39]

In addition, debtors often are required to act as agents of the states to collect and hold various payments by third parties, such as sales tax receipts, lottery ticket payments, or hunting and fishing license fees. In such situations, where the debtor's responsibilities are properly structured, it should have no equitable claim to ownership of the funds received because it merely serves as a fiduciary for the state in holding the funds. As a result, those assets will, again, not become property of the bankruptcy estate. States have often been successful in moving aggressively at the beginning of the case to assert a claim to any such trust funds to the extent that they can properly trace and attribute funds in the Debtor's hands to the monies owed to the state.[40]

Alternative State Law Proceedings

Many types of insolvency procedures are still available under state law despite the existence of the federal bankruptcy law. While the Constitution allows Congress to pass a federal bankruptcy law, and that law must have uniform national application, there is no obligation on Congress to enact such legislation. Indeed, until 1898, federal bankruptcy legislation only existed for three brief periods coinciding with substantial economic downturns in the nation and lasted for only about 15 years in total. In *Sturges v. Crowninshield,*[41] the Court held that states were not prohibited from passing bankruptcy or insolvency laws in the absence of a superseding federal law. However, any such law could not,

39 *See Crawford v. Riley (In re Wolverine, Proctor & Schwartz, LLC),* 436 B.R. 253 (D. Mass. 2010) and *Cox Enterprises, Inc. v. News-Journal Corp.*, 2014 U.S. Dist. LEXIS 57209 and 57534 (M.D. Fla. 2014).

40 The Supreme Court held in *Begier v. I.R.S.*, 496 U.S.53 (1990), that a debtor's voluntary choice to make tax payments out of a commingled account sufficiently identified those funds as being the funds held in trust for the taxes and barred any suit against the government to recover the payment as a preference. (The Code allows the debtor to avoid transfers to creditors during the 90 days prior to the filing where this would give the creditor a greater recovery than received by other creditors.) In addition, if the funds are maintained in a segregated account, they are clearly identified as trust fund payments and not made part of the estate. If the debtor does not segregate the payments or identify them through a voluntary payment, the courts apply normal trust law principles and require the creditor to trace the payments by use of the "lowest intermediate balance test." See *In re Megafoods Stores, Inc.*, 163 F.3d 1063 (5th Cir. 1998); *City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92 (3rd Cir. 1994) (trust funds are last amounts paid out of a commingled account, so trust continues to apply to lowest amount of funds in the account during the relevant period).

41 4 Wheat. 122, 17 U.S. 122 (1819).

except in very limited circumstances, grant a debtor a discharge of debt, because this would violate the Impairment of Contracts Clause. Since that clause does not apply to the federal government, only it may include a true discharge provision in its bankruptcy laws.[42]

Despite the discharge limitation, many other types of insolvency and asset disposition proceedings continue to be available under state law and through state court proceedings. These may include interpleader and receivership actions, or other procedures such as assignments for the benefit of creditors, bulk sales and similar measures. These proceedings may lawfully bind creditors to the terms of those payment arrangements if the creditors have chosen to participate in the process by, for instance, filing a claim, or agreeing to the assignment procedure. These alternative state procedures are being used more frequently in recent years. They are often simpler and less costly than a full scale Chapter 11 procedure, while serving most of the same purposes in cases where a limited, identifiable group of creditors must be dealt with.

Insurance companies present a special case. The McCarran-Ferguson Act bars the federal government from overriding state control of those companies.[43] Instead, insurers are regulated by states based on a model that places protection of the beneficiaries as the highest goal, rather than the bankruptcy model which focuses on the goals of the debtor's "fresh start" and the protection of the interests of creditors as paramount. States, through the National Association of Insurance Commissioners, coordinate insurance receiverships and administration of state insurance guaranty funds and the Code explicitly exempts insurance companies from its coverage. This is a matter that is often at issue in the case of Health Maintenance Organizations (HMOs), which may or may not be considered insurers in a particular state. The regulatory regime established by state law will determine whether an insolvent HMO will be administered by the states or by the federal bankruptcy courts.

Treatment of HMO obligations under the insurance model allows states to devote limited resources to ensure that service providers are paid and beneficiaries are cared for. In doing so, states have used the regulatory receivership approach to ensure that patient care is the primary goal to be served rather than financial rehabilitation of an intermediary entity that may have been the triggering cause of the insolvency. One such example was Massachusetts' involvement with the Harvard Pilgrim group of HMOs in 2000. Due to accounting errors, the debtors found that they were facing a cash and liquidity crisis that threatened

42 *In re Newport Offshore, Ltd.,* 219 B.R. 341 (D.R.I. 1998).

43 15 U.S.C.§ 1011 *et seq.*

health care for thousands of members in New England. The state Insurance Commissioner and attorney general worked together to put a temporary receivership in place that averted the immediate crisis, allowed for consideration of various financial options, and eventually resulted in implementation of a plan of reorganization that put the debtors back on their feet.[44]

One advantage of dealing with these issues through state receiverships is that a single entity is responsible for all aspects of the debtor, ranging from the regulatory aspects, to decisions on whether the debtor should be sold or combined with other entities in light of the health care needs of the community, to deciding whether to provide additional infusions of cash to keep the property operating during a crisis period. When similar issues arise in the non-insurer context, there are often clashes between the bankruptcy regime and that of the state regulators, which can result in added litigation that can complicate the rehabilitation process.[45] The 2005 amendments address some of these concerns by amending Section 363, which deals with the use and sale of estate property, to provide that estate property may only be transferred "in accordance with applicable nonbankruptcy law that governs the transfer of property by [non-profit entities]."[46] Thus, bankruptcy courts are now explicitly required to take into account state law concerns in running the case.

Emerging Issues

Automatic Stay Litigation

While pure revenue collection efforts by the state are subject to the automatic stay in Section 362(a) of the Code, attorney generals frequently pursue regulatory actions that do not seek to collect funds for the states' own coffers but rather for the benefit of its defrauded citizens, or to provide for clean-up of

44 A compendium of papers dealing with the Harvard/Pilgrim case is available at the Massachusetts Attorney General's website.

45 *See, e.g., In re United Healthcare System, Inc.*, 1997 U.S. Dist. LEXIS 5090 (D.N.J. Mar 26, 1997) (bankruptcy court sought to override state health commissioner's sale directive for debtor's facility; reversed on appeal); *In re Bankruptcy Appeal of Allegheny Health, Educ. and Research Foundation*, 252 B.R. 332 (W.D. Pa. 1999) (bankruptcy court held state's action to remove debtor's trustees for violation of duties to charitable entity and to take other actions to protect charitable assets were barred by the automatic stay; reversed on appeal).

46 11 U.S.C. § 363(d). Related provisions are also contained in 11 U.S.C. §§ 541(f) and 1129(a)(16).

contaminated property, or similar matters of public concern. It is not uncommon for a defendant facing aggressive enforcement action by an attorney general to file for bankruptcy and seek to invoke the automatic stay of litigation to disrupt an ongoing regulatory proceeding. Such a filing may come literally on the day of trial and could be seriously disruptive of the state's efforts to protect its citizens.

Modifying the Stay

If the stay does apply to an action related to a case pending before the bankruptcy court, only that bankruptcy court has the power, under Section 362(d), to modify, lift, or annul the stay. This power may be used by the bankruptcy court to allow it to allow the litigation to proceed in a forum in which it is already far-advanced (as part of a decision by that court to abstain from hearing the matter itself). As another example, if the debtor failed to notify a creditor about the filing, and the latter violated the stay because of its good-faith ignorance of the existence of the stay, the court may retroactively annul the stay to protect the innocent party and avoid rewarding the debtor for its own bad faith.[47]

Determining the Application of the Stay

The courts are generally in agreement, on the other hand, that other entities (including state and federal courts and agencies) have concurrent jurisdiction with the bankruptcy court to determine whether the stay applies to their actions *ab initio*. And, moreover, the courts generally agree that, if the stay does not apply at all, then there is no requirement that the state must go to the bankruptcy court to obtain a declaration to that effect.[48]

The courts are split, though, as to whether a bankruptcy court is *bound* by the determination of the state court on the application of the stay. That is, if the government asks the state court to proceed with a police and regulatory matter, asserting that the exception to the stay applies, and the court agrees to do so, after a fully-litigated hearing on the issue, may the debtor then return to the bankruptcy court and obtain a *de novo* review of the issue? Many courts apply

47 This may often occur where the debtor wants to "take two bites at the apple"—it hopes to win in the state court litigation, but if it does not, then it wants to be able to go back to bankruptcy court and ask that the state court decision be ignored because it was entered in violation of the stay. Courts have frequently condemned such gamesmanship and protected the creditor by annulling the stay to retroactively validate the action. *See, e.g.*, *Easley v. Pettibone Michigan Corp.*, 990 F.2d 905 (6th Cir. 1993); *In re Calder*, 907 F.2d 953 (10th Cir. 1990); *Matthews v. Rosene*, 739 F.2d 249 (7th Cir. 1984); *In re Smith Corset Shops, Inc.*, 696 F.2d 971(1st Cir. 1982).

48 *See, e.g.*, *In re Baldwin-United Corp.*, 765 F.2d 343 (2d Cir.1985); *NLRB v. Edward Cooper Painting, Inc.*, 804 F.2d 934 (6th Cir.1986).

the *Rooker-Feldman* doctrine,[49] which provides that, as a matter of jurisdiction, lower federal courts are not constitutionally empowered to sit in appellate judgment over state courts or to enter judgments premised on the basis that the state court judgment misinterpreted federal law. Instead, such arguments must be pursued through appeals in the state court system, with a final right to seek a hearing before the Supreme Court on the federal issue. Those decisions hold that state courts (or other nonbankruptcy courts) have concurrent jurisdiction over determining the applicability of the stay issues and, accordingly, their decisions on the merits—whether right or wrong—must be adhered to until reversed on direct appeal.[50] The same line of reasoning presumably also applies to decisions regarding the power of state courts to determine the effect of the debtor's discharge and those cases are similarly relevant to this issue.

The Ninth Circuit[51] and the Third Circuit[52], however, have taken the view that a decision entered in violation of the automatic stay is wholly "void," not merely voidable, and, as such, is not entitled to any weight if the bankruptcy court deems the state court's decision to have been incorrect. These courts hold that this situation is an exception to the *Rooker-Feldman* doctrine which they assert, does not bar a collateral attack on a void decision.[53] In those circuits, a debtor may proceed through the state court action for an extended period and if it does not like the result can opt out at any point and ask the bankruptcy court to undertake a *de novo* review of the issues that the state courts had already passed upon.

In a nonbankruptcy case, *Durfee v. Duke*,[54] the Supreme Court dealt with a similar issue that related to a collateral attack on a state court's decision on its

49 The doctrine derives from two cases: *D.C. Court of Appeals v. Feldman*, 460 U.S. 462, 482 (1983) and *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923).

50 *Cf. Celotex Corp. v. Edwards*, 514 U.S. 300, 312 (1995), which held that a decision entered by a court with jurisdiction to hear the issue must be respected unless the claim of jurisdiction only has a "frivolous pretense to validity." Cases applying the *Rooker-Feldman* doctrine include *In re Ferren*, 203 F.3d 559 (8th Cir. 2000); *In re Salem*, 290 B.R. 479 (S.D. N.Y. 2003); *In re Keeler*, 273 B.R. 416 (D. Md. 2002); *Continental Cas. Co. v. Gullett*, 253 B.R. 796 (S.D. Tex. 1999); *In re Singleton*, 230 B.R. 533 (B.A.P. 6th Cir. 1999); *Massa v. Addona*, 1998 WL 34256560 (W.D. N.Y. Jul 09, 1998), *aff'd on other grounds*, *In re Massa*, 187 F.3d 292 (2nd Cir. 1999); *In re Ivani*, 308 B.R. 132 (Bankr.E.D.N.Y.2004); *In re Glass*, 240 B.R. 782 (Bankr. M.D. Fla. 1999).

51 *In re Gruntz*, 202 F.3d 1074 (9th Cir. 2001) *(en banc)*.

52 *Raymark Industries, Inc. v. Lai*, 973 F.2d 1125 (1992).

53 The Sixth Circuit has adopted both views of the issue apparently without realizing the internal contradiction. *Compare Chao v. Hospital Staffing Services, Inc.*, 270 F.3d 374, 384 (2001) (following *Gruntz) with Easley, supra*, 990 F.2d at 911(action in violation of stay only voidable, and distinguishing Supreme Court precedent relied on in *Gruntz*).

54 375 U.S. 106 (1963). Interestingly, though, the Ninth Circuit's panel decision in *Gruntz* prior

own jurisdiction. The losing party filed a separate suit in federal court arguing that the state court had erred in finding that it had jurisdiction and its actions should, therefore, be held to be void. The Supreme Court rejected that approach, holding that later courts must abide by jurisdictional determinations that were made after full review in the first court. A "void" decision could only be attacked collaterally if the relevant jurisdictional issue had not been litigated in the first case. If it had been, then the values of finality outweighed the principle that a decision by a court without jurisdiction could be attacked in a later proceeding. The Court did note two prior decisions (including the bankruptcy case relied upon in *Gruntz*) that could be viewed as sanctioning a collateral attack, but noted that in neither of those cases had there been litigation of the relevant issue. As such, the value of "finality" did not come into play as a counterweight to the challenge to the court's jurisdiction.

While this issue continues to arise,[55] it is clear that state court decisions will more likely be deferred to if there is a clearly stated decision to litigate the relevant issues and an explicit decision by the state court that it has jurisdiction to proceed. By requesting such a decision, the attorney general's office will have the best chance to place itself under the scope of the analysis in *Durfee*.[56] Moreover, by explicitly asking the state court to *first* review and analyze the scope of the stay, the government makes clear that it recognizes and intends to abide by the supremacy of the Code and is not merely proceeding directly to trying to collect on its claim.

Governmental entities also sometimes choose to seek a declaratory judgment from the bankruptcy court to the effect that the stay does not apply before

to the rehearing *en banc* cited *Durfee* in support of its position that the federal court could review the state court's actions because it found that the jurisdictional issue had not been actually litigated in the state court action. The *en banc* court, though, dropped any reference to *Durfee* apparently in order to take a more sweeping view of the power of the bankruptcy court to collaterally attack the decision of the state court.

55 *See, e.g., In re Allison*, 2006 Bankr. LEXIS 2137 (Bankr. S.D. Tex. Sept. 12, 2006) in which the court concluded that actual litigation was *not* necessary to bar the collateral attack and *James v. Intown Ventures*, 2104 U.S. Dist. LEXIS 37219 (N.D. Ga. 3/21/14) (since state courts had concurrent jurisdiction to decide issues, there was no basis for bankruptcy court to disregard application of *Rooker-Feldman* even in bankruptcy proceeding). *Compare In re Dingley (Yellow Express, LLC v .Dingley)*, 514 B.R. 591 (9th Cir. BAP 2014) (stating that *Gruntz* had held that applicability of stay was within exclusive jurisdiction of bankruptcy courts, but ignoring *Lockyer v. Mirant Corp*., 398 F.3d 1098 (9th Cir. 2005), which stated the opposite).

56 *See also Heiser v. Woodruff*, 327 U.S. 726, 733 (1946) where the court held that bankruptcy courts may not use their equitable powers to allow relitigation of issues that have previously been adjudicated in state court,

they proceed with their actions. While such a determination by the bankruptcy court could be reversed on appeal, the lower court's ability to modify or annul the stay could presumably be invoked to protect any actions that had been taken by a party in reliance on the initial ruling.[57] (And, indeed, such requests for a declaratory ruling are also often accompanied by a request that the court lift or modify the stay as a discretionary matter regardless of its ruling on the statutory issue.) Deferring action in pending litigation, though, to await a ruling on such issues can result in delays and disruption in the government's enforcement actions, costing the government much of the benefit provided from the government's stay exception. As a result, the government always has to weigh the problems that will be caused by delaying litigation against the degree of certainty as to whether the stay exception applies to determine whether it should proceed without first going before the bankruptcy court to seek clarification of the extent of the stay or relief from its application.

Substantive Scope of the Stay

The Code provides a blanket exception from the automatic stay for all criminal proceedings.[58] While there is little dispute about the application of this provision to crimes of violence, questions are sometimes raised with respect to whether a criminal proceeding that has aspects of debt collection is covered by this exception. Examples are proceedings to revoke probation for failure to make restitution under a criminal sentence, or enforcement of criminal "bad check" statutes, which typically allow for the charge to be dismissed if the debt is paid.

A number of lower courts have suggested that collection of money cannot be part of a criminal proceeding, even though the case would otherwise seem to fall into the criminal category,[59] but on further review, those cases have generally been reversed. The appellate courts have noted that while the civil police and regulatory exception bars actual collection of money judgments, no such ban is included in the criminal exception. Under normal principles of statutory interpretation, they conclude, therefore, that this must mean that even collection actions (such as for restitution, fines, or forfeitures) are excepted from the stay

57 *See also In re Taggart (Emmert v. Taggart)*, 548 B.R. 275 (9th Cir. BAP 2016) (even where appellate court determined that state and bankruptcy court had erred in finding that creditor's declaratory motion was correct, creditor could not be sanctioned for merely bringing the action and seeking determination of the issue).

58 11 U.S.C. § 362(b)(1).

59 *See, e.g., In re Hucke*, 992 F.2d 950 (9th Cir. 1993), the original panel decision and panel decision on rehearing in *In re Gruntz*, 166 F.3d 1020 (9th Cir. 1999) and 177 F.3d 728 (9th Cir. 1999); *In re Rainwater*, 233 B.R. 126 (Bankr.N.D.Ala. 1999).

in a criminal matter.[60] Allowing such actions to go forward allows the government to force the actual payment of funds in cases such as criminal nonsupport of one's children or to collect criminal fines or restitution. In such cases, the state is at least as interested in ensuring that the amounts owed are paid to the victims as they are in incarcerating the debtor, so giving the exception a broad scope assists in the goals that these criminal provisions are meant to serve. The benefit of this exception, though, has been limited in some recent cases which hold that the exception only literally applies to proceedings against "the debtor" but not to actions that affect property of the estate. Thus, under that analysis, collection actions that impact estate property would be barred.[61]

Civil police and regulatory proceedings are governed by 11 U.S.C. § 362(b)(4). They receive a more limited exception from the stay, but the exception covers a much larger number of cases. It deals with those cases where the government is not acting as a typical commercial actor (i.e. suing for damages for a breach of a contract to supply it with goods or services) nor is it merely providing the forum for adjudication of a case between private parties. Rather, it applies where the government is taking affirmative actions to protect the public's physical and financial health and safety by investigating and prosecuting prior violations of the law, or by imposing prospective licensing and permitting regulations to forestall such threats from occurring in the future. The hallmark of police and regulatory actions is the exercise of prosecutorial discretion by the government and in many such cases, the attorney general will be involved in making decisions to prosecute violations or to defend the licensing actions of state agencies.[62]

60 The *en banc* opinion in *Gruntz*, 202 F.3d 1074 (9th Cir. 2001for instance, rejected the panel's decision and overruled the Circuit's prior position in *Hucke* which had limited the government's right to enforce a criminal restitution order. (It did this after finding that the bankruptcy court had erred in deferring to the state court's decision that it was not barred by the automatic stay from proceeding. Thus, while the Ninth Circuit insisted that the bankruptcy court had to carry out its own independent review of the issue, in the end it decided that the state court had been right all along). The district court reversed the bankruptcy court in *Bryan v. Rainwater*, 254 B.R. 273 (N.D. Ala. 2000). *See also United States v. Troxler Hosiery Co., Inc.*, 796 F.2d 723 (4th Cir. 1986) (action to collect criminal fine not barred by the stay) and *In re Simonini,* 69 Fed. Appx. 169 (4th Cir. 2003) (unpublished) (where automatic stay did not apply to bad check case, district court should not have imposed discretionary stay to bar pursuit of the case); *United States v. Coluccio*, 19 F.3d 1115, 1117, n.2 (6th Cir.1994); *United States v. Palm Beach Cruises, S.A.*, 204 B.R. 634 (S.D.Fla. 1996).

61 *See, e.g., United States v. Robinson (In re Robinson),* 764 F.3d 554, 559 (6th Cir. 2014) although the case noted that the *federal* government could still seek such restitution pursuant to its separate authority under 18 U.S.C. § 3613(a).

62 *See EEOC v. Waffle House*, 534 U.S. 279 (2002) for discussion of nature of governmental actions as protecting "public interest."

This is one of the most crucial issues that an attorney general may need to address in a bankruptcy. If there is no reasonably bright line between the actions that are allowed and those that are barred by the stay, the state will often be required to err on the side of caution to avoid the imposition of sanctions. At a minimum, the state may be forced to turn first to the bankruptcy court to request a declaratory ruling on the application of the stay. Such an action will, at best, require additional time and costs; at worst, it may cause serious delay and disruption in a pending case. Thus, it is critical to the states to seek rulings that provide for a broad—and readily applicable—interpretation of the stay.

Environmental Issues

Initially, there was a dispute over the perceived conflict between environmental laws and the Code, but in the early to mid 1990s, many of the issues were resolved in favor of the position taken by the states. Since that time, there have been fewer reported decisions as the states and the debtors instead negotiate the means by which the debtor can carry out its environmental obligations while still proposing a feasible plan.

The issues have arisen in several contexts. First, most courts have concluded that injunctive remedies ordered against the debtor are, in most instances, *not* monetary claims and not subject to the stay or to discharge.[63] In practice, this means that debtors that retain contaminated property that they own must continue to clean it up during the case and after they have confirmed a plan. This approach, while it has obvious benefits for the state also has benefits for the debtor. For a debtor to be in a position to *do* the cleanup, it must remain in operation, which gives the state an interest in working with the debtor to ensure that it can meet those obligations. Where the state has been required to do the work itself, either due to the debtor's inability or refusal to perform the tasks, the courts

63 *Penn Terra Ltd. v. Department of Environmental Resources, Com. of Pa.*, 733 F.2d 267 (3rd Cir. 1984*); United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2nd Cir. 1991); *Matter of CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992); *In re Torwico Electronics, Inc.*, 8 F.3d 146 (3rd Cir. 1993); *In re Davis*, 3 F.3d 113 (5th Cir. 1993). More recently, *see United States v. Apex Oil Co.,* 579 F.3d 734 (7th Cir. 2009) (determination of whether action is claim that can be stayed and discharged is "limited to cases in which the claim gives rise to a right to payment *because the equitable decree cannot be executed*, rather than merely imposing a cost on the defendant, as virtually all equitable decrees do."), *In re Davis*, 3 F.3d 113 (5th Cir. 1993), and *In re Appalachian Fuels, LLC*, 521 B.R. 779 (Bankr E.D. Ky. 2014) *But see United States v. Whizco, Inc.*, 841 F.2d 147 (6th Cir. 1988) (stay bars action that requires expenditure of funds) and other cases that conclude that the only issue is whether there is some basis on which the government could force payment of clean-up costs. If so, those courts hold that the government can be forced to accept that less then optimal form of remedy.

have generally agreed that the cost recovery proceedings to determine the *amount* of those costs are excepted from the stay by the police and regulatory exception.[64] Any attempts to actually collect the amounts that are determined to be owed, however, *are* subject to the stay.

Two areas where there are still some questions are the Code provisions that allow a debtor to "abandon" property from the estate, and to "reject" leases. Abandonment is similar to the exemptions that an individual debtor may use and removes property from the estate, but leaves the ownership of the asset in the debtor's hands. This distinction is relatively easy to make with respect to individual debtors, but is less clearly understood with respect to an intangible corporate debtors. Abandonment was normally used, prior to the rise of environmental liabilities, in two situations—first, when an asset was of minimal value (i.e., obsolete equipment or old sales records), or second, when the asset was covered by a security interest and the loan exceeded the value of the asset. Under the latter circumstance, there was no value in the asset for any party other than the secured creditor so there was no reason to retain the asset in the estate instead of releasing it so the creditor can foreclose thereon.

Contaminated property presents a different fact pattern; the land would normally be worth something, but the costs of clean-up may equal or exceed the value of the land even after it is returned to pristine condition. Accordingly, the debtor and the other creditors may not wish to use the estate's assets on cleaning up the site if there will be no net recovery in the end. The state, on the other hand, does not wish to have the property abandoned, because estate funds can no longer be expended thereon if the parcel is not property of the estate. Even if it is still possible to pursue an individual debtor personally or, in the case of a corporation, the debtor's shareholders, this is a far less certain remedy for both practical and legal reasons. On the other hand, if the debtor has few if any unencumbered assets then abandonment may have little meaningful effect since there are no funds available to use for the clean-up in any event.

In the *Midlantic* case,[65] the Supreme Court held that property could not be abandoned if this would pose an imminent threat to public health and safety. Among the issues that state governments are still grappling with are 1) what are the criteria for proving such an "imminent threat," 2) whether the same standard applies to an attempt to reject a lease for a contaminated property; 3) whether either abandonment or rejection totally bars the government from seeking to require the debtor to use estate funds to clean up a contaminated property

64 *City of New York v. Exxon Corp.*, 932 F.2d 1020 (2nd Cir. 1991).

65 *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494 (1986).

pursuant to applicable state law; and 4) what obligations remain on a debtor after it has abandoned property from its estate, but retains an ownership interest therein. In deciding whether to challenge abandonment, and how to apply *Midlantic*, the attorney general, in conjunction with the state environmental agency, must engage in a detailed review of the threats posed by the facility, the immediate and long-term remedial activities that must be carried out, and the availability of estate funds that could be used for that purpose. It is sometimes possible for the regulators to work with secured lenders to obtain their agreement to "carve out" a portion of the encumbered assets to pay for critical work, such as to fence in and secure a site where hazardous wastes have been deposited to protect against accidental entry and injury to children or others nearby.

The second, related issue has to do with when a debtor may "reject" a lease for property that has been contaminated by its activities. Rejecting a lease is, in effect, merely a breach of the contract post-petition with special treatment being prescribed for the priority of the damages arising from that breach. Rather than being treated as expenses of the administration of the debtor's estate, which would have to be paid in full, the debtor may treat them as if they arose pre-petition, and pay them *pro rata* with all of the other unsecured claims against it. The result allows debtors to escape the consequences of compliance with burdensome agreements at relatively minimal expense. Where the debtor has contaminated leased property, rejection may allow it to walk away from its liability to both the owner and the state. There is even less clarity in this situation than with respect to abandoned property as to the extent to which the debtor may be able to escape such liabilities.

Other Regulatory Issues

Governmental entities continue to face some difficulties in pursuing claims for damages owed to their citizens for violations of the law. The legislative history of the automatic stay exception explicitly states that it covers both the determination of liability *and* the liquidation of damages for such violations, but a number of lower courts have continued to view the restitution portion of such actions with suspicion.[66] On appeal, such decisions have generally been decisively reversed, although the issue reappears from time to time.[67]

66 *See e.g.*, *In re Luskin's, Inc.*, 213 B.R. 107 (D. Md. 1997); *In re Charter First Mortg., Inc.*, 42 B.R. 380 (Bankr. D. Or. 1984).

67 *In re First Alliance Mortgage Co.*, 264 B.R. 634 (C.D.Cal. 2001), 471 F.3d 97 (9th Cir. B.A.P. 2001).

While this problem is more a matter of delay during the appeal process, a Sixth Circuit opinion, *Chao v. Hospital Staffing Services, Inc.*,[68] raised new problems with the application of the standard tests for determining when a matter is police and regulatory. In applying the so-called "public interest vs. private rights" test, it suggested that some cases that were prosecuted by the government under a statute concededly enacted to serve the public interest might still only be actions to adjudicate a "private right" of the victims and were subject to the stay. The court's decision, though, provided no clear basis for deciding where a case falls on the line it tries to draw, but is typical of a number of decisions that have applied this court-devised "test" for police and regulatory actions.

The reason why the courts cannot readily draw such a line is because this "public interest/private rights" dichotomy really grew out of cases trying to distinguish between the government acting in its neutral judicial role (deciding "private rights" between competing private parties) and the government acting in its discretionary role as prosecutor seeking to protect public rights. The problem arises when courts try to apply that distinction *within* the category of prosecutorial actions and suggest that some such actions might *not* be efforts to protect the public interest, but without articulating how the court is to draw the distinction. Nor do those decisions explain how a public agency could legitimately act solely to protect a private party's interests without running afoul of its own governing statutes.

A better analysis can be seen in the decision in *EEOC v. Waffle House*,[69] cited above, where the Supreme Court held that an EEOC action to recover money damages for discrimination inflicted on a single employee was *inherently* an action taken to protect the public interest and not merely a matter of the private rights of the sole employee being directly benefitted. Rather, all employees benefit when it can be seen that regulatory provisions are enforced and can protect all workers. The *Waffle House* decision is likely to be of great benefit to the states when faced with this issue, which continues to make decisions on application of the automatic stay more difficult. The states will continue to argue that the key issue in analyzing these cases is not the nature of the relief sought for the victims, but rather the role the government plays in the matter, *i.e.*, as the attorney general exercising his or her prosecutorial discretion, or as a judicial body hearing private disputes. In the former case, the police and regulatory exception, the states argue, plainly applies regardless of the number of victims and the nature of the relief accorded.

68 270 F.3d 384 (6th Cir. 2001).

69 534 U.S. 279 (2002).

Multistate Cases

The Bankruptcy Counsel at the National Association of Attorneys General assists the states in protecting their interests in a growing number of multistate bankruptcy and enforcement matters, including directly presenting the states' position to the courts in a number of instances:

Asbestos—The first joint action by the states was in the Johns Manville bankruptcy during the 1980s where the states sought to be compensated for their claims for property damage to state-owned buildings due to the presence of asbestos-containing materials and the need to perform costly abatement procedures to avoid health hazards to the buildings' occupants. These cases, in which the states worked together, led to the creation of the position of Bankruptcy Counsel at NAAG. NAAG's Bankruptcy Counsel represented the states collectively on the asbestos creditors' committee in several later cases that were filed in the early 1990s. NAAG Bankruptcy Counsel presented the states' position in those cases during the negotiations for a plan of reorganization and later assisted the states with submitting their specific claims for payments. This work continued during a second wave of asbestos-related bankruptcies filed in late 2000. The total amount paid to the states to date has been in the tens of millions of dollars.

Circle K Corporation—In the fall of 1992, thirty states participated in a joint negotiation process with the Circle K Corporation to reach a global agreement regarding payments to be made by Circle K to resolve its liability for environmental remediation of contamination from leaking underground storage tanks at the sites that it had previously leased for its gas stations and which leases it sought to reject. After intensive negotiations, with the assistance of NAAG Bankruptcy Counsel, the debtor agreed to pay the states a total of $30 million over a six-year period. The payment was divided among the states based on the number of sites located within their boundaries. The states held the money in trust to reimburse the owners of the gas station sites for costs they incurred in doing cleanup work after Circle K terminated its leases and left the premises. The result was that the states obtained additional funds to supplement their Underground Storage Tank trust funds, while being able to leave the primary responsibility for actually performing the work to the land owners.

Direct American Marketers, Inc. (DAMI)—DAMI was being investigated by numerous states on charges of operating fraudulent sweepstakes that cost consumers tens of millions of dollars. When Missouri obtained a large judgment, DAMI filed for bankruptcy in California, and all of the states agreed to work together in the case. A creditors' committee of states was established and the debtor agreed to have counsel for the committee funded from the estate in order to facilitate the negotiation process.

Davis Industries, Inc.—In 1999, Davis Industries, a small handgun maker filed bankruptcy because of the costs of litigating suits by various local governmental entities alleging generally that the guns were physically defective, that they were marketed in ways that contributed to crime in the various cities, and that the manufacturers failed to monitor or control their distributors to ensure that the guns would not find their way to criminals. Although no state had filed such a suit, the debtor filed a claim in the bankruptcy "on behalf of" *all* governmental entities, reciting all the causes of action in the various law suits, and then objected to its own claim, hoping to obtain a ruling from the bankruptcy court that would bar all such suits from going forward. A number of states moved to dismiss this "claim," on that basis that the litigation would violate their Eleventh Amendment immunity. The bankruptcy court agreed and the debtor dropped its claim.

The debtor then proposed a plan that sought to bar governmental entities from bringing new law suits after the bankruptcy was over, even if those suits related to new, postconfirmation actions by the debtor. That effort was objected to by the District of Columbia (which continued to participate in the case because it does not have Eleventh Amendment immunity) and the local entities that had been sued. The bankruptcy court agreed with the government entities that it had no authority under the Code to allow a debtor to bar prospective law enforcement actions from going forward and refused to confirm the debtor's plan. When it became clear that the debtor could not propose a feasible plan that did not involve enjoining future governmental enforcement actions, it eventually decided to dismiss the case.

First Alliance Mortgage Company—A number of states had separate prepetition investigations and/or litigation pending involving First Alliance's allegedly predatory lending practices. Following publicity about the lawsuits, the company filed for bankruptcy in California. Six states filed claims in the case for their consumers, and were joined by the FTC, attorneys representing a proposed class, several plaintiffs under California's private attorney general statute, and about 1500 individual borrowers raising similar issues. Several automatic stay issues were litigated in the case, and appeals taken from the bankruptcy court's unfavorable decisions, resulting in those rulings being overturned by the district court and the Bankruptcy Appellate Panel. The states also successfully moved to have the district court withdraw the reference of the predatory lending claims from the bankruptcy court so they could be heard initially by the district court. Thereafter, the governmental entities and the private counsel worked jointly to prepare the allegations for trial, and later to reach a global settlement of all of the claims against the debtor and its officers. The final result was a settlement that provided more than $60 million for restitution to borrowers and attorneys fees in the case, some $20 million of which was contributed by the debtor's owners to resolve claims of personal liability against those parties. The settlement provided benefits for some 20,000 borrowers in about 20 states.

Worldcom—During this case, evidence emerged of a possible tax evasion scheme by the debtor that sought to improperly reallocate as much as $20 billion of income from high tax states to low or no-tax states in order to reduce the debtor's tax bills. A large number of states obtained permission to file late proofs of claim to address these issues, and worked through the Multistate Tax Commission to carry out an audit of the debtor's tax reporting. The states subsequently determined that they believed there had been improper reporting and filed claims seeking payment of hundreds of millions of dollars of additional taxes. A settlement of those claims was eventually reached, resulting in the payment of more than $415 million in taxes that had been improperly withheld from 17 States.

Chrysler, General Motors—In both of these cases, the States worked together to ensure that the reorganization of these companies did not take place at the expense of the legitimate expectations of consumer buyers who were injured by the companies' products, or who were expecting to be protected by warranty coverage of the vehicles they purchased. Those efforts did result in substantially improved protection of those persons, while allowing the companies to proceed with their restructuring. The States also ensured that the entities emerging from bankruptcy would remain liable for remediation of any environmental issues at locations they retained after confirmation.

Asarco, Chemtura, Lyondell, and Tronox—The States have also been active in recent years, often in close partnership with the United States, in a number of cases involving companies with major residual environmental clean-up obligations. In addition to filing and being prepared to defend those environmental claims, the States have also been actively involved in several of the cases with fraudulent transfer litigation that sought to undo prepetition transactions that removed highly valuable assets that could have been used to perform the clean-ups. In *Asarco*, the final result of the litigation was a plan that provided for 100 % payment of all remediation costs, a result that seemed far from likely when the case was first filed. In the *Tronox* case, the plan provided for assignment of a fraudulent conveyance action regarding the spin-off of Tronox from its profitable parent to a trust for the benefit of the environmental and personal injury creditors. That action was pursued with the assistance of the States and the final result, after an extended trial before the bankruptcy court, was a clear victory for the creditors. The case then settled (to preclude appeals) for a total value of $5.15 billion—an amount expected to fully compensate all of the environmental claims.

Tobacco Cases—The States have worked together through NAAG to be jointly represented in any filings by tobacco companies in connection with the Master Settlement Agreement (MSA) negotiated between the states and a number of tobacco manufacturers in 1998.[70] Although the initial impetus was to ensure that the States would be prepared if any of the several "Original Participating Manufacturers" under the MSA were forced to file bankruptcy in the face of pending litigation, the efforts since the original discussions have been focused on a number of filings by much smaller companies. Those companies have been both signatories to the MSA as well as Non-Participating Manufacturers. The cases have generally resulted in either the termination of the operations of the non-compliance manufacturer; or its agreement to make up all delinquent payments in full, or sometimes both. To date, the States' experience has been that the highly competitive market for tobacco products has made it difficult or impossible for a company that has become delinquent to be successful in maintaining compliance on a going-forward basis while also paying over additional funds to make up prior delinquencies. As a result, even the companies that promised to make up their arrearages have been unable to do so and have shut down as a result.

The States' goals in general are to ensure that bankruptcy filings by these companies do not undermine the enforcement of the injunctive relief contained in the MSA and, to the extent possible, that the economic provisions in the MSA and the escrow deposit statutes remain effective and are fully complied with. Those provisions, while providing direct revenue to the States in the case of the MSA payments, and a potential source of recovery in the case of the escrow deposits, also serve many regulatory purposes and assist in the States' goal of reducing or eliminating under-age smoking. The States seek, by means of their participation in the bankruptcy cases, to reduce those unfavorable effects as much as possible.

70 *See* Chapter 22.